UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	Chapter 11 Case No.
LEHMAN BROTHERS HOLDINGS INC., *et al.*,	:	08-13555 (JMP)
	:	(Jointly Administered)
Debtors.	:	

REPORT OF ANTON R. VALUKAS, EXAMINER

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VOLUME 1 OF 9

Sections I & II: Introduction, Executive Summary & Procedural Background

Section III.A.1: Risk

EXAMINER'S REPORT

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	Chapter 11 Case No.
LEHMAN BROTHERS HOLDINGS INC., *et al.*,	:	08-13555 (JMP)
	:	(Jointly Administered)
Debtors.	:	

REPORT OF EXAMINER ANTON R. VALUKAS

Introduction

Sections I & II: Executive Summary & Procedural Background

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INTRODUCTION

On January 29, 2008, Lehman Brothers Holdings Inc. ("LBHI"[1]) reported record revenues of nearly $60 billion and record earnings in excess of $4 billion for its fiscal year ending November 30, 2007.[2] During January 2008, Lehman's stock traded as high as $65.73 per share and averaged in the high to mid-fifties,[3] implying a market capitalization of over $30 billion.[4] Less than eight months later, on September 12, 2008, Lehman's stock closed under $4, a decline of nearly 95% from its January 2008 value.[5] On September 15, 2008, LBHI sought Chapter 11 protection,[6] in the largest bankruptcy proceeding ever filed.[7]

There are many reasons Lehman failed, and the responsibility is shared. Lehman was more the consequence than the cause of a deteriorating economic climate.

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[1] There are a significant number of acronyms, abbreviations and other specialized terms used throughout this Report. To avoid the necessity of defining terms repeatedly, the Report will generally use them without definition; the reader should consult the Glossary attached as Appendix 2. Except where the specific identity of an entity is relevant and set out, this Report will use "Lehman" to refer collectively to Lehman Brothers Holdings Inc. ("LBHI") and all of its affiliates and subsidiaries.

[2] Lehman Brothers Holdings Inc. ("LBHI"), Annual Report for 2007 as of Nov. 30, 2007 (Form 10-K) (filed Jan. 29, 2008), at p. 29 ("LBHI 2007 10-K"). LBHI was the holding company for hundreds of individual corporate entities, twenty-two of which are currently Chapter 11 debtors in jointly administered proceedings.

[3] Morningstar Document Research Co., LBHI Historic Stock Prices, Jan. 1, 2008 through Sept. 15, 2008, [LBEX-EXM 000001-14] (printed from www.10kwizard.com) (last visited Feb. 3, 2010).

[4] LBHI, Quarterly Report as of Feb. 29, 2008 (Form 10-Q) (filed on Apr. 9, 2008), at p. 1 ("LBHI 10-Q Apr. 9, 2008") (554 million common equity shares outstanding times $55 = approximately $30 billion).

[5] Morningstar Document Research Co., LBHI Historic Stock Prices (Jan. 1, 2008 through Sept. 15, , 2008) [LBEX-EXM 000001-14] (printed from www.10kwizard.com) (last visited Feb. 3, 2010).

[6] Voluntary Petition (Chapter 11), Docket No. 1, *Lehman Brothers Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 15, 2008).

[7] Yalman Onaran & John Helyar, *Fuld Sought Buffet Offer He Refused as Lehman Sank (Update 1)*, Bloomberg.com (Nov. 10, 2008), at p. 2.

Lehman's financial plight, and the consequences to Lehman's creditors and shareholders, was exacerbated by Lehman executives, whose conduct ranged from serious but non-culpable errors of business judgment to actionable balance sheet manipulation; by the investment bank business model, which rewarded excessive risk taking and leverage; and by Government agencies, who by their own admission might better have anticipated or mitigated the outcome.

Lehman's business model was not unique; all of the major investment banks that existed at the time followed some variation of a high-risk, high-leverage model that required the confidence of counterparties to sustain. Lehman maintained approximately $700 billion of assets, and corresponding liabilities, on capital of approximately $25 billion.[8] But the assets were predominantly long-term, while the liabilities were largely short-term.[9] Lehman funded itself through the short-term repo markets and had to borrow tens or hundreds of billions of dollars in those markets each day from counterparties to be able to open for business.[10] Confidence was critical. The moment that repo counterparties were to lose confidence in Lehman and decline to roll over its daily funding, Lehman would be unable to fund itself and continue to operate.

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[8] LBHI 2007 10-K, at p. 29; LBHI 10-Q Apr. 9, 2008, at pp. 5-6.

[9] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 8.

[10] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at pp. 4, 8 (Lehman financed the majority of its balance sheet in the short-term repo market, more than $200 billion a day in 2008; Lehman was reliant on short-term secured financing to conduct its daily operations); Examiner's Interview of Raymond Abary, Mar. 12, 2009.

So too with the other investment banks, had they continued business as usual. It is no coincidence that no major investment bank still exists with that model.[11]

In 2006, Lehman made the deliberate decision to embark upon an aggressive growth strategy, to take on significantly greater risk, and to substantially increase leverage on its capital.[12] In 2007, as the sub-prime residential mortgage business progressed from problem to crisis, Lehman was slow to recognize the developing storm and its spillover effect upon commercial real estate and other business lines. Rather than pull back, Lehman made the conscious decision to "double down," hoping to profit from a counter-cyclical strategy.[13] As it did so, Lehman significantly and repeatedly exceeded its own internal risk limits and controls.[14]

With the implosion and near collapse of Bear Stearns in March 2008, it became clear that Lehman's growth strategy had been flawed, so much so that its very survival

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[11] Bank of America, Press Release, Bank of America Buys Merrill Lynch Creating Unique Financial Services Firm (Sept. 15, 2008) (announcing its acquisition of Merrill Lynch); Morgan Stanley, Press Release, Morgan Stanley and Citi to Form Industry-Leading Wealth Management Business Through Joint Venture (Jan. 13, 2009) (announcing joint venture with Citi's Smith Barney Group to form Morgan Stanley Smith Barney); Federal Reserve, Press Release, Sept. 21, 2008 (announcing that the Federal Reserve granted the applications by Goldman Sachs and Morgan Stanley, the last two major investment banks, to become bank holding companies); Goldman Sachs, Press Release, Sept. 21, 2008 (announcing that Goldman Sachs will become a bank holding company and will be regulated by the Federal Reserve).

[12] *See* David Goldfarb, Lehman, Global Strategy Offsite (Mar. 2006) [LBEX-DOCID 2489987].

[13] Examiner's Interview of Dr. Henry Kaufman, May 19, 2009, at p. 9 (at a March 20, 2007 Board meeting, management advised that "virtually all subprime originators have cut back on their operations or gone out of business," but, despite that fact, it was management's view that "the current distressed environment provides substantial opportunities as in the late 1990s").

[14] Duff & Phelps, High Yield Total - Usage Versus Limits (Nov. 19, 2009), at pp. 4-9 (showing that Lehman's monthly average risk appetite exceeded its limit by $41 million in July 2007, $62 million in August 2007, $608 million in September 2007, $670 million in October 2007, $508 million in November 2007, $562 million in December 2007, $708 million in January 2008, and $578 million in February 2008).

was in jeopardy.[15] The markets were shaken by Bear's demise, and Lehman was widely considered to be the next bank that might fail.[16] Confidence was eroding. Lehman pursued a number of strategies to avoid demise.

But to buy itself more time, to maintain that critical confidence, Lehman painted a misleading picture of its financial condition.

Lehman required favorable ratings from the principal rating agencies to maintain investor and counterparty confidence; and while the rating agencies looked at many things in arriving at their conclusions, it was clear – and clear to Lehman – that its net leverage and liquidity numbers were of critical importance.[17] Indeed, Lehman's CEO Richard S. Fuld, Jr., told the Examiner that the rating agencies were particularly focused on net leverage;[18] Lehman knew it had to report favorable net leverage numbers to

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[15] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 11 (former Secretary of the Treasury Paulson stated that after Bear Stearns' near-collapse he was less optimistic about Lehman's chances than Fuld, and he informed Fuld that Lehman needed to raise capital, find a strategic partner or sell the firm).

[16] Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 2 (former President of the FRBNY and current Treasury Secretary Geithner believed that after Bear Stearns' near-collapse, Lehman was the most vulnerable investment bank); Examiner's Interview of Ben S. Bernanke, Dec. 22, 2009, at p. 3 (Chairman of the Federal Reserve Bernanke believed that, after Bear Stearns, Lehman was the next most vulnerable bank); Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 2 (Paulson thought Lehman could be next to fail after Bear Stearns); Examiner's Interview of Christopher Cox, Jan. 8, 2010, at p. 8 (former Chairman of the SEC Cox said that after Bear Stearns collapsed Lehman was the SEC's "number one focus." Lehman had suffered "diminution of value" and had "troubled assets").

[17] Erin M. Callan, Lehman Brothers Leverage Analysis (Apr. 7, 2008), at p. 1 [LBEX-DOCID 1401225] ("Reducing leverage [i]s necessary to remove refinancing risk and win back the confidence of the market, lenders, and investors."); Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 8 (rating agencies looked at net leverage); Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 5 (senior management made a "concerted effort" to manage and reduce the balance sheet with a view towards the rating agencies); Examiner's Interview of Eileen A. Fahey, Fitch, Sept. 17, 2009, at p. 6; Standard & Poor's RatingsDirect, Liquidity Management In Times Of Stress: How The Major Broker-Dealers Fare (Nov. 8, 2007), at p. 3 [LBHI_SEC07940_439424].

[18] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 7.

maintain its ratings and confidence. So at the end of the second quarter of 2008, as Lehman was forced to announce a quarterly loss of $2.8 billion – resulting from a combination of write-downs on assets, sales of assets at losses, decreasing revenues, and losses on hedges – it sought to cushion the bad news by trumpeting that it had significantly reduced its net leverage ratio to less than 12.5, that it had reduced the net assets on its balance sheet by $60 billion, and that it had a strong and robust liquidity pool.[19]

Lehman did not disclose, however, that it had been using an accounting device (known within Lehman as "Repo 105") to manage its balance sheet – by temporarily removing approximately $50 billion of assets from the balance sheet at the end of the first and second quarters of 2008.[20] In an ordinary repo, Lehman raised cash by selling assets with a simultaneous obligation to repurchase them the next day or several days later; such transactions were accounted for as financings, and the assets remained on Lehman's balance sheet. In a Repo 105 transaction, Lehman did exactly the same thing, but because the assets were 105% or more of the cash received, accounting rules permitted the transactions to be treated as sales rather than financings, so that the assets

[19] Final Transcript of Lehman Brothers Holdings Inc. Second Quarter Preliminary Earnings Call (June 9, 2008), at pp. 7-8.

[20] LBHI 2007 10-K, at p. 63; LBHI 10-Q Apr. 9, 2008, at p. 72; Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2008 (Form 10-Q) (filed on July 10, 2008), at p. 88 ("LBHI 10-Q July 10, 2008"); Examiner's Interview of Martin Kelly, Oct. 1, 2009; Examiner's Interview of Ed Grieb, Oct. 2, 2009.

could be removed from the balance sheet.[21] With Repo 105 transactions, Lehman's reported net leverage was 12.1 at the end of the second quarter of 2008; but if Lehman had used ordinary repos, net leverage would have to have been reported at 13.9.[22]

Contemporaneous Lehman e-mails describe the "function called repo 105 whereby you can repo a position for a week and it is regarded as a true sale to get rid of net balance sheet."[23] Lehman used Repo 105 for no articulated business purpose except "to reduce balance sheet at the quarter-end."[24] Rather than sell assets at a loss, "[a] Repo 105 increase would help avoid this without negatively impacting our leverage ratios."[25] Lehman's Global Financial Controller confirmed that "the only purpose or motive for [Repo 105] transactions was reduction in the balance sheet" and that "there was *no substance* to the transactions."[26]

Lehman did not disclose its use – or the significant magnitude of its use – of Repo 105 to the Government, to the rating agencies, to its investors, or to its own Board

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[21] See Section III.A.4 (discussing Repo 105).

[22] LBHI 10-Q July 10, 2008, at p. 89; Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 7. See also Section I.A of this Report, which discusses net leverage.

[23] E-mail from Anthony Jawad, Lehman, to Andrea Leonardelli, Lehman (Feb. 29, 2008) [LBEX-DOCID 224902].

[24] E-mail from Raymond Chan, Lehman, to Paul Mitrokostas, Lehman, *et al.* (Jul. 15, 2008) [LBEX-DOCID 3384937].

[25] Joseph Gentile, Lehman, Proposed Repo 105/108 Target Increase for 2007 (Feb. 10, 2007), at p. 1 [LBEX-DOCID 2489498], attached to e-mail from Joseph Gentile, Lehman, to Ed Grieb, Lehman (Feb. 10, 2007) [LBEX-DOCID 2600714].

[26] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 9.

of Directors.[27] Lehman's auditors, Ernst & Young, were aware of but did not question Lehman's use and nondisclosure of the Repo 105 accounting transactions.[28]

In mid-March 2008, after the Bear Stearns near collapse, teams of Government monitors from the Securities and Exchange Commission ("SEC") and the Federal Reserve Bank of New York ("FRBNY") were dispatched to and took up residence at Lehman,[29] to monitor Lehman's financial condition with particular focus on liquidity.[30]

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[27] Lehman did not disclose its use of Repo 105 in public filings. Examiner's Interview of Ed Grieb, Oct. 2, 2009, at p. 14; Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 15; Examiner's Interview of Matthew Lee, July 1, 2009, at p. 16. Lehman did not disclose its use of Repo 105 to rating agencies. See Lehman, S&P Ratings Q2 2008 Update (June 5, 2008) [S&P-Examiner 000946] (Lehman did not disclose its use of Repo 105 to Standard & Poor's in its ratings presentation); Lehman, Fitch Ratings Q2 2008 Update (June 3, 2008) [LBHI_SEC07940_513239] (Lehman similarly did not disclose its use of Repo 105 to Fitch as part of its presentation where Lehman touted its balance sheet reduction). The Examiner interviewed representatives from the three leading ratings agencies, Fitch, S&P and Moody's, and none had knowledge of Lehman's use of Repo 105/108 transactions, either by name or by description. Examiner's Interview of Eileen A. Fahey, Sept. 17, 2009, at p. 7; Examiner's Interview of Diane Hinton, Sept. 22, 2009, at p. 6; Examiner's Interview of Peter E. Nerby, Oct. 8, 2009, at p. 5. Lehman did not disclose its use of Repo 105 to Government regulators. Examiner's Interview of Ronald S. Marcus, Nov. 4, 2009, at p. 11; Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 5; Examiner's Interview of Jan H. Voigts, Oct. 1, 2009. Lehman did not disclose its use of Repo 105 to its Board of Directors. Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at p. 21; Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 10; Examiner's Interview of Roland Hernandez, Oct. 2, 2009; Examiner's Interview of Sir Christopher Gent, Oct. 21, 2009, at p. 22; Examiner's Interview of Roger Berlind, Dec. 18, 2009, at p. 4.

[28] Examiner's Interview of Ernst & Young, Repo 105 session, Oct. 16, 2009, at pp. 8-9 (statement of William Schlich); Examiner's Interview of Ernst & Young, Nov. 3, 2009, at pp. 14-15 (statement of Hillary Hansen).

[29] Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at p. 5 (Eichner told the Examiner that after Bear Stearns nearly collapsed, the SEC had monitors on-site at Lehman "almost all the time." Eichner also told the Examiner that the FRBNY had people "in residence" with actual offices at Lehman); Examiner's Interview of Jan H. Voigts, Aug. 25, 2009, at p. 1 (Voigts monitored Lehman's liquidity position, embedded on-site with the firm, from March 16, 2008 through mid-September, 2008).

[30] Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 4 (after Bear Stearns nearly collapsed, Geithner met with Lehman and other investment banks about moving the banks to a "more conservative place" regarding capital and liquidity. Geithner indicated that his primary concern was Lehman's funding structure. He told the Examiner that he was "consumed" with figuring out how to make Lehman "get more conservatively funded").

Lehman publicly asserted throughout 2008 that it had a liquidity pool sufficient to weather any foreseeable economic downturn.[31]

But Lehman did not publicly disclose that by June 2008 significant components of its reported liquidity pool had become difficult to monetize.[32] As late as September 10, 2008, Lehman publicly announced that its liquidity pool was approximately $40 billion;[33] but a substantial portion of that total was in fact encumbered or otherwise illiquid.[34] From June on, Lehman continued to include in its reported liquidity substantial amounts of cash and securities it had placed as "comfort" deposits with various clearing banks; Lehman had a technical right to recall those deposits, but its ability to continue its usual clearing business with those banks had it done so was far from clear.[35] By August, substantial amounts of "comfort" deposits had become actual

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[31] Final Transcript of Lehman Brothers Holdings Inc. Second Quarter 2008 Preliminary Earnings Call (June, 9, 2008), at p. 8 (Lehman's liquidity pool reported at $45 billion); Final Transcript of Lehman Brothers Holdings Inc. Second Quarter 2008 Earnings Call (June 16, 2008), at p. 6 (Lehman's liquidity pool reported at $45 billion); Final Transcript of Lehman Brothers Holdings Inc. Third Quarter 2008 Preliminary Earnings Call (Sept. 10, 2008), at p. 10 (Lehman's liquidity pool reported at $42 billion).

[32] Lehman, Liquidity Pool Table Listing Collateral and Ability to Monetize (Sept. 12, 2008) [LBEX-WGM 784607] (listing $30.1 billion of assets as "low ability to monetize").

[33] Final Transcript of Lehman Brothers Holdings Inc. Third Quarter 2008 Preliminary Earnings Call (Sept. 10, 2008), at p. 10.

[34] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 19 (Lehman included $2 billion that it pledged to Citibank as a comfort deposit in its liquidity pool); Security Agreement between LBHI and Bank of America, N.A. (Aug. 25, 2008) [LBEX-DOCID 000584] (providing for a $500 million security deposit from Lehman to BofA); Lehman, Liquidity Pool Table Listing Collateral and Ability to Monetize (Sept. 9, 2008), at p. 2 [LBHI_SEC07940_557815] (showing the $500 million BofA deposit in the liquidity pool); Lehman, Liquidity Update (Sept. 10, 2008), at p. 3 ($1 billion in Lehman's liquidity pool was earmarked to HSBC and listed as "Low ability to monetize.").

[35] *See* Section III.A.5 (discussing potential claims against secured lenders).

pledges.[36] By September 12, two days after it publicly reported a $41 billion liquidity pool, the pool actually contained less than $2 billion of readily monetizable assets.[37]

Months earlier, on June 9, 2008, Lehman pre-announced its second quarter results and reported a loss of $2.8 billion, its first ever loss since going public in 1994.[38] Despite that announcement, Lehman was able to raise $6 billion of new capital in a public offering on June 12, 2008.[39] But Lehman knew that new capital was not enough. Treasury Secretary Henry M. Paulson, Jr., privately told Fuld that if Lehman was forced to report further losses in the third quarter without having a buyer or a definitive survival plan in place, Lehman's existence would be in jeopardy.[40]

On September 10, 2008, Lehman announced that it was projecting a $3.9 billion loss for the third quarter of 2008.[41] Although Lehman had explored options over the summer, it had no buyer in place; its only announced survival plan was to spin off

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[36] *Id.*

[37] See Lehman, Liquidity Pool Table Listing Collateral and Ability to Monetize (Sept. 12, 2008) [LBEX-WGM 784607] (listing $1.4 billion of assets as "high ability to monetize" and $934 million of assets as "mid ability to monetize").

[38] Lehman Brothers Holdings Inc., Press Releases (Mar. 14, 2007, June 12, 2007, Sept. 18, 2007, Dec. 13, 2007, Mar. 18, 2008 and June 9, 2008).

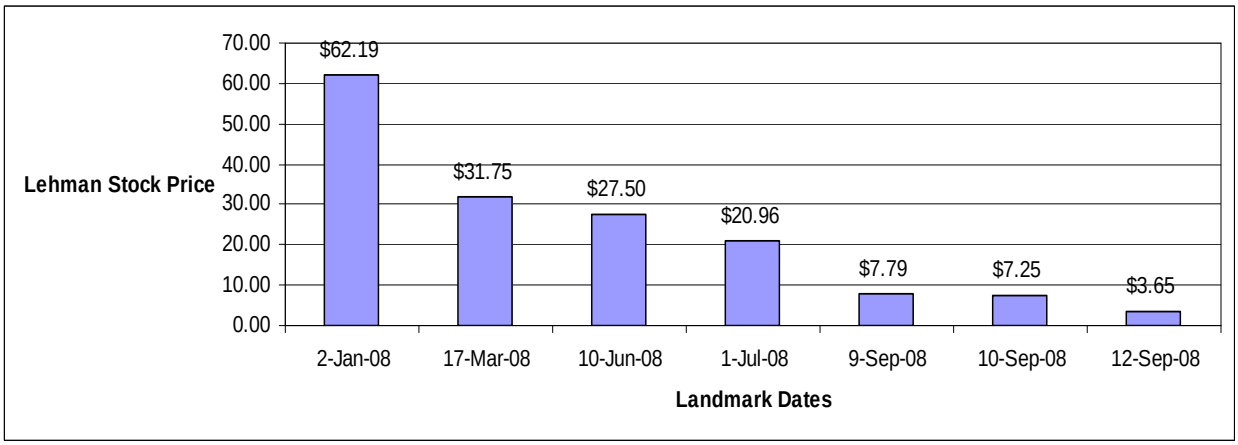
[39] Lehman Brothers Holdings Inc., Press Release (June 12, 2008); Lehman Brothers Holdings Inc., Press Release (June 16, 2008).

[40] Fuld does not recall that warning. Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 3, but Paulson told the Examiner that he consistently communicated to Fuld how dire Lehman's situation was and that he pointedly urged Fuld to find a buyer after Lehman announced a $2.8 billion loss for the second quarter of 2008, Examiner's Interview of Henry M. Paulson, June 25, 2009, at pp. 11-15.

[41] Final Transcript of Lehman Brothers Holdings Inc. Third Quarter 2008 Preliminary Earnings Call (Sept. 10, 2008), at p. 8; Lehman Brothers Holdings Inc., Press Release (Sept. 10, 2008), at p. 1 [LBHI_SEC07940_042866].

troubled assets into a separate entity. Secretary Paulson's prediction turned out to be right – it was not enough.

By the close of trading on September 12, 2008, Lehman's stock price had declined to $3.65 per share, a 94% drop from the $62.19 January 2, 2008 price.[42]



Over the weekend of September 12-14, an intensive series of meetings was conducted by and among Treasury Secretary Paulson, FRBNY President Timothy F. Geithner, SEC Chairman Christopher Cox, and the chief executives of leading financial institutions.[43] Secretary Paulson began the meetings by stating the Government was there to do all it could – but that it could not fund a solution.[44] The Government's

[42] Morningstar Document Research Co., LBHI Historic Stock Prices (Jan. 1, 2008 through Sept. 15, 2008) [LBEX-EXM 000001-14] (printed from www.10kwizard.com) (last visited on Feb. 3, 2010).

[43] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 15; Examiner's Interview of Christopher Cox, Jan. 8, 2010, at pp. 15-17; Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009 at p. 9.

[44] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at pp. 15-16 (Paulson told the Examiner that these meetings were part of the Government's attempt to "pull a rabbit out of a hat" and save Lehman); Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009 at pp. 9-10 (FRBNY General Counsel Baxter told the Examiner that Paulson explained to the group that the purpose of the meeting was twofold - (1) to attempt to facilitate the acquisition of Lehman; and (2) in the alternative, to resolve the consequences of Lehman's failure).

analysis was that it did not have the legal authority to make a direct capital investment in Lehman, and Lehman's assets were insufficient to support a loan large enough to avoid Lehman's collapse.[45]

It appeared by early September 14 that a deal had been reached with Barclays which would save Lehman from collapse.[46] But later that day, the deal fell apart when the parties learned that the Financial Services Authority ("FSA"), the United Kingdom's bank regulator, refused to waive U.K. shareholder-approval requirements.[47]

Lehman no longer had sufficient liquidity to fund its daily operations.[48] On the evening of September 14, SEC Chairman Cox phoned the Lehman Board and conveyed the Government's strong suggestion that Lehman act before the markets opened in

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[45] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at pp. 16-17 (Paulson told the Examiner that he concluded that the Federal Government lacked authority to inject capital into Lehman, even via an "exigent circumstances" loan from the Federal Reserve, because Lehman was not an institution "perceived to have capital and able to provide a guarantee."); Chairman of the Federal Reserve Ben S. Bernanke, Speech at the Kansas City Federal Bank Conference in Jackson Hole, Wyoming (Aug. 21, 2009) ("[T]he company's available collateral fell well short of the amount needed to secure a Federal Reserve loan of sufficient size to meet its funding needs."); Examiner's Interview of Ben S. Bernanke, Dec. 22, 2009, at p. 2 (Lehman's assets and securities fell "considerably short of the obligations that would become due").

[46] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 9 (Fuld told the Examiner that on the morning of September 14, 2008, he woke up thinking he had a transaction in place with Barclays); Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 13, 2008), at p. 1 [LBEX-AM 003927-003931] (The Lehman Board met at 5:00 p.m. to discuss a potential deal with Barclays).

[47] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at pp. 19-20; Examiner's Interview of Richard Fuld, Jr., Apr. 28, 2009, at 9. In a written statement to the Examiner, the FSA said that it never received a formal request to waive the shareholder-approval requirement. According to the FSA's statement, the FSA had serious concerns about the lack of precedent for such waivers. The FSA was also concerned about Lehman's liquidity and funding. FSA, Statement of the Financial Services Authority to the Examiner (Jan. 20, 2010), at pp. 8, 10.

[48] Lehman, Liquidity of Lehman Brothers [Draft] (Oct. 7, 2008), at p. 9 [LBHI_SEC07940_844701] (LBIE faced a cash shortage of $4.5 billion on September 15, 2008).

Asia.[49] On September 15, 2008, at 1:45 a.m., LBHI filed for Chapter 11 bankruptcy protection.[50]

Sorting out whether and the extent to which the financial upheaval that followed was the direct result of the Lehman bankruptcy filing is beyond the scope of the Examiner's investigation. But those events help put into context the significance of the Lehman filing. The Dow Jones index plunged 504 points on September 15.[51] On September 16, AIG was on the verge of collapse; the Government intervened with a financial bailout package that ultimately cost about $182 billion.[52] On September 16, 2008, the Primary Fund, a $62 billion money market fund, announced that – because of the loss it suffered on its exposure to Lehman – it had "broken the buck," *i.e.*, its share

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[49] Examiner's Interview of Christopher Cox, Jan. 8, 2010, at pp. 16-17 (Cox called Lehman's Board to urge that Lehman take whatever action it decided upon as soon as possible, before the markets opened. During the call, Cox related, FRBNY General Counsel Thomas C. Baxter, Jr., added that it had been made clear in the meetings earlier that day that the "action" should be that Lehman declare bankruptcy. Cox told the Examiner that the SEC was not "offering guidance or trying to influence the fiduciary responsibilities of [Lehman's] directors.").

[50] Voluntary Petition (Chapter 11), Docket No. 1, *Lehman Brothers Holdings Inc.*, Case No. 08-13555 (Bankr. S.D.N.Y. Sept. 15, 2008); Docket Activity Report, *Lehman Brothers Holdings Inc.*, Case No. 08-13555 (Bankr. S.D.N.Y. Sept. 15, 2008).

[51] Alexandra Twin, *Stocks Get Pummeled*, CNNMoney.com, Sept. 21, 2008, at p. 1 (stating "Wall Street sees worst day in 7 years with Dow down 504 points . . . "), available at http://money.cnn.com/2008/09/15/markets/markets_newyork2/index.htm (last visited Jan. 28, 2010).

[52] Sewell Chan, *Bernanke Wants an Audit of Fed's Bailout of AIG*, N.Y. Times, Jan. 19, 2010 (stating that the FRBNY and Treasury Department made about $182 billion available to AIG).

price had fallen to less than $1 per share.[53] On October 3, 2008, Congress passed a $700 billion Troubled Asset Relief Program ("TARP") rescue package.[54]

In his recent reconfirmation hearings, Federal Reserve Chairman Ben Bernanke, speaking of the overall economic crisis, candidly conceded that "there were mistakes made all around" and "we should have done more."[55] Lehman should have done more, done better. Some of these failings were simply errors of judgment which do not give rise to colorable causes of action; some go beyond and are indeed colorable.

* * *

Part I of this Report provides an executive summary of the Examiner's findings and conclusions.

Part II discusses the procedural background of the Examiner's appointment, the Examiner's authority, and the manner in which the Examiner conducted his investigation.

Part III details the facts and analysis on the topics assigned by the Court to the Examiner and contains the Examiner's analysis and conclusions.

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[53] See Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007-2008*, 23 J. Econ. Perspectives, Winter 2009, at 87 (2009); NewYorkFed.org, Financial Turmoil Timeline, http://www.newyorkfed.org/research/global_economy/Crisis_Timeline.pdf (last visited Jan. 26, 2010).

[54] David M. Herszenhorn, *A Curious Coalition Opposed Bailout Bill*, N.Y. Times, Oct. 3, 2008, at p. 1.

[55] Edmund L. Andrews, *Bernanke Says Fed "Should Have Done More,"* N.Y. Times, Dec. 4, 2009, at p. 1. The official transcript of Chairman Ben S. Bernanke's Confirmation Hearing Before the Senate Committee on Banking, Housing, and Urban Affairs, Dec. 3, 2009, was not available at the time this Report was released.

I. EXECUTIVE SUMMARY OF THE EXAMINER'S CONCLUSIONS

The Order appointing the Examiner (the "Examiner Order") assigns ten specific bulleted topics for the Examiner to investigate; in addition, the Examiner Order directs the Examiner to perform the duties specified in Section 1106(a)(3) and (4) of the Bankruptcy Code, that is, to "file a statement of . . . any fact ascertained pertaining to fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor, or to a cause of action available to the estate." [56] Because the ten bulleted topics set out at pages 3-4 of the Examiner Order overlap, the Examiner has grouped them into three substantive areas: (A) Why Did Lehman Fail? Are There Colorable Causes of Action That Arise From Its Financial Condition and Failure? (B) Are There Administrative Claims or Colorable Claims for Preferences or Voidable Transfers? and (C) Are There Colorable Claims Arising Out of the Barclays Sale Transaction?

A. Why Did Lehman Fail? Are There Colorable Causes of Action That Arise From Its Financial Condition and Failure?

Section (A) addresses the fifth, eighth and tenth bullets of the Examiner Order:

> *[Bullet 10] The events that occurred from September 4, 2008 through September 15, 2008 or prior thereto that may have resulted in commencement of the LBHI Chapter 11 case.*
>
> *[Bullet 5] Whether there are colorable claims for breach of fiduciary duties and/or aiding or abetting any such breaches against the officers and directors of LBCC and/or other Debtors arising in connection with the financial condition of the Lehman enterprise prior to the commencement of the LBHI Chapter 11 case on September 15, 2008.*

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[56] Order Directing Appointment of an Examiner Pursuant to Section 1104(c)(2) of the Bankruptcy Code, at pp. 3-5, Docket No. 2569, *Lehman Brothers Holdings Inc.*, Case No. 08-13555 (Bankr. S.D.N.Y. Jan. 16, 2009).

[Bullet 8] The transactions and transfers, including but not limited to the pledging or granting of collateral security interest among the debtors and the pre-Chapter 11 lenders and/or financial participants including but not limited to, JPMorgan Chase, Citigroup, Inc., Bank of America, the Federal Reserve Bank of New York and others.

Lehman failed because it was unable to retain the confidence of its lenders and counterparties and because it did not have sufficient liquidity to meet its current obligations. Lehman was unable to maintain confidence because a series of business decisions had left it with heavy concentrations of illiquid assets with deteriorating values such as residential and commercial real estate. Confidence was further eroded when it became public that attempts to form strategic partnerships to bolster its stability had failed.[57] And confidence plummeted on two consecutive quarters with huge reported losses, $2.8 billion in second quarter 2008[58] and $3.9 billion in third quarter 2008,[59] without news of any definitive survival plan.

The business decisions that brought Lehman to its crisis of confidence may have been in error but were largely within the business judgment rule. But the decision not to disclose the effects of those judgments does give rise to colorable claims against the

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[57] See Lehman Brothers Holdings Inc., Minutes of Meeting of the Board of Directors (Mar. 31, 2008) (Lehman approached Warren E. Buffett about a potential $3.5 billion private investment, but discussions were preliminary and did not result in any agreement on terms) [LBEX-AM 003597-604]; Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 11 (Fuld told the Examiner that KDB's press release on Sept. 9, 2008, announcing that negotiations between KDB and Lehman about a strategic partnership had ended, triggered Lehman's decision to announce third quarter earnings early. According to Fuld, Lehman's stock dropped significantly after KDB's announcement and short-sellers were "kicking the daylights" out of Lehman); Morningstar Document Research Co., LBHI Historic Stock Prices (Jan. 1, 2008 through Sept. 15, 2008) [LBEX-EXM 000001] (printed from www.10kwizard.com) (last visited on Feb. 3, 2010 (Lehman's stock fell 45% after KDB's announcement).

[58] Lehman Brothers Holdings Inc., Press Release (June 9, 2008).

[59] Lehman Brothers Holdings Inc., Press Release (Sept. 10, 2008).

senior officers who oversaw and certified misleading financial statements – Lehman's CEO Richard S. Fuld, Jr., and its CFOs Christopher O'Meara, Erin M. Callan and Ian T. Lowitt. There are colorable claims against Lehman's external auditor Ernst & Young for, among other things, its failure to question and challenge improper or inadequate disclosures in those financial statements.

The Examiner Order does not contain a definition of what constitutes a "colorable" claim. The Second Circuit has described colorable claims as ones "that on appropriate proof would support a recovery,"[60] "much the same as that undertaken when a defendant moves to dismiss a complaint for failure to state a claim."[61] But under such a standard, the Examiner would find colorable claims wherever bare allegations might survive a motion to dismiss. Because he has conducted an extensive factual investigation, the Examiner believes it is more appropriate to use a higher threshold standard, and in this Report a colorable claim is one for which the Examiner has found that there is sufficient credible evidence to support a finding by a trier of fact. The Examiner is not the ultimate decision-maker; whether claims are in fact valid will be for the triers of fact to whom claims are presented. The identification of a claim by the Examiner as colorable does not preclude the existence of defenses and is not a

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[60] *In re STN Enters.*, 779 F.2d 901, 905 (2d Cir. 1985).

[61] *In re KDI Holdings, Inc.*, 277 B.R. 493, 508 (Bankr. S.D.N.Y. 1999) (quoting *In re America's Hobby Center*, 223 B.R. 275, 281 (Bankr. S.D.N.Y. 1998)), *accord In re Adelphia Commc'ns Corp.*, 330 B.R. 364, 376 (Bankr. S.D.N.Y. 2005).

prediction as to how a court or a jury may resolve any contested legal, factual, or credibility issues.[62]

Although Repo 105 transactions may not have been inherently improper, there is a colorable claim that their sole function as employed by Lehman was balance sheet manipulation. Lehman's own accounting personnel described Repo 105 transactions as an "accounting gimmick"[63] and a "lazy way of managing the balance sheet as opposed to legitimately meeting balance sheet targets at quarter end."[64] Lehman used Repo 105 "to reduce balance sheet at the quarter-end."[65]

In 2007-08, Lehman knew that net leverage numbers were critical to the rating agencies and to counterparty confidence.[66] Its ability to deleverage by selling assets was severely limited by the illiquidity and depressed prices of the assets it had accumulated.[67] Against this backdrop, Lehman turned to Repo 105 transactions to

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[62] For a more complete analysis of the law relating to the colorable claim standard, see Appendix 1. The Examiner is not the ultimate decision-maker on any colorable claim; he simply is directed to identify the existence of such claims. While the Examiner has evaluated the at-times conflicting evidence to make his determinations as to potential colorable claims, it is neither necessary nor appropriate for the Examiner to make credibility assessments or resolve conflicting evidence; that will be the responsibility of a trier of fact when and if those claims are litigated.

[63] Examiner's Interview of Murtaza Bhallo, Sept. 14, 2009, at p. 3.

[64] Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 7.

[65] E-mail from Raymond Chan, Lehman, to Paul Mitrokostas, Lehman, *et al.* (July 15, 2008) [LBEX-DOCID 3384937].

[66] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 8 (rating agencies looked at net leverage); Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 2; Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at pp. 5-6 (Bismal told the Examiner that meeting leverage ratio targets was the most critical issue ("a very hot topic") for senior management by the end of 2007).

[67] Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at pp. 7-8 (Starting in mid 2007, many of Lehman's inventory positions had grown increasingly "sticky" – *i.e.*, difficult to sell without incurring

temporarily remove $50 billion of assets from its balance sheet at first and second quarter ends in 2008 so that it could report significantly lower net leverage numbers than reality.[68] Lehman did so despite its understanding that none of its peers used similar accounting at that time to arrive at their leverage numbers, to which Lehman would be compared.[69]

Lehman defined materiality, for purposes of reopening a closed balance sheet, as "any item individually, or in the aggregate, that moves net leverage by 0.1 or more (typically $1.8 billion)."[70] Lehman's use of Repo 105 moved net leverage not by tenths but by whole points:

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substantial losses. Moreover, selling sticky inventory at reduced prices could also have led to loss of market confidence in Lehman's valuations for inventory remaining on the firm's balance sheet).

[68] Lehman, Spreadsheet Summarizing Total Repo 105 & Repo 108 (May 30, 2008) [LBEX-DOCID 2078195] (total Repo 105 firm-wide on Feb. 29, 2008 was $49.102 billion and on May 30, 2008 was $50.383 billion).

[69] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 8 (Kelly told the Examiner that Lehman was the last of the CSE firms to continue using Repo 105-type transactions to manage its balance sheet by late 2007); Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 4 (Stewart believed that Lehman was the last of its peer group using Repo 105 transactions by December 2007).

[70] Ernst & Young, Walkthrough Template: Balance Sheet Close Process (Nov. 30, 2007), at p. 14 [EY-SEC-LBHI-CORP-GAMX-07-033384].

Date	Repo 105 Usage	Reported Net Leverage	Net Leverage Without Repo 105	Difference
Q4 2007	$38.6 B[71]	16.1[72]	17.8[73]	1.7
Q1 2008	$49.1 B[74]	15.4[75]	17.3[76]	1.9
Q2 2008	$50.4 B[77]	12.1[78]	13.9[79]	1.8

Lehman's failure to disclose the use of an accounting device to significantly and temporarily lower leverage, at the same time that it affirmatively represented those "low" leverage numbers to investors as positive news, created a misleading portrayal of Lehman's true financial health.[80] Colorable claims exist against the senior officers who were responsible for balance sheet management and financial disclosure, who signed and certified Lehman's financial statements and who failed to disclose Lehman's use and extent of Repo 105 transactions to manage its balance sheet.[81]

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[71] Lehman, Spreadsheet of Total Repo 105/108 Trend [LBHI_SEC07940_1957956] (listing total use of Repo 105/108 for the fourth quarter of 2007 as $38.634 billion).

[72] See LBHI 2007 10-K, at p.29.

[73] See Section III.A.4 (discussing Repo 105/108); Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 8.

[74] Lehman, Spreadsheet of Total Repo 105/108 Trend [LBHI_SEC07940_1658543].

[75] LBHI 10-Q Apr. 9, 2008, at p. 72.

[76] See Section III.A.4 (discussing Repo 105/108); Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 8.

[77] Lehman, Spreadsheet of Total Repo 105/108 Trend [LBHI_SEC07940_1658543].

[78] LBHI 10-Q July 10, 2008, at p. 89.

[79] See Section III.A.4 (discussing Repo 105/108); Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 8.

[80] Examiner's Interview of Matthew Lee, July 1, 2009, at p. 15 ("[Lehman] was telling the public they reduced the balance sheet, but not telling them they were doing so by unartful means." – Lehman "had way more leverage than people thought; it was just out of [the public's] sight").

[81] See Section III.A.4 (discussing Repo 105/108).

In May 2008, a Lehman Senior Vice President, Matthew Lee, wrote a letter to management alleging accounting improprieties;[82] in the course of investigating the allegations, Ernst & Young was advised by Lee on June 12, 2008 that Lehman used $50 billion of Repo 105 transactions to temporarily move assets off balance sheet and quarter end.[83] The next day - on June 13, 2008 - Ernst & Young met with the Lehman Board Audit Committee but did not advise it about Lee's assertions, despite an express direction from the Committee to advise on all allegations raised by Lee.[84] Ernst & Young took virtually no action to investigate the Repo 105 allegations.[85] Ernst & Young took no steps to question or challenge the non-disclosure by Lehman of its use of $50 billion of temporary, off-balance sheet transactions. Colorable claims exist that Ernst & Young did not meet professional standards, both in investigating Lee's allegations and in connection with its audit and review of Lehman's financial statements.[86]

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[82] Letter from Matthew Lee, Senior Vice President, Lehman, to Martin Kelly, Controller, Lehman, *et al.*, re: possible accounting improprieties (May 16, 2008), at pp. 1-3 [EY-LE-LBHI-KEYPERS 5826885].

[83] Examiner's Interview of Ernst & Young's Hillary Hansen, Nov. 3, 2009 at p. 14; e-mail from Beth Rudofker, Lehman, to William Schlich, Ernst & Young (June 5, 2008) [EY-SEC-LBHI-ML 000001-000142], forwarding May 21, 2008 e-mail from Matthew Lee regarding second request for balance sheet substantiation.

[84] Examiner's Interview of Roger Berlind, Dec. 18, 2009, at p. 2; Examiner's Interview of Michael L. Ainslie, Dec. 22, 2009, at pp. 2-3; Examiner's Interview of Sir Christopher Gent, Jan. 20, 2010, at p. 2; Examiner's Interview of Thomas Cruikshank, Jan. 20, 2010, at p. 3; Examiner's Interview of Beth Rudofker, Dec. 15, 2009, at pp. 6-7; see also Lehman Brothers Holdings Inc., Minutes of the Audit Committee (June 13, 2008) [LBEX-AM 003759-60].

[85] Examiner's Interview of Ernst & Young's Hillary Hansen, Nov. 3, 2009, at p. 15 (Hansen told the Examiner that she did no further follow up specifically on Repo 105/108 because E&Y was in the midst of collecting all the data, and its investigation was not finalized).

[86] See Section III.A.4 (discussing Repo 105/108).

In the sections that follow, this report will describe in detail the facts and analysis that support the Examiner's conclusions. That detail will include the bases not only for the colorable claims that the Examiner has found, but also for those the Examiner has considered but not found. The Examiner believes it is appropriate to set forth the facts and analysis on colorable claims that he has not found in equal detail, so that the parties can understand the process that led to those conclusions. The issues that the Examiner investigated were framed by the Examiner Order itself, by suggestions made by the parties and Government agencies with whom the Examiner has had extensive coordination, and by the natural course of investigation, where a new path (such as Repo 105) was uncovered in the course of the investigation.

The Report begins with a discussion of the business decisions that Lehman made well before the bankruptcy, and the risk management issues raised by those business decisions. Ultimately, the Examiner concludes that while certain of Lehman's risk decisions can be described in retrospect as poor judgment, they were within the business judgment rule and do not give rise to colorable claims. But those judgments, and the facts related to them, provide important context for the other subjects on which the Examiner has found colorable claims. For example, after saddling itself with an enormous volume of illiquid assets that it could not readily sell, Lehman increasingly turned to Repo 105 to manage its balance sheet and reduce its reported net leverage.

Lehman's acquisition of illiquid assets is also the predicate for the liquidity and valuation issues investigated by the Examiner.

Accordingly, the report will detail the following subjects that the Examiner has explored:

1. **Business and Risk Management –** The Examiner has explored this subject because it is central to the question of how and why Lehman amassed the assets that ultimately it could not monetize in time to maintain liquidity, acceptable leverage and confidence. The Examiner explored Lehman's reaction to the subprime lending crisis and other economic events to analyze whether Lehman's officers and directors fulfilled their fiduciary duties. The Examiner concludes that some of Lehman's management's decisions can be questioned in retrospect, but none fall outside the business judgment rule; the Examiner finds no colorable claims.[87]

2. **Valuation –** The Examiner has explored this subject because it is central to the question of Lehman's solvency and to whether Lehman's financial statements were accurately stated. The Examiner concludes that Lehman's valuation procedures may have been wanting and that certain valuations may have been unreasonable for purposes of a bankruptcy solvency analysis. The Examiner's conclusion that valuations were unreasonable for solvency analysis does not necessarily mean that individuals acted with sufficient scienter to support claims for breach of fiduciary duty, and the Examiner does not find sufficient credible evidence to support colorable claims.[88]

3. **Survival –** The Examiner has explored this subject because it is central to the question whether the officers and directors discharged their fiduciary duties. The Examiner finds no colorable claims.[89]

4. **Repo 105 –** The Examiner has explored this subject after uncovering the issue in the course of his investigation. The Examiner finds there are colorable claims against Richard Fuld, Jr., Christopher O'Meara, Erin Callan, and Ian Lowitt in connection with their failure to disclose the use of the practice and

[87] See Section III.A.1 (discussing Lehman's risk management).

[88] See Section III.A.2 (discussing Lehman's valuation).

[89] See Section III.A.3 (discussing Lehman's survival).

against Ernst & Young for its failure to meet professional standards in connection with that lack of disclosure.[90]

5. **Secured Lenders –** The Examiner has explored this subject because it was specifically assigned as part of the Examiner Order and because the subject was addressed in multiple communications with the parties. The Examiner finds colorable claims against JPMorgan Chase ("Chase") and CitiBank in connection with modifications of guaranty agreements and demands for collateral in the final days of Lehman's existence.[91] The demands for collateral by Lehman's Lenders had direct impact on Lehman's liquidity pool; Lehman's available liquidity is central to the question of why Lehman failed.

6. **Lehman's Interaction With Government Agencies –** As part of the Examiner's overall investigation, it was necessary to consider the interaction between Lehman and the Government agencies who regulated and monitored Lehman; for example, Lehman officers suggested to the Examiner that he should consider, in the course of determining whether they had breached any fiduciary duties, the completeness of the disclosures they made to the Government.[92]

B. Are There Administrative Claims or Colorable Claims For Preferences or Voidable Transfers?

Section (B) addresses the first, second, third, fourth, seventh and eighth bullets of the Examiner Order:

> *[Bullet 1] Whether LBCC [Lehman Brothers Commercial Corporation] or any other entity that currently is an LBHI Chapter 11 debtor subsidiary or affiliate ("LBHI Affiliate(s)") has any administrative claims against LBHI resulting from LBHI's cash*

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[90] See Section III.A.4 (discussing Repo 105/108). After reaching the tentative conclusion that these claims existed, the Examiner contacted counsel for each, advised them of the basis for the potential finding, and invited each of them to present any additional facts or materials that might bear on the final conclusion. The Examiner had individual, face-to-face meetings with each and carefully considered the materials raised by each. While the Examiner was directed to credible facts and arguments that might form the basis for successful defenses, the Examiner concluded in all cases that these possible defenses do not change his now final conclusion that there is sufficient credible evidence from which a trier of fact could find a breach of duty after weighing the credible evidence on both sides of the issue.

[91] See Section III.A.5 (discussing potential claims against Lehman's secured lenders).

[92] See Section III.A.6(discussing the government's role).

sweeps of cash balances, if any, from September 15, 2008, the commencement date of LBHI's Chapter 11 case, through the date that such applicable LBHI affiliate commenced its Chapter 11 case.

[Bullet 2] All voluntary and involuntary transfers to, and transactions with, affiliates, insiders and creditors of LBCC or its affiliates, in respect of foreign exchange transactions and other assets that were in the possession or control of LBHI Affiliates at any time commencing on September 15, 2008 through the day that each LBHI Affiliate commenced its Chapter 11 case.

[Bullet 3] Whether any LBHI Affiliate has colorable claims against LBHI for potentially insider preferences arising under the Bankruptcy Code or state law.

[Bullet 4] Whether any LBHI Affiliate has colorable claims against LBHI or any other entities for potentially voidable transfers or incurrences of debt, under the Bankruptcy Code or otherwise applicable law.

[Bullet 7] The inter-company accounts and transfers among LBHI and its direct and indirect subsidiaries, including but not limited to: LBI, LBIE, Lehman Brothers Special Finance ("LBSF") and LBCC, during the 30-day period preceding the commencement of the Chapter 11 cases by each debtor on September 15, 2008 or thereafter or such longer period as the Examiner deems relevant to the Investigation.

[Bullet 8] The transactions and transfers, including but not limited to the pledging or granting of collateral security interest among the debtors and the pre-Chapter 11 lenders and/or financial participants including but not limited to, JPMorgan Chase, Citigroup, Inc., Bank of America, the Federal Reserve Bank of New York and others

The Examiner has identified approximately $60 million of administrative claims.[93]

The Examiner has identified colorable claims that there were a limited number of preferential transfers.[94]

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[93] See Section III.B.2 (discussing possible administrative claims).

[94] See Section III.B.3 (discussing possible avoidance actions).

The Examiner has determined that there are a limited number of colorable claims for avoidance actions against JPMorgan[95] and Citibank.[96]

C. Do Colorable Claims Arise From Transfers of LBHI Affiliate Assets to Barclays, or From the Lehman ALI Transaction?

Section (C) addresses the sixth and ninth bullets of the Examiner Order:

> *[Bullet 6] Whether assets of any LBHI Affiliates (other than Lehman Brothers, Inc.) were transferred to Barclays Capital Inc. as a result of the sale to Barclays Capital Inc. that was approved by order of the Bankruptcy Court entered September 20, 2008, and whether consequences to any LBHI Affiliate as a result of the consummation of the transaction created colorable causes of action that inure to the benefit of the creditors of such LBHI subsidiary or affiliate.*
>
> *[Bullet 9] The transfer of the capital stock of certain subsidiaries of LBI on or about September 19, 2008 to Lehman ALI Inc.*

In the course of reviewing whether affiliates other than LBI were adversely impacted by the Barclays sale, the Examiner reviewed the facts related to the transfer of LBI assets in the post-filing sale to Barclays. Because the issues related to the sale are the subject of active, pending litigation filed by the Debtors, on which discovery is far from complete, the Examiner expresses no view on the merits of that litigation and will limit himself to setting out the factual record he has developed on the issues.[97]

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[95] The Examiner notified counsel for JPMorgan of his tentative conclusion and counsel made a presentation in response. The Examiner carefully considered that presentation but concludes that a colorable claim exists.

[96] See Section III.B.3 (discussing possible avoidance actions).

[97] See Section III.C (discussing the Barclays sale transaction).

The Examiner concludes that a limited amount of assets of LBHI Affiliates other than LBI were improperly transferred to Barclays.[98]

The Examiner concludes that the transfer of capital stock to ALI served a legitimate purpose and that there was no impropriety in those transactions.[99]

[98] See Section III.C (discussing the Barclays sale transaction).

[99] See Section III.C (discussing the Examiner's conclusions regarding the Lehman ALI transaction).

II. PROCEDURAL BACKGROUND AND NATURE OF THE EXAMINATION

A. The Examiner's Authority

On January 16, 2009, the United States Bankruptcy Court for the Southern District of New York entered an order directing the U.S. Trustee to nominate an Examiner, and outlining the subject matter of the Examiner's investigation (the "Examiner Order").[100] The Examiner Order lists ten bulleted topics that the Examiner was to investigate and, further, mandates that the "Examiner shall perform the duties specified in sections 1106(a)(3) and (4) of the Bankruptcy Code [unless otherwise ordered.]"[101] Under 11 U.S.C. § 1106(a)(3), the Examiner is to "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan [unless ordered otherwise.]" Under 11 U.S.C. § 1106(a)(4), the Examiner must, *inter alia*, "file a statement of any investigation conducted . . . including any fact ascertained pertaining to fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor, or to a cause of action available to the estate[.]"

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[100] Order Directing Appointment of an Examiner Pursuant to Section 1104(c)(2) of the Bankruptcy Code, at pp. 3-5, Docket No. 2569, *In re Lehman Brothers Holding Inc., et al.*, Case No. 08-13555 (Bankr. S.D.N.Y. Jan. 16, 2009).

[101] *Id*. at p. 5.

On January 19, 2009, the U.S. Trustee appointed Anton R. Valukas as Examiner.[102] The Court approved the appointment on January 20, 2009.[103] On February 11, 2009, the Court approved the Examiner's request to employ Jenner & Block LLP as counsel and provided the Examiner with authority to issue subpoenas under Fed. R. Bankr. P. 2004.[104] On February 17, 2009, the Court approved the Examiner's Preliminary Work Plan.[105] On February 25, 2009, the Court authorized the Examiner to employ Duff & Phelps, LLC as his financial advisors.[106]

Despite the complexity of Lehman's bankruptcy and the broad scope of the Examiner's investigation, the time available for the examination was limited by the practical needs of the bankruptcy proceeding. The Examiner initially targeted the week of February 1, 2010 to submit his report to the Court in order to assure that the report would be available prior to the March 15, 2010 deadline of the Debtors' exclusivity

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[102] Notice of Appointment of Examiner, Docket No. 2570, *In re Lehman Brothers Holdings Inc.,*Case No. 08-13555 (Bankr. S.D.N.Y. Jan. 19, 2009).

[103] Order Approving Appointment of Examiner, Docket No. 2583, *In re Lehman Brothers Holdings Inc.*, Case No. 08-13555 (Bankr. S.D.N.Y. Jan. 20, 2009).

[104] Order Authorizing the Examiner to Retain and Employ Jenner & Block LLP as His Counsel *Nunc Pro Tunc* as of January 19, 2009, Docket No. 2803, *In re Lehman Brothers Holdings Inc.,* Case No. 08-13555 (Bankr. S.D.N.Y. Feb. 11, 2009); and Order Granting Examiner's Motion Directing the Production of Documents and Authorizing the Examinations of the Debtors' Current and Former Officers, Directors and Employees, and Other Persons and Entities, Docket No. 2804, *In re Lehman Brothers Holdings Inc.*, Case No. 08-13555 (Bankr. S.D.N.Y. Feb. 11, 2009).

[105] Order Approving the Preliminary Work Plan of Anton R. Valukas, Examiner, Docket No. 2855, *In re Lehman Brothers Holdings Inc.,* Case No. 08-13555 (Bankr. S.D.N.Y. Feb. 17, 2009).

[106] Order Authorizing the Examiner to Retain and Employ Duff & Phelps LLC as His Financial Advisors *Nunc Pro Tunc* as of February 6, 2009, Docket No. 2924, *In re Lehman Brothers Holdings Inc.,* Case No. 08-13555 (Bankr. S.D.N.Y. Feb. 17, 2009).

period to propose a plan of reorganization.[107] Even though the Debtors have suggested that they may not file a plan by that date, the Examiner determined that all parties would be better served if he adhered to his self-imposed February 2010 schedule.

B. Document Collection and Review

The available universe of Lehman e-mail and other electronically stored documents is estimated at three petabytes of data – roughly the equivalent of 350 billion pages. The Examiner carefully selected a group of document custodians and search terms designed to cull out the most promising subset of Lehman electronic materials for review. In addition, the Examiner requested and received hard copy documents from Lehman and both electronic and hard copy documents from numerous third parties and Government agencies, including the Department of the Treasury, the SEC, the Federal Reserve, FRBNY, the Office of Thrift Supervision, the SIPA Trustee, Ernst & Young, JPMorgan, Barclays, Bank of America, HSBC, Citibank, Fitch, Moody's, S&P, and others.[108]

In total, the Examiner collected in excess of five million documents, estimated to comprise more than 40,000,000 pages. All of these documents have been converted to

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[107] Order Granting Debtors' Motion, Pursuant to Section 1121(d) of the Bankruptcy Code, Requesting Second Extension of Exclusive Periods for the Filing of and Solicitation of Acceptances for Chapter 11 Plans, Docket No. 4449, *In re Lehman Brothers Holdings Inc.,* Case No. 08-13555 (Bankr. S.D.N.Y. July 20, 2009).

[108] See Appendix 5 for full details of custodians, search request, search terms and related document metrics. Although a handful of subpoenas were threatened and in a few cases served, ultimately the Examiner received nearly all requested documents voluntarily. In the interest of time and efficiency, the Examiner did not, except where significant deficiencies were apparent, challenge the completeness of production or the withholding of documents upon claims of privilege.

electronic form and are maintained on two computerized databases, Stratify and CaseLogistix. The Stratify database, which is housed and maintained on servers by the Debtors' professionals, Alvarez & Marsal, contains approximately four and a half million unique documents, and consists of collected Lehman e-mails and attachments; the CaseLogistix database, which is housed and maintained by the Examiner's counsel, Jenner & Block, contains approximately seven hundred thousand unique documents, primarily consisting of third-party productions.

Documents were reviewed on at least two levels. First level review was conducted by lawyers trained to identify documents of possible interest and to code the substantive areas to which the documents pertained; those so identified were subjected to further and more careful review by lawyers or financial advisors especially immersed in the earmarked subjects. In order to reduce the cost of review, the Examiner sought and obtained the Court's approval to retain contract attorneys.[109] A group of more than 70 contract attorneys, supplemented by Jenner & Block attorneys, conducted first level reviews. All second level (and beyond) reviews were performed by Jenner & Block attorneys or Duff & Phelps professionals.

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[109] Order Authorizing the Examiner to Retain Certain Contract Attorneys to Perform Specific Document Review Tasks *Nunc Pro Tunc* as of April 15, 2009, Docket No. 3577, *In re Lehman Brothers Holdings Inc.*, Case No. 08-13555 (Bankr. S.D.N.Y. May 15, 2009); Order Authorizing the Examiner to Retain Additional Contract Attorneys to Perform Specific Document Review Tasks *Nunc Pro Tunc* as of May 11, 2009, Docket No. 3750, *In re Lehman Brothers Holdings Inc.*, Case No. 08-13555 (Bankr. S.D.N.Y. June 3, 2009); and Order Authorizing the Examiner to Retain Additional Contract Attorneys to Perform Specific Document Review Tasks *Nunc Pro Tunc* as of June 11, 2009, Docket No. 4428, *In re Lehman Brothers Holdings Inc.*, Case No. 08-13555 (Bankr. S.D.N.Y. July 16, 2009).

The Examiner estimates that he has reviewed approximately 34,000,000 pages of documents in the course of his investigation. The entire body of e-mail in the Stratify database – 4,439,924 documents, approximately 26 million pages – has been reviewed.[110] Approximately 340,000 of the CaseLogistix documents – roughly eight million pages – have been reviewed.[111] Although a large number of the CaseLogistix documents were not reviewed, that database is fully searchable, and the Examiner is reasonably confident that the repeated and focused searches applied against that database have discovered most if not all of the most relevant documents.[112]

In most cases, documents were produced to the Examiner under stipulated protective orders, which are described in Appendix 5. Subject to those orders, the document databases created by the Examiner remain a resource for the estate and the parties. The database includes computerized tagging which will allow persons interested in making their own searches to narrow and focus search requests. The Examiner will work with the parties and the Court to resolve logistical and

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[110] On January 30, 2010, the Examiner received about 55,500 unique e-mails from the Debtors responsive to long-outstanding requests that had not earlier been produced due to a data transfer issue. Earlier that week, the Examiner received 30,000 pages of documents from Ernst & Young responsive to long-outstanding requests that had not earlier been produced because a single custodian's files had inadvertently not been included. Despite the lateness of the receipt of these documents, the Examiner was able to complete review of them by deploying a team of lawyers to the task.

[111] The Examiner is able to count documents loaded in the two databases with precision, but page numbers are estimates. On average, the e-mail and attachments in the Stratify database are six pages per document; the documents in the CaseLogistix database tend to be larger, averaging 23 pages per document.

[112] A substantial number of additional documents were produced in the pending Barclays sale litigation in the weeks before this Report was due. Given the ongoing nature of that litigation and the Court's concurrence that the Examiner need not express conclusions on these still-in-active-litigation issues, those documents have not been reviewed except on a limited, focused basis.

confidentiality issues so that the databases can become an asset available to all interested parties.

C. Systems Access

Answering the questions posed by the Examiner Order necessarily required an extensive investigation and review of Lehman's operating, trading, valuation, financial, accounting and other data systems. Interrogating those systems proved particularly challenging, first because the vast majority of the systems had been transferred and were under the control of Barclays; by the time of the Examiner's appointment, Barclays had integrated its own proprietary and confidential data into some of the systems, so Barclays had legitimate concerns about granting access to those systems. Although it took some time, Barclays was cooperative and those issues were for the most part resolved.

The second challenge was more daunting. At the time of its bankruptcy filing, Lehman maintained a patchwork of over 2,600 software systems and applications. The Examiner, in consultation with his financial advisors, decided early on that it would not be cost effective to undertake the enormous effort and expense that would be required to learn and access each of these 2,600 systems. Rather, the Examiner directed his financial advisors to identify and acquire an in-depth understanding of the most promising of the systems.

The Examiner's financial advisors ultimately requested access to 96 of the most relevant systems.[113] The process of identifying those presented it own challenges. Many of Lehman's systems were arcane, outdated or non-standard. Becoming proficient enough to use the systems required training in some cases, study in others, and trial and error experimentation in others. In numerous instances, the Examiner's professionals would request access to a particular system, expend the time necessary to learn how to use the system and only then discover that access to two or three additional systems was required to answer the necessary questions. Lehman's systems were highly interdependent, but their relationships were difficult to decipher and not well documented. It took extraordinary effort to untangle these systems to obtain the necessary information.

Because some systems were in current use by Barclays in its operations, Barclays limited access to 79 of the requested 96 systems to "read-only." Read-only access made the review and organization of data more difficult. And in some cases, read-only access was severely restricted. For some systems, the ability to query the data and search for a particular transaction was limited to certain parameters. For others, the Examiner was denied direct access altogether, requiring the need to request that searches be done by Barclays's technology personnel, who would then forward findings to the Examiner.

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[113] *See* Appendix 6.

Finally, the accessibility of data was complicated by the fact that the filing of a bankruptcy petition by Lehman came with virtually no advance preparation. The filing did not occur at the close of a month or a quarter when Lehman would prepare reconciliations and summaries of its financial data. Record-keeping quickly fell into disarray upon Lehman's hurried filing. Reconstructing data during this period has proven a challenge not only for the Examiner but for all who must rely upon this data in Lehman's Chapter 11 proceedings.

In the end, the Examiner's financial advisors were generally able to get sufficient data to inform and support the Examiner's Report, but there may be areas, specifically noted where appropriate in the text below, where data limitations need to be considered.

D. Witness Interview Process

Shortly after his appointment, the Examiner spoke with examiners from other large bankruptcy proceedings, including WorldCom, SemCrude and Refco, and obtained their advice on best practices. One of the suggestions made was that wherever possible interviews be conducted informally, without requiring that the witness be sworn and without transcripts. There are obvious pros and cons to the use of sworn, transcribed interviews. On the plus side, oath and transcription make citations to testimony more certain; on the minus side, the formality of oath and transcription inevitably takes more time, creates additional expense and makes some witnesses less

willing to give full cooperation; moreover, the creation of transcribed statements might have impacted pending Government investigations. Balancing these factors, the Examiner decided to use informal interviews wherever possible – and that turned out to be possible in all cases. To assure accuracy, all interviews were conducted by at least two attorneys, one of whom was assigned to keep careful notes. Flash summaries were prepared as soon as possible, usually the day of the interview, and reviewed by all lawyers present while recollections remained sharp; and full summaries were made and reviewed as soon as practical after that.

In the vast majority of cases, the interviewees were represented by counsel. Nevertheless, the Examiner advised each interviewee that he is a neutral fact-finder and that he and his professionals should not be deemed to represent the witness nor any point of view. Consistent with that neutrality, prior to each interview the Examiner provided advance notice of the topics he intended to cover and advance copies of the documents he anticipated showing the witness. The Examiner did so in order to make the interview as efficient as possible and to permit the witness to refresh recollection before the interview rather than on the fly. Each witness was encouraged to advise the Examiner if he or she believed it was appropriate to correct or supplement the information given during the interview.

In all, the Examiner has interviewed more than 250 individuals. There was only one individual the Examiner sought to interview but could not. The Examiner

requested an interview with Hector Sants, chief executive of the UK's Financial Services Authority ("FSA"), to discuss the FSA's involvement in the events of Lehman Weekend and the Barclays transaction. The FSA considered the request, but did not make Mr. Sants available for an interview. However, the FSA did provide detailed, written answers to specific questions that would have been posed to Mr. Sants.

A full list of the persons interviewed by the Examiner is set out in Appendix 4.

E. Cooperation and Coordination With the Government and Parties

The Examiner received extraordinary cooperation, both from parties and non-parties, without which the completion of this Report would have taken far more time. Although the Debtors' professionals and personnel were and are extremely busy with the day-to-day requirements of Lehman's liquidation, they remained responsive to almost daily requests for information from the Examiner and his professionals. Many parties, such as the Debtors, provided documents to the Examiner on an expedited basis without taking the time for privilege review, subject to clawback agreements.

Shortly after his appointment, the Examiner met with and established a regular line of contact with the SIPA Trustee to share documents, interview summaries and other information to avoid duplication of effort. The Examiner met with the SEC and three United States Attorney Offices (New Jersey, Eastern District of New York, Southern District of New York) to establish protocols for clearing proposed interviews

so as not to interfere with any ongoing investigations. And the Examiner met with interested parties to obtain their guidance and thoughts.

Throughout the course of the investigation, the Examiner conducted regular, weekly calls with the SEC and U.S. Attorneys to update them on developments and to describe significant documents and the results of interviews. The Examiner has likewise made documents and the results of interviews available to the SIPA Trustee.

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The Report now continues with the detail.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	Chapter 11 Case No.
LEHMAN BROTHERS HOLDINGS INC., *et al.*,	:	08-13555 (JMP)
	:	(Jointly Administered)
Debtors.	:	

REPORT OF EXAMINER ANTON R. VALUKAS

Section III.A.1: Risk

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III. EXAMINER'S CONCLUSIONS

A. Why Did Lehman Fail? Are There Colorable Causes of Action That Arise From Its Financial Condition and Failure?

1. Business and Risk Management

a) Executive Summary

In 2006, Lehman adopted a more aggressive business strategy by expanding its investments in potentially highly profitable lines of business that also carried much more risk than Lehman's traditional investment banking activities. Through the first half of 2007, Lehman focused on making "principal" investments – committing its own capital in commercial real estate ("CRE"), leveraged lending, and private equity-like investments. These investments were considerably riskier for Lehman than its other business lines because Lehman was acquiring potentially illiquid assets that it might be unable to sell in a downturn.[114]

Lehman continued and even intensified this high-risk strategy after the onset of the subprime residential mortgage crisis in late 2006. As some Lehman officers described it, Lehman shifted from focusing almost exclusively on the "moving" business – a business strategy of originating assets primarily for securitization or syndication and distribution to others – to the "storage" business – which entailed making longer-term investments using Lehman's own balance sheet.[115] Lehman

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[114] *See* Tobias Adrian, Federal Reserve Bank of New York, and Hyun Song Shin, Princeton University, Financial Intermediaries, Financial Stability and Monetary Policy (Aug. 5, 2008), at p. 13.

[115] See Section III.A.1.b of this Report.

continued to pursue commercial real estate and leveraged loan transactions aggressively until July 2007.[116]

While the decision to shift into long-term investments was voluntary, market events pushed Lehman ever further from moving to storage. Lehman's primary mortgage origination subsidiaries, BNC Mortgage Inc. ("BNC") and Aurora Loan Services, LLC ("Aurora"), continued to originate subprime and other non-prime mortgages to a greater extent than other mortgage originators, many of whom had recently gone out of business, or would soon do so.[117] BNC's and Aurora's continued mortgage originations increased the volume of illiquid assets on Lehman's balance sheet – albeit unintentionally – because Lehman became unable to securitize and distribute these mortgages to third parties.[118]

Lehman's continued pursuit of this aggressive growth strategy, even in the face of the subprime crisis, was based on two important calculations by Lehman's management. First, like some other market participants, not to mention governmental officials, Lehman's management believed that the subprime crisis would not spread to

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[116] See Section III.A.1.b of this Report.

[117] Lehman, Update on Lehman Brothers' Subprime Mortgage Origination Business Presentation to Lehman Board of Directors (Mar. 20, 2007), at p. 5 [LBHI_SEC07940_025839].

[118] Lehman, Securitized Products, MBS: Non Investment Grade Retained Interests (Jan. 16, 2007), at p. 1 [LBEX-DOCID 839039]; Lehman, Update on Lehman Brothers' Subprime Mortgage Origination Business Presentation to Lehman Board of Directors [Draft] (Mar. 18, 2007), at p. 14 [LBEX-DOCID 610173] ("Limited ability to sell below Investment Grade risk profitably in current environment"); Examiner's Interview of Matthew Miller, Sept. 24, 2009, at p. 2.

other markets and to the economy generally.[119] Second, Lehman's management believed that while other financial institutions were retrenching and reducing their risk profile, Lehman had the opportunity to pick up ground and improve its competitive position. Lehman had benefited from a similar "countercyclical growth strategy" during prior market dislocations, and its management believed it could similarly benefit from the subprime lending crisis.[120] Lehman miscalculated. As Lehman's Chief Executive Officer ("CEO") Richard S. Fuld, Jr. later admitted, Lehman underestimated both the severity of the subprime crisis and the extent of the contagion to Lehman's other business lines.[121]

The Examiner investigated Lehman's adoption and implementation of this aggressive countercyclical business strategy for several reasons. First, the potentially illiquid assets Lehman acquired played a significant role in Lehman's ultimate financial failure. Lehman's losses were largely concentrated in its commercial real estate portfolio and in certain less liquid aspects of its residential mortgage origination and securitization business. Similarly, Lehman's liquidity was compromised by its

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[119] *E.g.*, Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at pp. 16, 24; Examiner's Interview of Joseph Gregory, Nov. 13, 2009, at p. 7; Examiner's Interview of Treasury Secretary Timothy F. Geithner, Nov. 24, 2009, at p. 3.

[120] *See* Section III.A.1.b of this Report.

[121] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at pp. 16, 24; Examiner's Interview of Richard McKinney, Aug. 27, 2009, at pp. 2, 9; Richard S. Fuld, Jr., Lehman, Notes for Senior Management Speech (June 16, 2008), at pp. 5-6 [LBEX-DOCID 529241], attached to e-mail from Taimur Hyat, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (June 25, 2008) [LBEX-DOCID 556064].

accumulation of assets that it could not sell, including not only the commercial and residential real estate assets, but also, to a lesser extent, the leveraged loan positions.

Second, e-mails written by Lehman risk management personnel suggest that Lehman senior management disregarded its risk managers, its risk policies, and its risk limits.[122] Press reports prior to Lehman's bankruptcy stated that in 2007 Lehman had removed Madelyn Antoncic, Lehman's Chief Risk Officer ("CRO"), and Michael Gelband, head of its Fixed Income Division ("FID"), because of their opposition to management's growing accumulation of risky and illiquid investments.[123] And external monitors of Lehman's affairs, such as the Office of Thrift Supervision ("OTS") and Moody's Investor Services ("Moody's"), also raised serious questions about Lehman's risk management, particularly with respect to its commercial real estate investments.[124]

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[122] *See, e.g.*, e-mail from Kentaro Umezaki, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Sept. 10, 2008) [LBEX-DOCID 1718043] (noting "history of `end arounds' on risk decisions," risk management's lack of authority and lack of authority over balance sheet and inability to enforce risk limits); e-mail from Vincent DiMassimo, Lehman, to Christopher M. O'Meara, Lehman (Sept. 1, 2008) [LBEX-DOCID 203219] ("whatever risk governance process we had in place was ultimately not effective in protecting the firm [.] Risk Appetite measures were not effective in establishing clear enough warning signals that the Firm was taking on too much risk relative to capital. . . . The [Risk Management] function lacked sufficient authority within the Firm. Decision-making was dominated by the business. . . ."); e-mail from Satu Parikh, Lehman, to Michael Gelband, Lehman, Sept. 15, 2008 [LBEX-DOCID 882447] ("I am shocked at the poor risk mgmt at the highest levels, and I don't think it started with Archstone. It is all unbelievable and I think there needs to be an investigation into the broader issue of malfeasance. Mgmt gambled recklessly with thousands of jobs and shareholder wealth. . . .").

[123] *See, e.g.,* Yalman Onaran, *Lehman Fault-Finding Points to Last Man Fuld as Shares Languish*, Bloomberg.com, July 22, 2008.

[124] *See* Office of Thrift Supervision, Report of Examination, Lehman Brothers Holdings Inc. (as of May 31, 2008), at p. 2 [LBEX-OTS 000392] (finding that Lehman did not employ sound risk management practices in its commercial real estate business); e-mail from Stephen Lax, Lehman, to Erin M. Callan, Lehman, *et al.* (June 9, 2008) [LBEX-DOCID 017840] (forwarding text of Moody's release announcing downgrade of Lehman ratings outlook: "The rating action also reflects Moody's concerns over risk management

Accordingly, the Examiner investigated (1) whether there are colorable claims for breach of the duty of care against Lehman's officers for the manner in which they administered Lehman's risk management system in connection with the acquisition of these illiquid assets; (2) whether there are colorable claims for breach of the duty of good faith and candor against Lehman's officers for failing fully to inform the Board of Directors (the "Board")[125] of the extent of the risk and illiquidity that Lehman assumed through the new strategy; and (3) whether there are colorable claims against Lehman's directors for breach of their duty to monitor Lehman's risk management.

The Examiner concludes that the conduct of Lehman's officers, while subject to question in retrospect, falls within the business judgment rule and does not give rise to colorable claims. The Examiner concludes that Lehman's directors did not breach their duty to monitor Lehman's risks.

(1) The Examiner Does Not Find Colorable Claims That Lehman's Senior Officers Breached Their Fiduciary Duty of Care by Failing to Observe Lehman's Risk Management Policies and Procedures

Delaware law, which governs a Delaware corporation such as Lehman, sets a high bar for establishing a breach of the fiduciary duty of care.[126] Officers' and directors' business decisions are generally protected from personal liability by the

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decisions that resulted in elevated real estate exposures and the subsequent ineffectiveness of hedges to mitigate these exposures").

[125] References to the "Board" in this Section of the Report refer to Lehman's outside directors, not to Fuld, who was CEO and Chairman of the Board.

[126] For a detailed discussion of Delaware corporate fiduciary law, see Appendix 1.

business judgment rule, and even if the business judgment rule does not apply, there is no liability unless the officer or director was grossly negligent. "In the duty of care context gross negligence has been defined as 'reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason.'"[127]

The proof necessary to defeat the business judgment rule and establish gross negligence is particularly high with respect to risk management and financial transactions. Banking is inherently risky and prone to financial losses caused by unforeseen changes in the markets.[128] Profitability depends largely on the firm's ability to evaluate the risks of potential investments and balance them against their potential gains.[129] Consequently, to establish a colorable claim that Lehman officers breached their fiduciary duty by mismanaging business risk, the evidence must show that Lehman's senior management was reckless or irrational in managing the risks associated with the principal investment strategy that Lehman pursued during 2006 and 2007.[130]

Lehman had sophisticated policies, procedures, and metrics in place to estimate the risk that the firm could assume without jeopardizing its ability to achieve a target

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[127] *McPadden v. Sidhu*, 964 A.2d 1262, 1274 (Del. Ch. 2008) (quoting *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 192 (Del. Ch. 2005)).

[128] *See In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 126 (Del. Ch. 2009).

[129] *See id.*

[130] *See* Appendix 1, Legal Issues.

rate of return, and to apprise management and the Board whether Lehman was within various risk limits.[131] Lehman also used an array of stress tests to determine the potential financial consequences of an economic shock to its portfolio of assets and investments.[132] Lehman had an extensive staff that was devoted solely to risk management.[133]

These risk limits and stress tests, however, did not impose legal requirements on management or prevent management and the Board from exceeding those limits if they chose to do so.[134] The role of the risk limits and stress tests was to cause management to consider whether a particular investment or a broad business strategy was worth the risk it carried.[135] In addition, Lehman used its risk management system to promote its capabilities to investors, rating agencies, and regulators.[136] Lehman's management always retained the discretion to use its judgment to decide whether to pursue particular strategies or transactions.[137]

The Examiner did find that in pursuing its aggressive growth strategy, Lehman's management chose to disregard or overrule the firm's risk controls on a regular basis. The question whether there is a colorable claim that Lehman's senior officers breached

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[131] *See generally* Appendix 1, Legal Issues.
[132] Appendix No. 8, Risk Management Organization and Controls.
[133] *Id.*
[134] *Id.*
[135] *See id.*
[136] *Id.*
[137] *See id.*

their fiduciary duty of care focuses on facts relating to Lehman's acquisition of potentially illiquid investments in 2007 and the manner in which management used Lehman's risk management system as part of its process of making investment decisions:

- Lehman's management decided to exceed risk limits with respect to Lehman's principal investments, namely, the "concentration limits" on Lehman's leveraged loan and commercial real estate businesses, including the "single transaction limits" on the leveraged loans. These limits were designed to ensure that Lehman's investments were properly limited and diversified by business line and by counterparty. Lehman took highly concentrated risks in these two business lines, and, partly as a result of market conditions, ultimately exceeded its risk limits by margins of 70% as to commercial real estate and by 100% as to leveraged loans.[138]

- Lehman's management excluded certain risky principal investments from its stress tests. Although Lehman conducted stress tests on a monthly basis and reported the results of these stress tests periodically to regulators and to its Board of Directors, the stress tests excluded Lehman's commercial real estate investments, its private equity investments, and, for a time, its leveraged loan commitments. Thus, Lehman's management did not have a regular and systematic means of analyzing the amount of catastrophic loss that the firm could suffer from these increasingly large and illiquid investments.[139]

- Lehman did not strictly apply its balance sheet limits, which were designed to contain the overall risk of the firm and maintain the firm's leverage ratio within the range required by the credit rating agencies, but instead decided to exceed those limits. To mitigate the apparent effect of these overages, Lehman used Repo 105 transactions to take assets temporarily off the balance sheet before the ends of reporting periods. (The Repo 105 transactions are discussed in Section III.A.4 of this Report.)[140]

- Lehman's management decided to treat primary firm-wide risk limit – the risk appetite limit – as a "soft" guideline, notwithstanding Lehman's

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[138] Appendix No. 9, comparing risk appetite and VaR usage versus limits.

[139] *See* Section III.A.1.b of this Report.

[140] S*ee id.*

representations to the Securities Exchange Commission ("SEC") and the Board that the risk appetite limit was a meaningful constraint on Lehman's risk-taking.[141] Lehman management's decision not to enforce the risk appetite limit was apparent in several ways:

- Between December 2006 and December 2007, Lehman raised its firm-wide risk appetite limit three times, going from $2.3 to $4.0 billion.[142]

- Between May and August 2007, Lehman omitted some of its largest risks from its risk usage calculation. The primary omitted risk was a $2.3 billion bridge equity position in the Archstone-Smith Real Estate Investment Trust ("Archstone" or "Archstone REIT") real estate transaction, an extraordinarily large and risky commitment. Had Lehman's management promptly included that risk in its usage calculation, it would have been immediately apparent that Lehman was over its risk limits.[143]

- After Lehman did include the Archstone risk in the firm's risk appetite usage, Lehman continued to exceed the limit for several more months. Rather than aggressively reduce Lehman's balance sheet in response to these indicators of excessive risk-taking, Lehman raised its firm-wide risk limit again.[144]

Although these decisions by Lehman's management ultimately proved to be unwise, the Examiner finds insufficient evidence to support a determination that Lehman's senior officers' conduct with respect to risk management was outside the business judgment rule or reckless or irrational.[145]

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[141] *E.g.*, SEC, Lehman Monthly Risk Review Meeting Notes (July 19, 2007), at p. 5 [LBEX-SEC 007363] ("Jeff [Goodman] told us that . . . VaR is just one measure that Lehman uses, and is more of a speed bump/warning sign that a true, hard limit -- that role falls to RA [(i.e. risk appetite)]. [….] He said that Madelyn [Antoncic], Dave [Goldfarb], and the executive committee tend to look more at RA. As an aside, Madelyn came in after Jeff's explanation and gave virtually the same speech"); *see also* Section III.A.1.b of this Report.

[142] *See* Section III.A.1.b of this Report.

[143] *See id.*

[144] *See id.*

[145] *See* Section III.A.1.c of this Report.

Based upon their considerable business experience and successful track record, Lehman's senior managers decided to place a higher priority on increasing profits than on keeping the firm's risk level within the limits arising from its risk management policies and metrics. Lehman's senior managers were confident making business judgments based on their understanding of the markets, and did not feel constrained by the quantitative metrics generated by Lehman's risk management system. These decisions raise questions about the role of risk management in a complex financial institution, but they do not give rise to a colorable claim of the breach of the fiduciary duty of care given the high bar to liability established by Delaware law.

(2) The Examiner Does Not Find Colorable Claims That Lehman's Senior Officers Breached Their Fiduciary Duty to Inform the Board of Directors Concerning the Level of Risk Lehman Had Assumed

The Examiner finds insufficient evidence to support a determination that Lehman's senior managers breached their fiduciary duty of candor, which required them to provide the Board with material reports concerning Lehman's risk and liquidity.[146]

The factual issues relevant to the duty of candor are the same risk management issues relevant to the duty of care. Lehman's officers did not disclose certain

[146] Appendix No. 1, Legal Issues; *In re Amer. Int'l Group, Inc.*, 965 A.2d 763, 806-07 (Del. Ch. 2009) ("In colloquial terms, a fraud on the board has long been a fiduciary violation under our law and typically involves the failure of insiders to come clean to the independent directors about . . . information that the insiders fear will be used by the independent directors to take actions contrary to the insiders' wishes").

information concerning the amount or duration of the firm-wide risk limit overages, their decisions to exceed certain concentration limits, or the limitations in the firm's stress testing. Nor did Lehman's officers disclose that Lehman's originations of Alt-A mortgages – mortgages that were considered riskier than typical prime mortgages but not so risky as to be categorized as "subprime" – were exposing the firm to subprime mortgage risk, even as Lehman was curtailing originations of loans actually denominated as "subprime." Lehman's directors generally said that if such risk management issues were significant and long-lasting, they would have liked to have received more information about them, but would not necessarily have taken action as a result.[147]

However, the Examiner found that Lehman's management did inform the Board, clearly and on more than one occasion, that it was taking increased business risk in order to grow the firm aggressively; that the increased business risk resulted in higher risk usage metrics and ultimately firm-wide risk limit overages; and that market conditions after July 2007 were hampering the firm's liquidity.[148] Lehman's management also informed the Board, accurately, that the subprime mortgage crisis

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[147] Examiner's Interview of Roger S. Berlind, May 8, 2009, at p. 4; Examiner's Interview of Marsha Johnson Evans, May 22, 2009, at p. 6; Examiner's Interview of Roland A. Hernandez, Oct. 2, 2009, at p. 10; Examiner's Interview of John D. Macomber, Sept. 25, 2009, at p. 17; Examiner's Interview of Henry Kaufman, May 19, 2009, at p. 17; Examiner's Interview of Sir Christopher Gent, Oct. 21, 2009, at pp. 14-16; Examiner's Interview of Michael Ainslie, Sept. 22, 2009, at pp. 3-4. For information concerning the Board meetings where these general topics were discussed, the directors' statements to the Examiner about those meetings, and the directors' statements about the materiality of these facts, see Section III.A.1.b of this Report.

[148] Sections III.A.1.b of this Report.

was constricting profitability and that management was tightening origination standards and taking other steps to address that crisis.[149]

These disclosures were not so incomplete as to lead to the conclusion that Lehman's management misled the Board of Directors. Nor did Lehman's officers have a legal duty to disclose additional details to the Board. Lehman's risk limits and controls were designed primarily for management's internal use in making business decisions concerning the core issue faced by any financial institution: what business risks to take and what business risks to decline.[150] While the overall risk management of the firm is an appropriate topic for board consideration, the day-to-day decisions are primarily the responsibility of officers, not directors. [151]

(3) The Examiner Does Not Find Colorable Claims That Lehman's Directors Breached Their Fiduciary Duty by Failing to Monitor Lehman's Risk-Taking Activities

Lehman's corporate charter and related aspects of Delaware law protect its directors from personal liability based upon their business decisions. As a result, the directors cannot be held liable for a breach of the duty of care; rather the directors can be liable for inadequately monitoring Lehman's affairs only if their failure to monitor was so egregious as to rise to the level of a breach of the duty of loyalty or the duty of

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[149] Section III.A.1.b of this Report.

[150] *See* Appendix No. 8, Risk Management Organization and Controls.

[151] *See* 17 C.F.R. §§ 240.15c3-1e & 15c3-4 (2007) (requiring Lehman to submit a comprehensive description of its internal risk management control system to the SEC); NYSE, Inc., Listed Company Manual §303A(7)(c)(iii)(D) & cmt. (2010) (requiring audit committee of board to "discuss policies with respect to risk assessment and risk management" while noting that "it is the job of the CEO and senior management to assess and manage the company's exposure to risk").

good faith. The Delaware courts have called this type of claim – referred to as a *Caremark* claim – "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[152]

The conduct typically evaluated in *Caremark* claims has been the failure to monitor managers' unlawful conduct. In contrast here, a claim that the directors failed to satisfy their duty to monitor the extent of risk assumed by management and its compliance with corporate risk policies would require proof that the directors failed to monitor managers' judgment as to internal procedures that were not legally binding. The business judgment rule applies with particular force to such a claim because the question of how much risk an investment bank can reasonably assume goes to the core of its business.[153]

The Examiner finds insufficient evidence of a breach of fiduciary duty by any Lehman director. The directors received reports concerning Lehman's business and the level and nature of its risk-taking at every Board meeting. Although these reports noted the elevated levels of risk to Lehman's business beginning in late 2006, management informed the directors that the increased risk-taking was part of a deliberate strategy to grow the firm. The directors continued to receive such reports throughout 2007, and were repeatedly informed about developments in the subprime markets and the credit markets generally. Management assured the directors that it was taking prudent steps

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[152] *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996).
[153] *In re Citigroup Inc. S'holder Litig.*, 964 A.2d 106, 126 (Del. Ch. 2009).

to address these risks but that management saw the unfolding crisis as an opportunity to pursue a countercyclical growth strategy. Management's reports to the directors did not contain "red flags" imposing on the directors a duty to inquire further.[154]

Delaware law permits directors to rely on management's reports and immunizes the directors from personal liability when they do so.[155] Consequently, there is insufficient evidence to establish a colorable claim that Lehman's directors breached their duty to monitor Lehman's management of its risks.

* * * * *

Although the Examiner does not find colorable claims against Lehman's senior officers or directors concerning Lehman's risk management, a complete discussion of the facts discovered by the Examiner's investigation of risk management is important in two fundamental respects. First, the Examiner sets out the facts in detail so that the Court and the parties have the basis for the Examiner's conclusion that Lehman management's decisions with respect to risk and its countercyclical growth strategy do not give rise to colorable claims.

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[154] *See, e.g.*, Lehman Brothers Holdings Inc., Minutes of Meeting of the Board of Directors (June 19, 2007) [LBHI_SEC07940_026267]; Lehman, Lehman Board of Directors Materials for June 19, 2007 Board Meeting (June 19, 2007) [LBHI_SEC07940_026214]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 11, 2007) [LBHI_SEC07940_026364]; Lehman, Lehman Board of Directors Materials for Sept. 11, 2007 Board Meeting (Sept. 7, 2007) [LBHI_SEC07940_026282]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Oct. 15, 2007), at p. 6 [LBHI_SEC07940_026407]; Lehman, Lehman Board of Directors Materials for Oct. 15, 2007 Board Meeting (Oct. 11, 2007) [LBHI_SEC07940_026371].

[155] *See* DEL. CODE ANN. tit. 8, § 141(e) (2009).

Second, these facts show how Lehman's approach to risk ultimately created the conditions that led Lehman's top managers to use Repo 105 transactions as discussed in Section III.A.4 of this Report. Lehman's aggressive growth strategy also provides context for several other issues discussed in this Report, including issues concerning Lehman's liquidity pool and asset valuations. Lehman's growth strategy resulted in a dramatic growth of Lehman's balance sheet:

All figures in ($ Billions)	**Q4 06**	**Q1 07**	**Q2 07**	**Q3 07**	**Q4 07**	**Q1 08**	**Q2 08**
Reported Net Assets[156]	268.936	300.797	337.667	357.102	372.959	396.673	327.774

Lehman's net assets increased by almost $128 billion or 48% in a little over a year – from the fourth quarter of 2006 through the first quarter of 2008.

This increase in Lehman's net assets was primarily attributable to the accumulation of potentially illiquid assets that could not easily be sold in a downturn. By one measure, Lehman's holdings of "less liquid assets" more than doubled during the same time period – increasing from $86.9 billion at the end of the fourth quarter of 2006 to $174.6 billion at the end of the first quarter of 2008.[157]

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[156] Lehman defined net assets as total assets excluding: (1) cash and securities segregated and on deposit for regulatory and other purposes; (2) securities received as collateral; (3) securities purchases under agreements to resell; (4) securities borrowed; and (5) identifiable intangible assets and goodwill. Lehman Brothers Holdings Inc., Annual Report for 2007 10-K as of Nov. 30, 2007 (Form 10-K) (filed on Jan. 29, 2008), at p. 63.

[157] Lehman Brothers Holdings Inc., Lehman Brothers Fact Book Q2 2008 (June 13, 2009), at p. 16 [LBHI_SEC07940_593047]. Lehman's public filings include a different quantification of Lehman's less liquid assets. According to these sources, Lehman's less liquid asset holdings almost quadrupled from the third quarter of 2006 until the first quarter of 2008, with a particularly sudden spike in the fourth quarter of 2007. Lehman Brothers Holdings Inc., Quarterly Report as of Aug. 31, 2006 (Form 10-Q) (filed on Oct. 10, 2006), at pp. 16, 71-72 ("LBHI 10-Q (filed Oct 10, 2006)"); Lehman Brothers Holdings Inc.,

To explain the business and risk decisions that led Lehman management down this path, the following portions of this Section of the Report describe:

1. Lehman's decision in 2006 to take more principal risk;
2. The dramatic growth in Lehman's principal investments and in its balance sheet during the first half of Lehman's fiscal 2007, culminating in the acquisition of Archstone, to which Lehman committed in May 2007;
3. It became apparent during 2007 that Lehman's balance sheet had grown too large, and that Lehman had taken on too much risk;
4. How, even after it became apparent that Lehman's growth strategy had exposed the firm to financial peril, Lehman still acted without sufficient urgency to deleverage.

b) Facts

(1) From Moving to Storage: Lehman Expands Its Principal Investments

During the course of 2006, Lehman's management and Board made the deliberate business decision to increase the firm's risk profile generally, and to take more risk specifically with respect to principal investments with the firm's capital. This new strategy was directed by Lehman's highest officers – primarily Fuld, Joseph

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Annual Report for 2006 as of Nov. 30, 2006 (Form 10-K) (filed on Feb. 13, 2007), at pp. 66-67 ("LBHI 2006 10-K"); Lehman Brothers Holdings Inc., Quarterly Report as of Feb. 28, 2007 (Form 10-Q) (filed on Apr. 9, 2007), at pp. 15, 19, 60 ("LBHI 10-Q (filed Apr. 9, 2007)"); Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2007 (Form 10-Q) (filed on July 10, 2007) , at pp. 17, 22, 64 ("LBHI 10-Q (filed July 10, 2007)"); Lehman Brothers Holdings Inc., Quarterly Report as of Aug. 31, 2007 (Form 10-Q) (filed on Oct. 10, 2007), at pp. 18, 23, 67 ("LBHI 10-Q (filed Oct. 10, 2007)"); Lehman Brothers Holdings Inc., Annual Report for 2007 as of Nov. 30, 2007 (Form 10-K) (filed on Jan. 29, 2008), at pp. 61-62, 104 ("LBHI 2007 10-K"); Lehman Brothers Holdings Inc., Quarterly Report as of Feb. 29, 2008 (Form 10-Q) (filed on Apr. 9, 2008), at pp. 21, 27, 55, 71 ("LBHI 10-Q (filed Apr. 9, 2008)"); Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2008 (Form 10-Q) (filed on July 10, 2008), at pp. 26, 29 ("LBHI 10-Q (filed July 10, 2008)"); see also Section III.A.1.b.4 of this Report.

Gregory (Lehman's President and Chief Operating Officer), and Hugh E. (Skip) McGee III (Global Head of Investment Banking) – after significant internal debate.

This Section of the Report describes the principal investment strategy adopted by Lehman in 2006; explains the risks that this strategy posed to the firm; describes how Lehman's risk controls were applied (or not) to the new strategy; and explains the Board's understanding of, and agreement with, the new strategy.

(a) Lehman's Changed Business Strategy

In 2006, Lehman made a significant change in its business strategy from a lower risk brokerage model to a higher risk, capital-intensive banking model. Historically, Lehman described itself as being primarily in the moving business, not the storage business.[158] Lehman, for the most part, did not use its balance sheet to acquire assets for its own investment; rather, Lehman acquired assets – such as commercial and residential real estate mortgages – primarily to move them by securitization or syndication and distribution to third parties.

During 2006, Lehman's management decided to emphasize the storage business – using Lehman's balance sheet to acquire assets for longer-term investment.[159] Fuld believed that other banks were using their balance sheets to make more proprietary investments, that these investments were highly profitable relative to their risk in the

[158] Examiner's Interview of Paul Shotton, June 5, 2009, at p. 12.
[159] *Id.* at p. 2.

then-buoyant economic environment, and that Lehman was missing out on significant opportunities to do the same.[160]

Lehman's management primarily focused on expanding three specific areas of principal investment: commercial real estate; leveraged loans; and private equity.

Commercial real estate investments were considered a strong candidate for expansion because those investments had historically been a strength of the firm.[161] Mark A. Walsh, Lehman's head of the Global Real Estate Group ("GREG"), was one of the most successful and trusted operators at the firm; management believed that Walsh could invest Lehman's capital wisely and could distribute any excess risk to other investors.[162] The firm was even willing to make commercial real estate bridge equity investments – taking potentially riskier equity pieces of real estate investments – on the theory that the bridge equity, though riskier than the debt, could quickly be resold to third parties at a profit.[163] Lehman was well paid for bridge equity in the commercial

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[160] Examiner's Interview of Richard S. Fuld Jr., Sept. 25, 2009, at pp. 10-12 (Fuld said that Lehman expanded into the leveraged lending, bridge equity and principal investing to gain "wallet share." Fuld wanted to use the "80-20 rule" to get the wallet share of Lehman's top clients. The 80-20 rule says that the top 20% of the firm's clients will provide 80% of the firm's earnings.); Examiner's Interview of Jeremy M. Isaacs, Oct. 1, 2009, at p. 6.

[161] Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 3.

[162] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 14; Examiner's Interview of Mark Walsh, Oct. 21, 2009, at pp. 4-5; e-mail from Jeffrey Goodman, Lehman, to Mark A. Walsh, Lehman (Sept. 19, 2006) [LBEX-DOCID 1368068].

[163] Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 6.

real estate business, and management believed that Walsh's distribution network minimized the risk that the firm would be unable to sell it.[164]

The business strategy to expand the leveraged loan business was somewhat different. Lehman's management recognized that leveraged loans in their own right, including the bridge equity components of those transactions, were risky relative to their profitability.[165] But Fuld, Gregory, and McGee in particular believed that if Lehman made loans to private equity sponsors as part of major M&A transactions, Lehman would build long-term client relationships with the sponsors and perhaps with other institutions involved in the transaction.[166] Fuld, Gregory, and McGee believed that every dollar that Lehman made from a leveraged loan would lead to five dollars of follow-on profits in the future.[167]

The firm's aggressive growth strategy was apparent in various firm-wide presentations given by senior management and in certain high-level business and risk-taking decisions made during 2006 and at the outset of the 2007 fiscal year. As David Goldfarb (then Lehman's Global Head of Strategic Partnerships, Principal Investing,

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[164] Lehman, FID Offsite Presentation and Notes (Sept. 28, 2006), at p. 10 [LBEX-DOCID 2042292, 2068495], attached to e-mail from Michael Gelband, Lehman, to Richard S. Fuld, Jr., Lehman, *et al.* (Sept. 26, 2006) [LBEX-DOCID 2384245].

[165] Examiner's Interview of Kentaro Umezaki, June 25, 2009, at pp. 10, 13; Examiner's Interview of Michael Gelband, Aug. 12, 2009, at p. 6; Examiner's Interview of Alex Kirk, Jan. 12, 2010, at p. 6.

[166] Examiner's Interview of Hugh E (Skip) McGee III, Aug. 12, 2009, at pp. 7-8; Examiner's Interview of Joseph Gregory, Nov. 13, 2009, at p. 3; *accord* Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 12.

[167] Examiner's Interview of Joseph Gregory, Nov. 13, 2009, at p. 3; Examiner's Interview of Alex Kirk, Jan. 12, 2010, at p. 7.

and Risk) put it, Lehman was pursuing "13% annual growth" in revenues, and "to support this revenue growth [Lehman was] targeting an even faster increase in the firm's balance sheet, total capital base and risk appetite – each of which [was] projected to increase by 15% per year."[168] Goldfarb noted that Lehman had been "pedal to the metal in growth mode" for the previous two years, but planned to continue that going forward.[169] That year, Fuld and Gelband (then head of FID) also gave presentations in which they discussed Lehman's aggressive growth strategy.[170]

(b) The Increased Risk From Lehman's Changed Business Strategy

The business strategy that Lehman pursued beginning in 2006 was risky in light of the firm's high leverage and small equity base. Commercial real estate investments, leveraged loans and other principal investments consumed more capital, entailed more risk, and were less liquid than Lehman's traditional lines of business.[171]

The lack of liquidity increased the risk to the firm in several ways. Having a large volume of illiquid assets made it much more difficult for the firm to accomplish

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[168] David Goldfarb, Lehman, Global Strategy Offsite Presentation (Mar. 2006), at pp. 30-31 [LBEX-DOCID 1342496], attached to e-mail from Christopher M. O'Meara, Lehman, to Jacqueline Roncagliolo, Lehman (Apr. 3, 2006) [LBEX-DOCID 1357100].

[169] *Id.* at p. 10.

[170] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 11; Lehman, FID Offsite Presentation and Notes (Sept. 28, 2006) [LBEX-DOCID 2042292, 2068495], attached to e-mail from Michael Gelband, Lehman, to Richard S. Fuld, Jr., Lehman, *et al.* (Sept. 26, 2006) [LBEX-DOCID 2384245].

[171] Less liquid investments were "Level 3." Level 1 assets have readily available markets to provide prices and liquidity, such as exchange-traded equities. Level 2 assets have observable events to provide pricing, such as comparable sales. Level 3 assets have no readily available pricing mechanism and therefore are less liquid than Level 1 and 2 assets.

three important goals in a difficult financial environment: to raise cash; to hedge risks; or to sell assets to reduce the leverage in its balance sheet.

When a financial institution suffers losses, it often needs to raise cash to fund itself.[172] But illiquid investments are difficult to use for that purpose because they cannot be sold quickly.[173] When illiquid investments are sold in a difficult market, the seller often takes a much larger loss on the sale than on a liquid asset.[174] Similarly, illiquid assets are more difficult to use as collateral for borrowing.[175] They often cannot be used in the repo market, which was a crucial source of funding for investment banks such as Lehman.[176] If a borrower pledges illiquid assets as collateral, there will be a larger "haircut," that is, a discount from the market value of the pledged collateral, than for liquid assets.[177]

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[172] *See* Lehman, Capital Adequacy Review (Sept. 11, 2008), at p. 1 [LBEX-DOCID 012124].

[173] *See* Tobias Adrian, Federal Reserve Bank of New York, and Hyun Song Shin, Princeton University, *Financial Intermediaries, Financial Stability and Monetary Policy* (Aug. 5, 2008), at p. 13.

[174] Martin Oehmke, *Putting the Brakes on Collateral Liquidations*, Columbia Business School Ideas at Work, July 28, 2009, http://www4.gsb.columbia.edu/ideasatwork/feature/731624/Putting+the+Brakes+on+Collateral+Liquidations (last visited on Feb. 1, 2010).

[175] *Id.*; *see also* Moody's Investor Services, Press Release: Moody's Text: Changes Lehman Outlook From Stable To Negative (June 9, 2008).

[176] Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 10; Lehman, Accounting Policy Manual (Sept. 9, 2006) [LBEX-DOCID 3213287], attached to e-mail from Marie Stewart, Lehman, to Martin Kelly, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223385].

[177] *See* Lehman, Update on Risk, Liquidity and Capital Adequacy Presentation (Aug. 17, 2007), at p. 48 [LBEX-DOCID 2031705] (Lehman's funding framework took account of the inability to fund illiquid assets through the repo market; therefore the firm always funded illiquid holdings with long-term assets and liabilities).

Financial institutions generally engage in transactions designed to hedge their risks.[178] But illiquid investments are typically more difficult to hedge.[179] In fact, Lehman decided not to try to hedge its principal investment risks to the same extent as its other exposures for precisely this reason – its senior officers believed that hedges on these investments would not work and could even backfire, aggravating instead of mitigating Lehman's losses in a downturn.[180] As a result, Lehman acquired a large volume of un-hedged assets that ultimately caused Lehman significant losses.[181]

In a difficult financial environment, it also is important for financial institutions to be able to reduce their leverage and risk profile.[182] The more highly leveraged the institution is, the more important it is for the institution to begin reducing leverage as soon as market conditions turn against it. But if the need to reduce leverage forces the sale of illiquid assets at a loss, it has a double impact; in addition to the loss, the

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[178] *Cf.* Examiner's Interview of Alex Kirk, Jan. 12, 2010, at p. 9; Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at pp. 3, 13.

[179] *Cf.* Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at pp. 3, 13.

[180] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at pp. 3, 13; Examiner's Interview of Roger Berlind, May 8, 2009, at p. 7; Examiner's Interview of Fred S. Orlan, Sept. 21, 2009, at p. 6; Examiner's Interview of Paul Shotton, June 5, 2009, at pp. 7-8; Examiner's Interview of Kentaro Umezaki, June 25, 2009, at p. 17; Lehman, 2nd Quarter 2007 Review: Credit Facilitation Group (June 2007), at pp. 1-2 [LBEX-DOCID 514908]; Lehman, Leveraged Finance Risk Presentation (June 2007), at p. 12 [LBEX-DOCID 3283752]; e-mail from Christopher M. O'Meara, Lehman, to Ian T. Lowitt, Lehman (Sept. 27, 2007) [LBEX-DOCID 193218]; e-mail from Jeffrey Goodman, Lehman, to Christopher M. O'Meara, Lehman (Oct. 1, 2007) [LBEX-DOCID 201866]; e-mail from Jeffrey Goodman, Lehman, to Paul Shotton, Lehman, *et al.* (Mar. 19, 2008) [LBEX-DOCID 335666]; Andrew J. Morton, Lehman, Hedging Fixed Income's Portfolio Presentation (Aug. 8, 2008), at pp. 2, 3, 8, 11 [LBEX-DOCID 011869], attached to e-mail from Thomas Odenthal, Lehman, to Andrew J. Morton, Lehman, *et al.* (Aug. 6, 2008) [LBEX-DOCID 069824].

[181] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at pp. 3, 13; Examiner's Interview of Paul Shotton, June 5, 2009, at pp. 7-8.

[182] *Cf.* Examiner's Interview of Treasury Secretary Timothy F. Geithner, Nov. 24, 2009, at pp. 7-8.

perception can be that there is "air" in the valuation of the other illiquid assets that remain on the balance sheet, exacerbating the risk of a loss of confidence in the firm's future.[183]

During the declining market of 2007-08, Lehman suffered from all these problems. Lehman had difficulty selling "sticky" assets and was unable to reduce its balance sheet quickly through typical means. Instead, Lehman expanded the volume of Repo 105 transactions that misleadingly and temporarily reduced its balance sheet solely for the purpose of the firm's public financial reports.[184]

(c) Application of Risk Controls to Changed Business Strategy

Lehman's principal investments in illiquid assets presented new and increased forms of risk to the firm, but Lehman's management did not recalibrate the firm's pre-existing risk controls to ensure that its new investments were properly evaluated, monitored and limited. If anything, to facilitate the new investment strategy, Lehman's management relaxed its controls in several ultimately fateful ways, discussed below. Lehman's senior officers took this tack notwithstanding their periodic statements to

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[183] *Id.*; *see* Moody's Investor Services, Press Release: Moody's Text: Changes Lehman Outlook From Stable To Negative (June 9, 2008).

[184] See Section III.A.4 of this Report.

Lehman's Board, the rating agencies, and the SEC that its risk management system was a rigorous independent check on the risks undertaken by its business lines.[185]

(i) Stress Testing Exclusions

One of Lehman's major risk controls was stress testing. Historically, Lehman's stress testing had not been designed to encompass the risks posed to the firm by principal investments in real estate and private equity, because those positions previously made up a small portion of Lehman's portfolio.[186] Lehman did not revise its stress testing to address its evolving business strategy.

Lehman was required by the SEC[187] to conduct some form of regular stress testing on its portfolio to quantify the catastrophic loss it could suffer over a defined period of time.[188] Lehman ran a series of stress tests based on 13 or 14 different scenarios.[189] Some of the scenarios were historical events, such as the 1987 stock market

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[185] Madelyn Antoncic, Risk Management Presentation to Standard & Poor's [Draft] (Aug. 17, 2007), at p. 5 [LBEX-DOCID 342851] ("Global Risk Management Division is independent of the trading areas"), attached to e-mail from Lisa Rathgeber, Lehman, to Jeffrey Goodman, Lehman, *et al*. (Aug. 15, 2007) [LBEX-DOCID 305205]; SEC Division of Market Regulation, Lehman Brothers - Consolidated Supervised Entity Market and Credit Risk Review (June 2005), at pp. 3-4 [LBEX-DOCID 2125011] (saying Risk Management was "independent of Lehman's business units"), attached to e-mail from Michelle Danis, SEC, to David Oman, Lehman, *et al.* (Apr. 21, 2006) [LBEX-DOCID 2068428]; Lehman, Risk Update Presentation to Lehman Board of Directors (July 18, 2006), at pp. 5, 8 [LBEX-DOCID 2125293] (saying Lehman's risk approach "applie[d] analytical rigor overlaid with sound practical judgment"; Lehman, Risk Management Update Presentation to Lehman Board of Directors (Apr. 15, 2008), at pp. 1-2 [LBHI_SEC07940_027909-29] (saying Lehman "provided an independent view of risk").

[186] Examiner's Interview of Paul Shotton, Oct. 16, 2009, at p. 2.

[187] *See infra*, Section III.A.6.

[188] Examiner's Interview of the Securities and Exchange Commission, Aug. 24, 2009, at p. 13.

[189] *See, e.g.*, Lehman, Stress Test Report for March 31, 2006 [LBEX-DOCID 2078161], attached to e-mail from Sandeep Garg, Lehman, to Patrick Whalen, Lehman, *et al.* (Apr. 24, 2006) [LBEX-DOCID 2118206]; Lehman, Stress Test Report for February 28, 2007 [LBEX-DOCID 632363], attached to e-mail from Melda

crash or the 1998 Russian financial crisis, while other scenarios were hypothesized by Lehman's risk managers.[190] Lehman's management represented to its external constituents that regular and comprehensive stress tests "were performed to evaluate the potential P&L impact on the Firm's portfolio of abnormal yet plausible market conditions."[191] Stress testing was designed to measure "tail risk" – a one in ten year type event.

When Lehman first adopted stress testing in about 2005, it applied the testing only to its tradable instruments such as stocks, bonds, and other securities; it did not include its un-traded assets such as its commercial real estate or private equity investments.[192] Because these assets did not trade freely, they were not considered susceptible to stress testing over a short-term scenario.[193] And since Lehman did not then have significant investments in these areas, excluding them from the stress testing

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Elagoz, Lehman, to Paul Shotton, Lehman, *et al.* (Mar. 9, 2007) [LBEX-DOCID 630356]; Stress Test Report for October 31, 2007 [LBEX-DOCID 632432], attached to e-mail from Jeffrey Goodman, Lehman, to Cherie Gooley, Lehman (Dec. 19, 2007) [LBEX-DOCID 665513]; Stress Test Report for Apr. 30, 2008 [LBEX-DOCID 3296803], attached to e-mail from Mark Weber, Lehman, to Cherie Gooley, Lehman, *et al.* (May 28, 2008) [LBEX-DOCID 3302270].

[190] Lehman, Risk Management Presentation to Fitch (Apr. 7, 2006), at p. 47 [LBEX-DOCID 691768]; Lehman, Risk, Liquidity, Capital, and Balance Sheet Update Presentation to Finance and Risk Committee of Lehman Board of Directors (Sept. 11, 2007), at p. 28 [LBEX-AM 067167].

[191] *E.g.*, Madelyn Antoncic, Lehman, Risk Management Presentation to Standard & Poor's [Draft] (Aug. 17, 2007), at pp. 38-39 [LBEX-DOCID 342851], attached to e-mail from Lisa Rathgeber, Lehman, to Jeffrey Goodman, Lehman, *et al*. (Aug. 15, 2007) [LBEX-DOCID 305205].

[192] Examiner's Interview of Paul Shotton, Oct. 16, 2009, at pp. 5-6; Examiner's Interview of Jeffrey Goodman, Aug. 28, 2009.

[193] Examiner's Interview of Jeffrey Goodman, Aug. 28, 2009.

did not undermine the usefulness of the results.[194] The SEC was aware of this exclusion.[195]

At various points in 2006 and 2007, Lehman's risk managers considered whether to include principal investments in Lehman's stress testing.[196] An internal audit advised that Lehman "address the main risks in the Firm's portfolio," including "illiquidity" and "concentration risk."[197] But Lehman did not take significant steps to include these private equity positions in the stress testing until 2008, even though these investments became an increasingly large portion of Lehman's risk profile.[198]

Until late 2007, Lehman's stress testing also excluded its leveraged loan commitments – *i.e.*, the leveraged loans that Lehman had committed to fund in the future, but had not yet closed.[199] This exclusion appears to have been inadvertent.[200]

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[194] Examiner's Interview of Paul Shotton, Oct. 16, 2009, at pp. 5-6.

[195] Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at p. 12; Examiner's Interview of Paul Shotton, Oct. 16, 2009, at p. 6.

[196] E-mail from Marc Henn, Lehman, to Maria Turner, Lehman, (Mar. 2, 2007) [LBEX-DOCID 264992]; e-mail from Melda Elagoz, Lehman, to Jeffrey Goodman, Lehman, *et al*. (June 11, 2007) [LBEX-DOCID 384503]; Lehman, 2006 Competitor Analysis - Key Considerations (Dec. 1, 2006) [LBEX-DOCID 2110930], attached to e-mail from Mirey Nadler, Lehman, to Fred Steinberg, Lehman (Dec. 1, 2006) [LBEX-DOCID 2042308]; e-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman (May 17, 2006) [LBEX-DOCID 1342418]; e-mail from James Ballentine, Lehman, to Michael Gelband, Lehman, *et al*. (Jan. 4, 2007) [LBEX-DOCID 384818].

[197] Lehman, Internal VaR Audit Report [Draft] (Feb. 26, 2007), at p. 3 [LBEX-DOCID 232917], attached to e-mail from Lisa Rathgeber, Lehman, to Paul Shotton, Lehman (Feb. 26, 2007) [LBEX-DOCID 232916].

[198] Examiner's Interview of Christopher M. O'Meara, Aug. 14, 2009, at p. 25.

[199] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at pp. 10-11; Examiner's Interview of Paul Shotton, Oct. 16, 2009, at p. 4; e-mail from Melda Elagoz, Lehman, to Jeffery Goodman, Lehman (July 16, 2007) [LBEX-DOCID 385103]; e-mail from Jeffery Goodman, Lehman, to Stephen Lax, Lehman, *et al.* (Nov. 14, 2007) [LBEX-DOCID 297400].

[200] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at pp. 10-11; Examiner's Interview of Paul Shotton, Oct. 16, 2009, at p. 4.

Because Lehman's stress testing did not include its real estate investments, its private equity investments or, during a crucial time period, its leveraged loan commitments, Lehman's management pursued its transition from the moving business to the storage business without the benefit of regular stress testing on the primary business lines that were the subject of this strategic change. For example, as described below, Lehman entered into a series of large and risky commercial real estate transactions in the first half of 2007 without stress testing the particular transactions and without conducting regular stress testing on Lehman's aggregate commercial real estate book.[201]

This exclusion was significant. Experimental stress tests conducted in 2008 showed that a large proportion of Lehman's tail risk – perhaps even a large majority of its overall tail risk – lay with the businesses that were previously excluded from the stress testing. One stress test posited maximum potential losses of $9.4 billion, including $7.4 billion in losses on the previously excluded real estate and private equity positions, and only $2 billion on the previously included trading positions.[202] Another stress test showed total losses of $13.4 billion, of which $2.5 billion was attributable to

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[201] *See* Section III.A.1.b of this Report.

[202] Lehman, Stress Test Report (June 30, 2008), at p. 3 [LBEX-DOCID 3326829], attached to e-mail from Nancy Malik, Lehman, to Paul Shotton, Lehman, *et al*. (June 30, 2008) [LBEX-DOCID 3301915]; Lehman, Private Equity and Real Estate Stresses, Global Market Risk Management presentation (June 30, 2008), at pp. 3-4 [LBEX-DOCID 3301916] attached to e-mail from Nancy Malik, Lehman, to Paul Shotton, Lehman, *et al*. (June 30, 2008) [LBEX-DOCID 3301915].

the firm's included positions, and $10.9 billion was attributable to the excluded positions.[203]

But these stress tests were conducted long after these assets had been acquired, and they were never shared with Lehman's senior management.[204] For a more detailed discussion of Lehman's stress testing, see Appendix 8, Risk Management Organization and Controls.

(ii) Risk Appetite Limit Increase For Fiscal 2007

Lehman had a series of "risk appetite limits" that it considered the "center of its approach to risk."[205] Risk appetite was a measure that aggregated the market risk, credit risk, and event risk faced by Lehman.[206] Lehman had an elaborate set of procedures designed to calculate the "risk appetite usage" in each of its business lines, each of its divisions, and for the firm as a whole.[207] These risk appetite usage figures were calculated every day.[208]

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[203] Lehman, Stress Test Report (June 30, 2008), at p. 1 [LBEX-DOCID 384227] attached to e-mail from Nancy Malik, Lehman, to Paul Shotton, Lehman, *et al*. (Sept. 2, 2008) [LBEX-DOCID 385413].

[204] Examiner's Interview of Mark Weber, Aug. 11, 2009, at p. 14; Examiner's Interview of Christopher M. O'Meara, Sept. 23, 2009, at p. 19.

[205] *See*, *e.g.*, Jared Pedowitz, BMRM-Market Risk Management Walkthrough Template (Nov. 30, 2007), at p. 9 [EY-LE-LBHI-KEYPERS 1015089]; Madelyn Antoncic, Lehman, Risk Management Presentation to Standard & Poor's [Draft] (Aug. 17, 2007), at p. 23 [LBEX-DOCID 342851], attached to e-mail from Lisa Rathgeber, Lehman, to Jeffrey Goodman, Lehman, *et al.* (Aug. 15, 2007) [LBEX-DOCID 305205].

[206] Madelyn Antoncic, Lehman, Risk Management Presentation to Standard & Poor's [Draft] (Aug. 17, 2007), at p. 21 [LBEX-DOCID 342851], attached to e-mail from Lisa Rathgeber, Lehman, to Jeffrey Goodman, Lehman, *et al*. (Aug. 15, 2007) [LBEX-DOCID 305205].

[207] SEC Division of Market Regulation, Lehman Brothers - Consolidated Supervised Entity Market and Credit Risk Review (2005), at pp. 4-5 [LBEX-DOCID 2125011].

[208] *See*, *e.g.*, e-mail from Jenny Peng, Lehman, to David Goldfarb, Lehman, *et al*. (Oct. 12, 2007) [LBEX-DOCID 152049] (containing summary "Daily Risk Appetite and VaR Report" for Oct. 10, 2007), and

At the beginning of each year, Lehman set numerical limits on the risk appetite usage it was willing to take for each such business unit and for the firm as a whole.[209] Management presented the firm-wide limit to the Board.[210]

Under Lehman's limit policy, lower-level limits applicable to a single business line or geographic area were relatively "soft" and could be exceeded based on appropriate authority.[211] Lehman's higher-level limits were "harder" and required greater authorization if they were exceeded.[212] The firm-wide risk appetite limit was the "hardest" of all, and if it was exceeded, the "Risk Committee" of the firm was required to consider the proper course of action to take.[213] The Risk Committee was composed of the Executive Committee of the firm, the Chief Risk Officer ("CRO"), and the Chief Financial Officer ("CFO"). While one witness said that the only permissible reaction to

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attached spreadsheet (Oct. 12, 2007) [LBEX-DOCID 150128] (containing daily risk appetite report, global risk appetite report organized by risk type, and daily VaR report).

[209] SEC Division of Market Regulation, Lehman Brothers - Consolidated Supervised Entity Market and Credit Risk Review (2005), at pp. 4-5 [LBEX-DOCID 2125011]. *See* Appendix 8, Risk Management Organization and Controls (discussing risk appetite limits). Risk appetite measured the amount Lehman could lose in a give year and still achieve an acceptable level of net profit.

[210] It is not clear whether the presentation was for ratification and approval or simply for information. *See e.g.*, Lehman, 2008 Financial Plan Summary Presentation to Lehman Board of Directors (June 29, 2008), at p. 11 [LBHI_SEC07940_027374].

[211] Lehman, Market Risk Management Limit Policy Manual (Oct. 2006), at p. 2 [LBHI_SEC07940_767665), attached to e-mail from Christopher M. O'Meara to Kristi Michelle Reynolds (Apr. 7, 2008) [LBHI_SEC07940_767661].

[212] Lehman Brothers Global Risk Management, Second Quarter 2008 Report (July 21, 2008), at p. 29 [LBEX-DOCID 738522], attached to e-mail from Elizabeth Agosto, Lehman, to Jeffrey Goodman, Lehman, *et al.* (July 21, 2008) [LBEX-DOCID 670132].

[213] *E.g.*, SEC, Lehman Monthly Risk Review Meeting Notes (July 19, 2007), at p. 5 [LBEX-SEC 007363]; SEC Division of Market Regulation, Lehman Brothers - Consolidated Supervised Entity Market and Credit Risk Review (2005), at p. 6 [LBEX-DOCID 2125011].

exceeding the firm-wide limit was immediately reducing the risk faced by the firm,[214] most Lehman personnel said that senior management could cure a limit excess by granting a temporary reprieve from the limit or by increasing the limit.[215] As with the stress tests, management described the risk appetite limits to regulators, rating agencies and the Board as a meaningful control that Lehman used to manage its risk-taking.[216]

At the end of 2006, Lehman dramatically increased its risk appetite limits applicable to fiscal 2007. The firm-wide limit increased from $2.3 billion to $3.3 billion, and subsidiary limits also increased significantly, particularly insofar as the principal investing businesses were concerned.[217]

These increases in the risk appetite limits were somewhat controversial. The CRO at the time, Madelyn Antoncic, argued for a significantly lower increase to $2.6 or $2.7 billion, and the much higher $3.3 billion figure was apparently the result of a

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[214] Examiner's Interview of Kentaro Umezaki, June 25, 2009, at p. 5.

[215] *E.g.*, Examiner's Interview of Madelyn Antoncic, Oct. 6, 2009, at p. 7; Examiner's Interview with David Goldfarb, Sept. 21, 2009, at p. 5; Examiner's Interview of Paul Shotton, June 5, 2009, at pp. 10-11 (saying that the firm-wide risk appetite limit was a "hard" limit, the breach of which had to be cured by either reducing the firm's overall risk or raising the limit).

[216] Madelyn Antoncic, Risk Management Presentation to Standard & Poor's [Draft] (Aug. 17, 2007), at p. 23 [LBEX-DOCID 342851], attached to e-mail from Lisa Rathgeber, Lehman, to Jeffrey Goodman, Lehman, *et al*. (Aug. 15, 2007) [LBEX-DOCID 305205]; SEC Division of Market Regulation, Lehman Brothers - Consolidated Supervised Entity Market and Credit Risk Review (June 2005), at pp. 4-5 [LBEX-DOCID 2125011], attached to e-mail from Michelle Danis, SEC, to David Oman, Lehman, *et al.* (Apr. 21, 2006) [LBEX-DOCID 2068428]; Lehman, Risk Update Presentation to Lehman Board of Directors (July 18, 2007), at pp. 11-12 [LBEX-DOCID 2125293].

[217] Lehman Brothers, 2007 Risk Appetite Limit (Jan. 7, 2007), at p. 1 [LBEX-DOCID 158938], attachment to e-mail from Robert Azerad, Lehman, to Madelyn Antoncic, Lehman (Jan. 11, 2007) [LBEX-DOCID 158331].

compromise with other senior managers.[218] Moreover, to justify the increased limit amount, Lehman changed the way that it calculated the limit; had Lehman used the same method to calculate the 2007 limit that it had used to calculate the 2006 limit, the 2007 limit would have been several hundred million dollars lower.[219]

Increasing the firm-wide limit to $3.3 billion facilitated a rapid expansion of the firm's risk profile between 2006 and 2007. As described below, within the first few months of fiscal 2007, Lehman quickly used the full amount of the new $3.3 billion risk appetite limit – and then some. In late 2007 and early 2008, Lehman relaxed its risk appetite limits in several other ways, which are described below. For a more detailed discussion of Lehman's risk appetite limits, *see* Appendix 8, Risk Management Organization and Controls.

(iii) Decision Not To Enforce Single Transaction Limit

In 2006, to facilitate the planned expansion of the leveraged loan business, Lehman's Executive Committee decided to be more flexible with respect to the firm's single transaction limit.[220] The single transaction limit was actually two limits – one limit applicable to the notional amount of the expected leveraged loan and a second

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[218] Examiner's Interview of Madelyn Antoncic, Mar. 27, 2009, at p. 13; e-mail from David Goldfarb, Lehman, to Madelyn Antoncic, Lehman, *et al.* (Nov. 2, 2006) [LBEX-DOCID 2125677]; e-mail from Madelyn Antoncic, Lehman, to Christopher M. O'Meara, Lehman (Nov. 2, 2006) [LBEX-DOCID 2125679]; e-mail from Christopher M. O'Meara, Lehman, to Madelyn Antoncic, Lehman (Nov. 2, 2006) [LBEX-DOCID 2125680].

[219] Lehman, 2007 Financial Plan Presentation to Finance and Risk Committee of the Board of Directors (Jan. 30, 2007), at pp. 21-22 [LBEX-AM 067099].

[220] Examiner's Interview of Alex Kirk, Jan. 12, 2010, at pp. 7-8.

limit applicable to a calculated amount that Lehman was at risk of losing on the leveraged loan. The limits were partly a function of Lehman's equity. Lehman had previously agreed with the rating agencies that it would adopt a single transaction limit akin to limits previously adopted by commercial banks.[221]

Although Lehman's Executive Committee always retained the freedom to waive the single transaction limit as to any individual transaction, Lehman informed its external constituents that this prerogative would be exercised only in "rare circumstances."[222]

In late 2006, Lehman's management decided not to enforce the single transaction limit because it had cost Lehman significant opportunities.[223] Because Lehman had a dramatically smaller equity base than its commercial banking competitors, and a somewhat smaller equity base even than its investment banking competitors, Lehman had a lower single transaction limit than its competitors, which forced it to forgo or limit its participation in a number of big deals.[224] Lehman's management decided that

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[221] Appendix 8, Risk Management Organization and Controls.

[222] Madelyn Antoncic, Lehman, "Standard" Risk Management Presentation (Undated), at p. 21 [LBEX-DOCID 194031], attached to e-mail from Paul Shotton, Lehman, to Christopher M. O'Meara, Lehman (Feb. 20, 2008) [LBEX-DOCID 214223]; Madelyn Antoncic, Lehman, "Standard" Risk Management Presentation, at p. 21 [LBEX-DOCID 194031].

[223] Examiner's Interview of Alex Kirk, Jan. 12, 2010, at pp. 7-8; Lehman, Appendix to Financial Sponsors Strategies (Including Lending Capacity Solutions) Presentation to the Executive Committee (Aug. 3, 2006), at p. 6 [LBEX-DOCID 1343776], attached to e-mail from Blair Sieff, Lehman, to Madelyn Antoncic, Lehman, *et al.* (Aug. 2, 2006) [LBEX-DOCID 1360977].

[224] Lehman, Appendix to Financial Sponsors Strategies (including Lending Capacity Solutions) Presentation to the Executive Committee (Aug. 3, 2006), at pp. 3, 6 [LBEX-DOCID 1343776], attached to e-mail from Blair Sieff, Lehman, to Madelyn Antoncic, Lehman, *et al.* (Aug. 2, 2006) [LBEX-DOCID

in the future, it would participate in such deals without regard to the single transaction limit.[225] Moreover, Lehman did not apply the single transaction limit to its commercial real estate deals, even though some of its risk managers advocated for this broader application of the limit.[226]

Like the decision to increase the firm-wide risk appetite limit, the decision not to enforce the single transaction limit was controversial within Lehman's management. Alex Kirk, then head of Lehman's Credit Business, had primary responsibility for the leveraged loan business, thought that the single transaction limit was an important method of limiting the firm's risk on its leveraged loans.[227] Antoncic also thought that the firm should continue to abide by the single transaction limit in part because the substantive terms of the leveraged loans were increasingly lopsided in favor of the private equity sponsors and unfavorable for the lending banks.[228] Although Antoncic

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1360977]; Lehman, Financial Sponsors Strategies (including Lending Capacity Solutions) Presentation to the Executive Committee (Aug. 3, 2006), at pp. 10-11 (LBEX-DOCID 1343775], attached to e-mail from Blair Sieff, Lehman, to Madelyn Antoncic, Lehman, *et al.* (Aug. 2, 2006) ([LBEX-DOICD 1360977].

[225] E-mail from Joe Li, Lehman, to Paul Mitrokostas, Lehman (Aug. 30, 2007) [LBEX-DOCID 2547330]; Joe Li, Lehman, STL Backtesting Excel Spreadsheet (July 25, 2007) [LBEX-DOCID 2506462], attached to e-mail from Joe Li, Lehman, to Fred S. Orlan, Lehman, *et al.* (July 25, 2007) [LBEX-DOCID 2563167]; *accord* Examiner's Interview of Alex Kirk, Jan. 12, 2010, at pp. 7-8.

[226] *Cf.* Examiner's Interview of Madelyn Antoncic, Oct. 6, 2009, at p. 12; e-mail from Jeffrey Goodman, Lehman, to Zev Klasewitz, Lehman (Jan. 17, 2007) [LBEX-DOCID 794864]; e-mail from Jeffrey Goodman, Lehman, to Zev Klasewitz, Lehman (Feb. 12, 2007) [LBEX-DOCID 794879].

[227] Examiner's Interview of Alex Kirk, Jan. 12, 2010, at pp. 7-8.

[228] Examiner's Interview of Madelyn Antoncic, Mar. 27, 2009, at p. 9.

thought the firm should abide by the single transaction limit,[229] Kirk and Antoncic were overruled by Fuld, Gregory, and McGee.[230]

(d) The Board's Approval of Lehman's Growth Strategy

Lehman's Board fully embraced Lehman's growth strategy. In a January 2007 Board meeting, the directors were informed of the large increase in the risk appetite limit for fiscal 2007, and of the firm's intention to expand its footprint in principal investments, and they agreed with Lehman's senior officers that Lehman needed to take more risk in order to compete.[231] All of the directors told the Examiner that they agreed with Lehman's growth strategy at the time it was undertaken.[232.]

Although the periodic materials that the Finance and Risk Committee[233] received about the firm's stress testing disclosed that tests were conducted on the firm's "trading portfolio" and "We subject both our trading and our counterparty portfolio to stress

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[229] *Id.*; Examiner's Interview of Alex Kirk, Jan. 12, 2010, at pp. 6-8.

[230] Examiner's Interview of Alex Kirk, Jan. 12, 2010, at pp. 7-8; Examiner's Interview of Madelyn Antoncic, Mar. 27, 2009, at p. 9.

[231] Examiner's Interview of Sir. Christopher Gent, Oct. 21, 2009, at pp. 7-8; Examiner's Interview of Thomas Cruikshank, Oct. 8, 2009, at pp. 2-3; Examiner's Interview of Roland A. Hernandez, Oct. 2, 2009; Examiner's Interview of John D. Macomber, Sept. 28, 2009, at p. 12; Examiner's Interview of Michael L. Ainslie, Sept. 22, 2009, at p. 8; Examiner's Interview of Marsha Johnson Evans, May 22, 2009, at p. 12; Examiner's Interview of Dr. Henry Kaufman, May 19, 2009, at pp. 7-8, 14; Examiner's Interview of Roger Berlind, May 8, 2009, at pp. 6-7; Examiner's Interview of John F. Akers, Apr. 22, 2009, at p. 9.

[232] *Id.*

[233] The Board had a Finance and Risk Committee that generally met twice a year and received more detailed information than the full Board on these topics. Dr. Henry Kaufman, former managing director of Salmon Brothers, was the head of the Finance and Risk Committee.

tests,"[234] management did not inform the Finance and Risk Committee that many of the firm's commercial real estate and private equity investments were excluded from the firm's stress tests.[235]

The omission was noted on January 29, 2008, when the Finance and Risk Committee received materials stating that "real estate owned and private equity" were excluded from the stress testing.[236] No member of the Board who was asked by the Examiner about the issue recalled noticing this revised disclosure, and no member recalled Lehman's officers explaining it or otherwise bringing it to the attention of the Board.[237] Some directors were not concerned about the exclusion of these investments from the stress testing, saying that the exclusions appeared reasonable at the time.[238]

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[234] Lehman Brothers Holdings Inc., Risk, Liquidity, Capital and Balance Sheet Update Presentation to Finance and Risk Committee of Lehman Board of Directors (Sept. 11, 2007), at p. 28 [LBEX-AM 067167-233].

[235] Examiner's Interview of Paul Shotton, Oct. 16, 2009, at p. 5; *see* also Lehman Brothers Holdings Inc., Risk, Liquidity, Capital and Balance Sheet Update Presentation to Finance and Risk Committee of Lehman Board of Directors (Sept. 11, 2007), at p. 29 [LBEX-AM 067167-233].

[236] Lehman, 2008 Financial Plan Presentation to Lehman Finance and Risk Committee of the Board of Directors (Jan. 29, 2008), at p. 19 [LBHI_SEC 07940_068559].

[237] *Cf.* Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 7; Examiner's Interview of Roland A. Hernandez, Oct. 2, 2009; Examiner's Interview of John D. Macomber, Sept. 25, 2009, at p. 4; Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at p. 11; *contra* Examiner's Interview of Christopher M. O'Meara, Sept. 23, 2009, at p. 18.

[238] Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at pp. 2-3, 10-11 ("Despite [these] exclusions, [Kaufman] was not concerned with the result to the stress tests."); Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 7 (saying the exclusion "looked reasonable and that it would be hard for [Grundhofer] to believe Lehman was not following the standard for conducting stress tests."); *see* Examiner's Interview of Sir Christopher Gent, Oct. 21, 2009, at pp. 13-14 (saying he did not find stress tests helpful and thought some assets might be excluded).

However, one director said that if the exclusion was material, he would have wanted to know about it.[239]

The Board also was not told that Lehman's management had decided not to apply the single transaction limits to its leveraged loans. Although the Examiner has found no evidence that before 2008, Lehman's management had represented to the Board that any single transaction limit had been adopted,[240] some directors said that concentration limits were important protections for the firm, and they would have wanted to know about significant excesses above concentration limits.[241]

In sum, during the second half of 2006, Lehman began to pursue a more aggressive principal investment strategy, and it relaxed several risk limits to facilitate that strategy.

(2) Lehman Doubles Down: Lehman Continues Its Growth Strategy Despite the Onset of the Subprime Crisis

Late in the second half of 2006, the first signs of weakness in the subprime residential mortgage market were apparent.[242] For example, delinquency rates on subprime loans, which had hovered near 10% in 2004 and 2005, reached 13% by the end

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[239] Examiner's Interview of John D. Macomber, Sept. 25, 2009, at p. 11.

[240] *See, e.g.*, Lehman, Risk Update Presentation to Lehman Board of Directors (July 18, 2006) [LBEX-WGM 986315] (not mentioning single transaction limit); *but see* Lehman, Risk Management Update Presentation to Lehman Board of Directors (Apr. 15, 2008), at p. 1 [LBHI_SEC07940_027909] ("We have an overall Risk Appetite limit which is supplemented by . . . single transaction, country and other concentration limits.").

[241] Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at p. 6; Examiner's Interview of John Macomber, Sept. 25, 2009, at pp. 6, 17.

[242] Bank for International Settlements, 77th Annual Report (June 24, 2007), at p. 109.

of 2006.[243] In addition, after peaking in mid-2006, housing prices began to decline steeply.[244] This decline in prices threatened the subprime mortgage market because the market's health depended on continued price appreciation in housing.[245] As a result, beginning in November 2006, significant widening of spreads on non-investment grade tranches of home equity loans was evident.[246] By the spring of 2007, the crisis had advanced to the point that several major subprime lenders had gone bankrupt or been acquired by stronger partners.[247]

Lehman's management saw the subprime crisis as an opportunity to pick up ground on its competitors.[248] Lehman's management adopted a "countercyclical growth

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[243] *Id.*

[244] Standard & Poor's, Press Release: Home Price Declines Worsen As We Enter the Fourth Quarter of 2008 According to the S&P/Case-Shiller Home Price Indices (Dec. 30, 2008), at p. 1 (*available at* http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice_Release_123062.pdf); *see also* Vikas Bajaj, *Home Prices Fall in More Than Half of Nation's Biggest Markets*, N.Y. Times, Feb. 16, 2007, at p. C1.

[245] Gary Gorton, *Information, Liquidity and the (Ongoing) Panic of 2007* 2 (NIBR Working Paper No. w14649, 2009); *see also* Gary Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo* 5 (Yale Int'l Center for Finance, Working Paper No. 09-14, 2009).

[246] Bank for International Settlements, 77th Annual Report (June 24, 2007), at p. 109.

[247] *Id.* at pp. 109-10.

[248] Lehman, 2008 Financial Plan Summary Presentation to Lehman Board of Directors (Jan. 24, 2008), at p. 5 [LBHI_SEC07940_027374] ("Current environment presents a unique long-term growth opportunity for the Firm. . . . The Firm's competitors, with the notable exceptions of Goldman Sachs and JP Morgan Chase, have sustained large losses, weakening their competitive positions. . . . This presents an opportunity for the Firm to pursue a countercyclical growth strategy, similar to what it did during the 2001-2002 downturn, to improve its competitive position and, over time, generate superior returns for our shareholders."); *see also* Lehman, Update on Lehman Brothers' Subprime Mortgage Origination Business Presentation to Lehman Board of Directors (Mar. 20, 2007), at p. 10 [LBHI_SEC07940_025834] ("Most of large subprime independents have gone out of business, have been sold or are selling. . . . Current distressed environment provides substantial opportunities, as in late 1990's"); Lehman, Notes for Presentation for the Fixed Income Division Offsite Meeting (Sept. 26, 2006), at pp. 10-12 [LBEX-DOCID 1715601] (stating that Lehman viewed the 2006 growth strategy as a countercyclical opportunity to grow business), attached to e-mail from Lesley Oramas-Scala, Lehman, to Michael Gelband, Lehman (Sept. 26, 2006) [LBEX-DOCID 1945744].

strategy."[249] Lehman's management believed that the subprime crisis would not spread to the economy generally, or even to the commercial real estate market, where Lehman was a major player.[250] In past recessions and financial crises, Lehman had successfully taken on more risk while its competitors retrenched.[251]

During the first half of 2007, Lehman continued its growth strategy. Although Lehman's management decided to curtail its residential mortgage origination business, it did so less dramatically than many of its competitors in that business, several of which went out of business.[252]

Lehman, along with other market participants and government regulators, underestimated the severity of the subprime mortgage crisis;[253] the subprime crisis impaired Lehman's ability to securitize and sell residential mortgages and forced the firm to retain an increasingly large volume of residential mortgage-related risk on its

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[249] *Id.*

[250] *Id.*

[251] *Id.*

[252] Lehman, Update on Lehman Brothers' Subprime Mortgage Origination Business Presentation to Lehman Board of Directors (Mar. 20, 2007), at pp. 5, 10 [LBHI_SEC07940_025834]; e-mail from Dimitrios Kritikos, Lehman, to Jeffrey Goodman, Lehman (Feb. 2, 2007) [LBEX-DOCID 566140] ("While the rest of the industry is tightening credit and increasing prices in these areas, we are moving in the opposite direction.").

[253] Examiner's Interview of Treasury Secretary Timothy F. Geithner, Nov. 24, 2009, at p. 3; Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at pp. 16, 24; Examiner's Interview of Richard McKinney, Aug. 27, 2009, at pp. 2, 9; Richard S. Fuld, Jr., Lehman, Notes for Senior Management Speech (June 16, 2008), at pp. 5-6 [LBEX-DOCID 529241], attached to e-mail from Taimur Hyat, Lehman, to Herbert H. McDade III, Lehman, *et al.* (June 25, 2008) [LBEX-DOCID 556064].

own balance sheet.[254] At the same time, during the first two quarters of 2007, Lehman continued to grow its leveraged loan, commercial real estate, energy, and principal investments businesses.[255] Lehman's growth strategy culminated in the acquisition of the Archstone REIT in late May 2007.[256] Together, these transactions continued the ongoing increase in the size of Lehman's balance sheet, with a particularly strong concentration in assets that could not easily be sold in a crisis. Beginning in the fourth quarter of 2006, FID's businesses consistently exceeded their limits even though returns on assets and earnings were decreasing.[257] By February 2007, FID had a "serious balance sheet issue."[258]

This Section of the Examiner's Report discusses Lehman's actions with respect to each of these business lines separately below. This Section also discusses the major personnel move during the first half of 2007 – the replacement of Michael Gelband with Roger Nagioff as the head of FID. Finally, this section discusses the extent to which

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[254] Lehman, Securitized Products, MBS: Non Investment Grade Retained Interests (Jan. 16, 2007), at pp. 1, 3 [LBEX-DOCID 839039], attached to e-mail from James Guarino, Lehman, to Richard McKinney, Lehman, *et al.* (Jan. 16, 2007) [LBEX-DOCID 865925].

[255] *See* Section III.A.1.b.1 of this Report.

[256] *See* Section III.A.1.b.2.d of this Report.

[257] Lehman, Fixed Income Division Balance Sheet Management (Apr. 2007), at p. 2 [LBEX-DOCID 787297], attached to e-mail from Kieron Keating, Lehman, to David N. Sherr, Lehman, *et al.* (June 6, 2007) [LBEX-DOCID 808850]; Lehman Balance Sheet and Disclosure Scorecard For Trade Date Apr. 21, 2008 (Apr. 22, 2008), at p. 3 [LBEX-DOCID 3187588], attached to e-mail from Tal Litvin, Lehman, to Herbert H. McDade III, Lehman, *et al.* (Apr. 22, 2008) [LBEX-DOCID 3187333].

[258] E-mail from Joseph Gentile, Lehman, to Michael Gelband, Lehman, *et al.* (Feb. 21, 2007) [LBEX-DOCID 810934].

Lehman's officers informed the Board of Directors of the continuing expansion of Lehman's balance sheet and risk-taking.

(a) Lehman's Residential Mortgage Business

(i) Lehman Decides to Curtail Subprime Originations but Continue to Pursue "Alt-A" Originations

In the second half of 2006, Lehman began to see the first cracks in the subprime mortgage market.[259] Lehman reacted to these signs by tightening its origination standards, particularly with respect to subprime mortgages,[260] but Lehman continued to pursue growth in its mortgage origination business generally, particularly through its Alt-A originator, Aurora.[261] Alt-A loans are a "somewhat loosely defined category between prime and subprime" that are "designed for borrowers with good credit records who do not meet standard guidelines for documentation requirements."[262]

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[259] Examiner's Interview of Thomas L. Wind, Apr. 21, 2009, at p. 8; Examiner's Interview of Susan Harrison, Apr. 28, 2009, at pp. 2, 5; Examiner's Interview of Marie Jean Burruel, Apr. 28, 2009, at p. 5; Dimitrios Kritikos, Lehman, BNC Risk Review December 2006 (Jan. 20, 2007), at p. 50 [LBEX-DOCID 251077]; Dimitrios Kritikos, Lehman, Risk Review: Aurora and BNC February 2007 (Mar. 19, 2007), at p. 10 [LBEX-DOCID 188325].

[260] Dimitrios Kritikos, Lehman, BNC Risk Review December 2006 (Jan. 20, 2007), at p. 6 [LBEX-DOCID 251077]; Lehman, Materials Prepared for Office of Thrift Supervision Safety and Soundness/Compliance Examination 2007 (Aug. 13, 2007), at pp. 13-15 [LBEX-DOCID 538654]; Lehman, Presentation to Moody's [Draft] (Oct. 16, 2007), at pp. 12-15 [LEH-FINRA-E-MAIL00088455]; Lehman, Presentation to Radian: Mortgage Operations Review (July 24, 2007), at pp. 15-17 [LBEX-DOCID 839141]; Examiner's Interview of Marie Jean Burruel, Apr. 28, 2009, at pp. 8-10; Examiner's Interview of Dimitrios Kritikos, Apr. 16, 2009, at p. 8.

[261] Dimitrios Kritikos, Lehman, Aurora Loan Services Risk Review January 2008 (Feb. 7, 2008), at pp. 10, 12 [LBEX-DOCID 394711].

[262] Saundra F. Braunstein, Director of Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve, Testimony Before U.S. House of Representatives Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit (Mar. 27, 2007); *see also* Lehman, Product Definitions of Alt-A, Mortgage Maker, and Subprime (Oct. 17, 2007), at p. 1 [LBEX-DOCID 537902];

Although Lehman's Alt-A mortgages were never as risky as subprime mortgages, its Alt-A mortgages became increasingly risky towards the end of 2006 and the beginning of 2007.[263] This portion of the Report describes those events.

Lehman considered its residential mortgage securitization business to be a distribution business.[264] Lehman had a vertically integrated residential mortgage business in which BNC originated subprime loans and Aurora originated Alt-A loans, and Lehman itself securitized pools of those mortgages into residential mortgage-backed securities ("RMBS").[265] BNC and Aurora were part of Lehman's Mortgage Capital Division, which originated residential mortgages, while FID was responsible for securitizing the mortgages.[266] By selling the RMBS to investors, Lehman shifted the risks of the underlying mortgages to the investors.[267] Lehman, however, bore the risk that it would not be able to securitize the mortgages or sell the RMBS.[268] The mortgages

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Cynthia Angell & Clare D. Rowley, Federal Deposit Insurance Corp., FDIC Outlook (Second Quarter 2006) (last updated Mar. 21, 2007) (http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006_summer04.html)

[263] E-mail from Dimitrios Kritikos, Lehman, to Jeffrey Goodman, Lehman (Jan. 31, 2007) [LBEX-DOCID 380035]; Dimitrios Kritikos, Lehman, Selected trends from Aurora Risk Review (Feb. 2, 2007), at p. 2 [LBEX-DOCID 537846]; Examiner's Interview of Dimitrios Kritikos, July 29 & 30, 2009, at pp. 12, 14-15.

[264] Madelyn Antoncic, Lehman, 2007 Bondholder Meeting Presentation (Oct. 18, 2007), at p. 6 [LBEX-DOCID 244792]; Lehman, Presentation to Standard and Poor's, Lehman Brothers Securitized Products Business (Oct. 7, 2005), at p. 2 [LBEX-DOCID 095356]; Lehman, Strategic and Financial Review (Jan. 18, 2008), at p. 9 [LBEX-DOCID 1412341]; Examiner's Interview of Richard McKinney, Aug. 27, 2009, at p. 5.

[265] Vikas Shilpiekandula, Lehman, An Overview of the Residential Mortgage Market (Oct. 25, 2007), at p. 2 [LBEX-DOCID 894664].

[266] Examiner's Interview of David N. Sherr, May 6, 2009, at p. 4.

[267] Lehman, Securitized Products, MBS: Non Investment Grade Retained Interests (Jan. 16, 2007), at p. 1 [LBEX-DOCID 839039].

[268] *Id.;* Lehman, Presentation to Standard and Poor's, Lehman Brothers Securitized Products Business (Oct. 7, 2005), at pp. 9, 10 [LBEX-DOCID 095356].

that Lehman could not shift to third-party investors through securitization were known as "retained interests."[269]

By late 2006, Lehman's non-investment grade retained interests began to increase sharply; investors were growing increasingly cautious about purchasing RMBS bonds backed by subprime mortgages, "and as a result the [Lehman residential mortgage trading] desk [was] struggling to sell residuals and [non-investment grade] bonds."[270] Lehman's diminished ability to shift the mortgage-based risk to investors meant that the formerly profitable moving business could become a money-losing storage business.[271]

At the same time, Lehman's mortgage business experienced other troubling trends, including sharp increases in repurchase requests, rises in delinquency rates and a spike in first-payment defaults.[272] By the fourth quarter of 2006, Lehman's internal research reports were suggesting that investors in RMBS bonds, and particularly those backed by subprime mortgages, would become increasingly risk-averse, and subprime-backed RMBS bonds would be at heightened risk of a rating agency downgrade.[273]

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[269] Lehman, Securitized Products, MBS: Non Investment Grade Retained Interests (Jan. 16, 2007), at p. 25 [LBEX-DOCID 839039]; *see also* LBHI_SEC07940_581174 10-Q (filed Apr. 9, 2008), at pp. 20, 55.

[270] Lehman, Securitized Products, MBS: Non Investment Grade Retained Interests (Jan. 16, 2007), at p. 13 [LBEX-DOCID 839039].

[271] *Id*. at p. 1.

[272] Examiner's Interview of Susan Harrison, Apr. 28, 2009, at pp. 2, 5; Dimitrios Kritikos, Lehman, BNC Risk Review December 2006 (Jan. 20, 2007), at p. 50 [LBEX-DOCID 251077]; Dimitrios Kritikos, Lehman, Risk Review: Aurora and BNC February 2007 (Mar. 19, 2007), at p. 10 [LBEX-DOCID 188325].

[273] Srinivas Modukuri, Lehman, Securitized Products Outlook for 2007: Bracing for a Credit Downturn (Dec. 2006), at pp. 8, 19 [LBEX-DOCID 245013].

Because of these trends, Lehman tightened its subprime lending operations. In about August 2006, Lehman replaced BNC's CEO and also created a new executive position (filled by Thomas L. Wind) to oversee both BNC and Aurora operations.[274] Wind and new BNC CEO Steven Skolnik initiated changes to BNC's underwriting guidelines and product mix.[275] These changes included reduction in the size of one of BNC's leading lending programs, known as "80/20," in which BNC extended two separate loans to bring the borrower's loan-to-value ratio to 100% based only on income data as stated by the borrower.[276] Production under the 80/20 program dropped by two thirds from 2005 to 2006, and BNC discontinued the program entirely in late March 2007.[277] Yet even in early 2007, BNC was originating a substantial quantity of subprime mortgages (about $750 million worth during the month of February 2007, for

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[274] Examiner's Interview of Thomas L. Wind, Apr. 21, 2009, at pp. 3, 8; Examiner's Interview of Dimitrios Kritikos, July 29-30, 2009, at pp. 8-9; Examiner's Interview of Richard McKinney, Aug. 27, 2009, at pp. 5-6; Examiner's Interview of Lana Franks Harber, Sept. 23, 2009, at p. 6; Lehman, Presentation to the Office of Thrift Supervision, Lehman Brothers Bank, FSB: Safety & Soundness/Compliance Examination 2007 (Aug. 7, 2007), at p. 5 [LBEX-DOCID 1693347]; Lehman, Update on Lehman Brothers' Subprime Mortgage Origination Business Presentation to Lehman Board of Directors (Mar. 20, 2007), at p. 6 [LBHI_SEC07940_025834].

[275] Examiner's Interview of Thomas L. Wind, Apr. 21, 2009, at pp. 6, 7-8.

[276] Dimitrios Kritikos, Lehman, BNC Risk Review December 2006 (Jan. 20, 2007), at p. 6 [LBEX-DOCID 251077]; Examiner's Interview of Marie Jean Burruel, Apr. 28, 2009, at pp. 8-10.

[277] Lehman, Materials Prepared for Office of Thrift Supervision Safety and Soundness/Compliance Examination 2007 (Aug. 13, 2007), at p. 13 [LBEX-DOCID 538654]; Lehman, Presentation to Moody's [Draft] (Oct. 16, 2007), at p. 12 [LEH-FINRA-E-MAIL00088444]; Lehman, Presentation to Radian: Mortgage Operations Review (July 24, 2007), at p. 14 [LBEX-DOCID 839141]; Examiner's Interview of Marie Jean Burruel, Apr. 28, 2009, at pp. 8-10; Examiner's Interview of Dimitrios Kritikos, Apr. 16, 2009, at p. 8.

example).[278] Lehman did not discontinue subprime lending (as Lehman defined it) through BNC until its closure of BNC on August 22, 2007.[279]

Lehman executives had different recollections concerning whether managers within FID had advocated an earlier and more rapid reduction in Lehman's subprime mortgage originations.[280] Certain FID executives noted that Lehman managers from the Mortgage Capital Division wished to continue aggressive origination and that Mortgage Capital's view prevailed, while others in Mortgage Capital did not recall the disagreement or maintained that FID could have reduced originations itself if it wished.[281]

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[278] Dimitrios Kritikos, Lehman, Risk Review: Aurora and BNC February 2007 (Mar. 19, 2007), at p. 6 [LBEX-DOCID 188325].

[279] Examiner's Interview of Lana Franks Harber, Sept. 23, 2009, at p. 12; Examiner's Interview of Theodore P. Janulis, Sept. 25, 2009, at p. 3; Examiner's Interview of Marie Jean Burruel, Apr. 28, 2009, at p. 10; Lehman Brothers Holdings Inc., Press Release: Lehman Brothers Announces Closure of BNC Mortgage (Aug. 22, 2007) [LBEX-DOCID 880148]; Lehman, Subprime(r) (Sept. 4, 2007), at p. 14 [LBEX-DOCID 894656]; e-mail from Edward Grieb, Lehman, to Christopher M. O'Meara, Lehman (Aug. 22, 2007) [LBEX-DOCID 197143]; e-mail from Tasha Pelio, Lehman, to Jasjit (Jesse) Bhattal, Lehman, *et al*. (Aug. 22, 2007) [LBEX-DOCID 176893].

[280] Examiner's Interview of Kentaro Umezaki, June 25, 2009, at pp. 2, 15; Examiner's Interview of Michael Gelband, Aug. 12, 2009, at pp. 2, 10-12; Examiner's Interview of Lana Franks Harber, Sept. 23, 2009, at pp. 4, 6; Examiner's Interview of Theodore P. Janulis, Sept. 25, 2009, at pp. 3, 5.

[281] *Compare* Examiner's Interview of Kentaro Umezaki, June 25, 2009, at pp. 2, 15 (stating that he, Gelband and Sherr, wanted to scale back originations while Janulis did not); Examiner's Interview of Michael Gelband, Aug. 12, 2009, at p. 11; (recalling that as late as 2007, he recommended managing the residential real estate business more conservatively, and that in general, MCD had an incentive to continue to push for originations because it was rewarded when its origination volumes were high and the risk was shifted to the Securitized Products Group after the mortgages were originated.), *with* Examiner's Interview of David N. Sherr, Sept. 25, 2009, at pp. 2-3, 4-5 (stating that he did not recall a dispute between MCD and FID over any proposed scaling back of originations, but that there was tension between FID and MCD over the control of the residential mortgage origination business,); Examiner's Interview of Theodore P. Janulis, Sept. 25, 2009, at pp. 3, 5 (stating that he did not recall a disagreement about whether originations should be slowed and that FID could have slowed origination volumes if it wished to do so); Examiner's Interview of Lana Franks Harber, Sept. 23, 2009, at p. 6. (stating that she did not recall internal

Even as Lehman was tightening standards on its subprime originations through BNC, Lehman was also using its Aurora subsidiary to expand its Alt-A lending.[282] Moreover, Aurora's Alt-A lending reached borrowers of lesser credit quality than those who historically had been considered Alt-A borrowers.[283] The vehicle for that aspect of the Aurora business plan was the Mortgage Maker product.[284] As Mortgage Maker expanded to more than half of Aurora's Alt-A production by February 2007, many of Aurora's loans denominated as Alt-A came more and more to resemble the subprime loans that Lehman was supposedly exiting by tightening origination standards at BNC.[285]

By late January 2007, Lehman's residential mortgage analyst began to notice disturbing trends with respect to Aurora's Mortgage Maker program:

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presentations by Gelband questioning the continued viability of subprime residential lending); *see also* Examiner's Interview of Joseph Gregory, Nov. 13, 2009, at p. 10 (suggesting that he agreed with MCD's view and approved a strategy of continuing to originate residential mortgages aggressively).

[282] Examiner's Interview of Carl Peterson, May 27, 2009, at pp. 6-8.

[283] *Id.* at pp. 5-7.

[284] *Id.* at p. 5; Examiner's Interview of Diane May, Apr. 16, 2009, at p. 5; Aurora Loan Services, Presentation to Securities and Exchange Commission (Feb. 6-7, 2007), at p. 2 [LBEX-DOCID 357348].

[285] Examiner's Interview of David N. Sherr, May 6, 2009, at p. 8; Examiner's Interview of John Vedra, Apr. 15, 2009, at p. 8; Examiner's Interview of Diane May, Apr. 16, 2009, at p. 5; Dimitrios Kritikos, Lehman, Risk Review: Aurora and BNC February 2007 (Mar. 19, 2007), at p. 4 [LBEX-DOCID 188325]; *see also* e-mail from Dimitrios Kritikos, Lehman, to Ken Linton, Lehman, *et al.* (Mar. 30, 2007) [LBEX-DOCID 286265] (noting that the riskier segments of Mortgage Maker performed three to five times worse than the rest of Aurora's loans); Russell V. Brady, Aurora, Response to LXS Performance Issues (Jan. 24, 2007), at p. 1 [LBEX-DOCID 885450] (suggesting that Aurora needed to "[d]etermine whether a segment of the [Mortgage] Maker population should be serviced similar to subprime"); e-mail from Richard McKinney, Lehman, to Thomas L. Wind, Aurora, *et al.* (Feb. 12, 2007) [LBEX-DOCID 1369758] (noting that the performance of Lehman's LXS securitizations that consisted mostly of Mortgage Maker had worsened versus its largest competitor for 2006 production, and stating "Expected subordination levels are 11.7% to AAA loss coverage. This compares with 20-25% for a typical subprime deal. That is, we are creating worse performance than subprime, while the rating agencies assume our performance should be substantially better").

> Looking at the trends on originations and linking them to first payment defaults, the story is ugly: The last four months Aurora has originated the riskiest loans ever, with every month being riskier than the one before - the industry meanwhile has pulled back during that time.[286]

At the same time, other participants in the Alt-A industry were reporting default rates and late payment data that indicated that "[t]he credit deterioration [in Alt-A] has been almost parallel to the one of the subprime market."[287] Thus, while Aurora's mortgages were not as risky as subprime mortgages, Aurora's risk profile was increasing in much the same way as the risk in subprime mortgages.

As a result of all these factors, Lehman's risk managers sometimes considered the Mortgage Maker loans to be distinct from Alt-A mortgages, and described Mortgage Maker as Alt-B.[288] While the term Alt-B was not an accepted term or categorization in the business, Lehman's managers occasionally used it as a way of differentiating the riskier mortgages in the Mortgage Maker program from what had more traditionally been considered Alt-A mortgages, though not so risky as to merit the label subprime.[289]

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[286] E-mail from Dimitrios Kritikos, Lehman, to Jeffrey Goodman, Lehman (Jan. 31, 2007) [LBEX-DOCID 380035].

[287] Dimitrios Kritikos, Lehman, Risk Review: Aurora and BNC February 2007 [Draft] (Mar. 9, 2007), at p. 1 [LBEX-DOCID 538518].

[288] E-mail from Dimitrios Kritikos, Lehman, to Jeffery Goodman, Lehman (Mar. 12, 2007) [LBEX-DOCID 307101] ("Aurora's product is far from Alt-A anymore. The traditional Alt-A program is only 40% of Aurora's production"); e-mail from Dimitrios Kritikos, Lehman, to Charlie Lu, Lehman (Apr. 12, 2007) [LBEX-DOCID 566105] ("MortgageMaker is NOT Alt-A"); Dimitrios Kritikos, Lehman, Selected trends from Aurora Risk Review February 2007 (Feb. 2, 2007), at p. 2 [LBEX-DOCID 537846] ("The product mix of Aurora production has shifted substantially in the last 6 months from Alt-A to MortgageMaker (Alt-B)").

[289] Dimitrios Kritikos, Lehman, Selected trends from Aurora Risk Review February 2007 (Feb. 2, 2007), at p. 2 [LBEX-DOCID 537846]; Examiner's Interview of Dimitrios Kritikos, July 29-30, 2009, at pp. 3, 18 (stating that Mortgage Maker loans were neither Alt-A nor subprime).

To make matters worse, Lehman's risk managers saw indications that Lehman would not be able to distribute the risk on the mortgages it was originating. By January 2007, it was apparent that Lehman's holding of non-investment grade retained interests in securitizations had been increasing.[290] And by March 2007, Lehman was noting sharp declines in securitization revenue,[291] causing the Securitized Products Group within FID to exceed its risk appetite and VaR limits.[292]

To respond to these risks in its Alt-A portfolio, in March 2007 Lehman undertook a series of changes designed to make Mortgage Maker loans less available to borrowers with lower credit scores, or to borrowers who wished to take out loans at 100% of a home's value.[293] Although the volume of Mortgage Maker loans originated by Lehman

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[290] Lehman, Securitized Products, MBS: Non Investment Grade Retained Interests (Jan. 16, 2007), at p. 3 [LBEX-DOCID 839039].

[291] Lehman, Mortgage Update 1Q 07, at p. 9 [LBHI_SEC07940_845984].

[292] *See, e.g.*,George Hansman, Lehman, Securitized Products Risk Appetite and VaR limit and overage graphs (May 17, 2007) [LBEX-DOCID 861260]; e-mail from Lehman Risk, to Lehman Risk Limit Excess e-mail group (Mar. 8, 2007) [LBEX-DOCID 229930]; e-mail from Lehman Risk, to Lehman Risk Limit Excess e-mail group (Mar. 19, 2007) [LBEX-DOCID 229944]; e-mail from Lehman Risk, to Lehman Risk Limit Excess e-mail group (Mar. 22, 2007) [LBEX-DOCID 229954]; e-mail from Lehman Risk, to Lehman Risk Limit Excess e-mail group (Apr. 9, 2007) [LBEX-DOCID 790039]; e-mail from Lehman Risk, to Lehman Risk Limit Excess e-mail group (Apr.16, 2007) [LBEX-DOCID 790029]; e-mail from Lehman Risk, to Lehman Risk Limit Excess e-mail group (May 29, 2007) [LBEX-DOCID 790059]; e-mail from Lehman Risk, to Lehman Risk Limit Excess e-mail group (May 30, 2007) [LBEX-DOCID 790060]; e-mail from Lehman Risk, to Lehman Risk Limit Excess e-mail group (Sept. 5, 2007) [LBEX-DOCID 230188]; e-mail from Lehman Risk, to Lehman Risk Limit Excess e-mail group (Oct. 12, 2007) [LBEX-DOCID 230789903]; e-mail from Lehman Risk, to Lehman Risk Limit Excess e-mail group (Oct. 17, 2007) [LBEX-DOCID 789908]; e-mail from Lehman Risk, to Lehman Risk Limit Excess e-mail group (Oct. 18, 2007) [LBEX-DOCID 789910]; e-mail from Lehman Risk, to Lehman Risk Limit Excess e-mail group (Oct. 19, 2007) [LBEX-DOCID 789909]; e-mail from Lehman Risk, to Lehman Risk Limit Excess e-mail group (Oct. 22, 2007) [LBEX-DOCID 790089]; e-mail from Lehman Risk, to Lehman Risk Limit Excess e-mail group (Oct. 30, 2007) [LBEX-DOCID 789916].

[293] Dimitrios Kritikos, Lehman, Risk Review: Aurora and BNC February 2007 (Mar. 19, 2007), at p. 3 [LBEX-DOCID 188325] (summarizing underwriting guideline changes at BNC and Aurora).

declined following implementation of the March 2007 guideline changes, Lehman continued to originate significant volumes of Alt-A mortgages until August 2007.[294]

(ii) The March 20, 2007 Board Meeting

On March 20, 2007, the Mortgage Capital and Fixed Income Divisions gave a presentation to Lehman's Board of Directors about the state of Lehman's residential mortgage origination and securitization business in light of the deepening subprime crisis.[295] The presentation was given by David N. Sherr, the head of Lehman's Securitized Products Group; Theodore P. Janulis, the head of the Mortgage Capital Division; and Lana Franks Harber, Chief Administrative Officer ("CAO") of the Mortgage Capital Division.[296]

While preparing to give this presentation, Harber e-mailed one of her colleagues to inform him about a conversation that she had with Lehman's President, Joseph Gregory, about the presentation:

> Board is not sophisticated around subprime market – Joe doesn't want too much detail. He wants to candidly talk about the risks to Lehman but be

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[294] Dimitrios Kritikos, Lehman, Aurora Loan Services Risk Review January 2008 (Feb. 7, 2008), at p. 12 [LBEX-DOCID 394711].

[295] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Mar. 20, 2007), at pp. 6-7 [LBHI_SEC07940_025779]; Lehman, Update on Lehman Brothers' Subprime Mortgage Origination Business Presentation to Lehman Board of Directors (Mar. 20, 2007) [LBHI_SEC07940_025834].

[296] Lehman, Update on Lehman Brothers' Subprime Mortgage Origination Business Presentation to Lehman Board of Directors (Mar. 20, 2007) [LBHI_SEC07940_025834]; Examiner's Interview of Lana Franks Harber, Sept. 23, 2009, at p. 2; Examiner's Interview of Theodore P. Janulis, Sept. 25, 2009, at p. 2; Examiner's Interview of David N. Sherr, Sept. 25, 2009, at p. 9.

> optimistic and constructive – talk about the opportunities that this market creates and how we are uniquely positioned to take advantage of them.[297]

Consistent with this direction, the Board presentation emphasized that Lehman's management considered the crisis an opportunity to pursue a countercyclical strategy.[298] The March 2007 Board presentation first noted the difficulties in the subprime market, including the fact that seven of the top twenty subprime originators had already been sold to stronger partners or gone bankrupt and that the business was significantly less profitable than in past years because of lower origination volumes, lower sale and securitization margins, and increased loan loss reserves.[299] The presentation further noted that in response to these market events, Lehman had improved BNC's risk and credit profile, tightened its lending criteria, retained new management, and significantly reduced headcount.[300]

The presentation concluded by highlighting management's belief that Lehman had "substantial opportunities, as in late 1990's" to improve its competitive position.[301] This countercyclical strategy was based on several stated premises. Most important, Lehman's management believed that the subprime crisis would present only a "Limited Contagion To Other Markets" – in particular, Lehman's management did not expect the

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[297] E-mail from Lana Franks Harber, Lehman, to Steven Skolnik, BNC Mortgage, *et al.* (Mar. 9, 2007) [LBEX-DOCID 306198]; *accord* Examiner's Interview of Lana Franks Harber, Sept. 23, 2009, at pp. 9-10; Examiner's Interview of Theodore P. Janulis, Sept. 25, 2009, at p. 6.

[298] Lehman, Update on Lehman Brothers' Subprime Mortgage Origination Business Presentation to Lehman Board of Directors (Mar. 20, 2007), at pp. 1, 10 [LBHI_SEC07940_025834].

[299] *Id.* at pp. 4-5.

[300] *Id.* at pp. 6-7.

[301] *Id.* at p. 10.

subprime crisis to have a significant impact on the "[b]roader credit markets."[302] Lehman's management also believed that a "substantial part of [the] subprime market is here to stay" and that "[p]rofitability will return when environment improves."[303] In sum, Lehman management thought that the market was nearing the bottom of the cycle in spring and summer of 2007, and that Lehman would benefit from preserving the option to expand the business in the future.[304] Management informed the Board that the down cycle in subprime presented "substantial opportunities" for Lehman, and that management expected Lehman to be better positioned for profitable growth once the industry cycle turned.[305]

The presentation did not discuss Aurora's Alt-A mortgage originations at all, notwithstanding the significant concerns that Lehman's residential mortgage analyst had recently raised about that group of mortgages.[306] Instead, the presentation grouped the Alt-A category of mortgages with prime and described "Prime/Alt-A Mortgages" as follows: "credit performance not problematic - delinquencies are within expected range."[307] An earlier draft of the slideshow presented to the Board had used the term "Alt-A/Alt-B Mortgages" above the words "credit performance not problematic –

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[302] *Id.* at p. 9.
[303] *Id.* at p. 10.
[304] Examiner's Interview of Lana Franks Harber, Sept. 23, 2009, at p. 2; Examiner's Interview of Theodore P. Janulis, Sept. 25, 2009, at p. 8; Examiner's Interview of David N. Sherr, Sept. 25, 2009, at p. 6.
[305] Lehman, Update on Lehman Brothers' Subprime Origination Business Presentation to Lehman Board of Directors (Mar. 20, 2007), at pp. 1, 10 [LBHI_SEC07940_025834].
[306] *Id.* at pp. 1-10.
[307] *Id.* at p. 9.

delinquencies are within expected range,"[308] but this reference to Alt-B was deleted from the final version of the materials in favor of "Prime/Alt-A Mortgages."[309]

Sherr, Janulis, and Harber told the Examiner that they did not include a specific reference to Mortgage Maker or Alt-B in their presentation because they believed that the loans in the Mortgage Maker program were distinct from subprime mortgages, which were the subject of the presentation.[310] The Lehman risk analyst who had studied the performance issues in Mortgage Maker told the Examiner that leaving Mortgage Maker out of a presentation on subprime was proper given the differences between what Lehman considered subprime (FICO scores below 620) and Mortgage Maker (average FICO score of 691).[311]

After the Board presentation, Lehman continued to originate subprime and especially Alt-A/Alt-B mortgage loans, thereby pursuing its countercyclical strategy, and likely exacerbating Lehman's residential mortgage losses. The Examiner's financial advisors have estimated the losses from residential mortgage positions from the first quarter of 2007 through the third quarter of 2008 at $7.4 billion.[312]

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[308] Lehman, State of Lehman Brothers' Subprime Mortgage Origination Business Presentation to Lehman Board of Directors [Draft] (Mar. 15, 2007), at p. 12 [LBEX-DOCID 2485576].

[309] Lehman, Update on Lehman Brothers' Subprime Origination Business Presentation to Lehman Board of Directors (Mar. 20, 2007), at p. 9 [LBHI_SEC07940_025834].

[310] Examiner's Interview of Lana Franks Harber, Sept. 23, 2009, at p. 3; Examiner's Interview of Theodore P. Janulis, Sept. 25, 2009, at pp. 2, 7; Examiner's Interview of David N. Sherr, Sept. 25, 2009, at p. 7.

[311] Examiner's Interview of Dimitrios Kritikos, July 29-30, 2009, at p. 19.

[312] Lehman, Mortgage Update - 1Q 07 (Apr. 9, 2007) [LBEX-DOCID 540069]; Lehman, Mortgage Update - 2Q 07 (June 8, 2007) [LBEX-DOCID 505835]; Lehman, Mortgage Update - June 07 (Aug. 9, 2007) [LBEX-DOCID 611902]; Lehman, Mortgage Update - August 07 (Sept. 25, 2007) [LBEX-DOCID 505889]; Lehman,

These losses were tempered by effective hedging strategies through at least 2007 and into early 2008.[313] Between the first quarter of 2007 and the third quarter of 2008, Lehman had a gain of $2.96 billion on its residential mortgage credit hedges.[314] Of this $2.96 billion gain, $2.623 billion was gained between the first quarter of 2007 and the end of the first quarter of 2008.[315] For the second and third quarters of 2008, however, Lehman had essentially no gains on its hedges.[316] As a result, during those quarters, Lehman suffered very substantial losses on its residential mortgage business.[317]

Flash - Mortgage Update - November 07 (Dec. 21, 2007) [LBEX-DOCID 505890]; Lehman, Flash - Mortgage Update - January 07 (Feb. 15, 2008) [LBEX-DOCID 3237972]; Lehman, Flash - Mortgage Update - March 07 (Apr. 23, 2008) [LBEX-DOCID 2432630]; Lehman, Flash - Mortgage Update - Apr. 07 (May 15, 2008) [LBEX-DOCID 1362958]; Lehman, Flash - Mortgage Update - May 07 (June 11, 2008) [LBEX-DOCID 3238001]; Lehman, Securitized Products P&L - June 2008 (July 11, 2008) [LBEX-DOCID 505776]; Lehman, Securitized Products P&L - July 2008 (Aug. 14, 2008) [LBEX-DOCID 505778].

[313] Examiner's Interview of Kentaro Umezaki, June 25, 2009, at p. 17; Lehman, Minutes of Meeting of the Board of Directors (Sept. 11. 2007), at p. 6 [LBHI_SEC07940_263264].

[314] Lehman, Mortgage Update - 1Q 07 (Apr. 9, 2007) [LBEX-DOCID 540069]; Lehman, Mortgage Update - 2Q 07 (June 8, 2007) [LBEX-DOCID 505835]; Lehman, Mortgage Update - June 07 (Aug. 9, 2007) [LBEX-DOCID 611902]; Lehman, Mortgage Update - August 07 (Sept. 25, 2007) [LBEX-DOCID 505889]; Lehman, Flash - Mortgage Update - November 07 (Dec. 21, 2007) [LBEX-DOCID 505890]; Lehman, Flash - Mortgage Update - January 07 (Feb. 15, 2008) [LBEX-DOCID 3237972]; Lehman, Flash - Mortgage Update - March 07 (Apr. 23, 2008) [LBEX-DOCID 2432630]; Lehman, Flash - Mortgage Update - Apr. 07 (May 15, 2008) [LBEX-DOCID 1362958]; Lehman, Flash - Mortgage Update - May 07 (June 11, 2008) [LBEX-DOCID 3238001]; Lehman, Securitized Products P&L - June 2008 (July 11, 2008) [LBEX-DOCID 505776]; Lehman, Securitized Products P&L - July 2008 (Aug. 14, 2008) [LBEX-DOCID 505778].

[315] *Id*.

[316] LBHI 10-Q (July 10, 2008), at p. 67.

[317] The Examiner's financial advisors estimate that Lehman's secured losses from residential mortgages exceeded $1 billion in the second quarter and in excess of $3.5 billion in the third quarter of 2008.

(b) The Explosion in Lehman's Leveraged Loan Business

During the first half of fiscal 2007, the high yield market was active, notwithstanding the onset of the crisis in the subprime residential mortgage market.[318] Like other market actors during this period, Lehman participated in more leveraged finance deals than ever before and entered into deals that were generally bigger than the leveraged finance deals it had done in the past.[319] Compared to its competitors, Lehman was the most aggressive lender per dollar of shareholder equity in the first half of 2007.[320]

Lehman continued down this path despite the fact that the terms of these deals became less and less favorable over time from an investment banking perspective. Because there was so much competition to finance these loans, sponsors were able to negotiate terms that significantly increased the risk to the banks. For example, according to some estimates, covenant light loans – loans that did not include previously standard covenants requiring the borrower to maintain certain levels of collateral, cash flow, and payment terms – increased from less than 1% of all leveraged

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[318] E-mail from Roopali Hall, Lehman (Jan. 4, 2008) [LBHI_SEC07940_066187]; Lehman Loan Syndicate, Year-End Recap (Jan. 7, 2008), at p. 1 [LBHI_SEC07940_066190].

[319] E-mail from Evette Saldana, Lehman, to HYCC members, Lehman, *et al.* (June 15, 2007) [LBEX-DOCID 494525]; Lehman Credit Facilitation Group, 2nd Quarter 2007 Review (June 2007), at p. 1 [LBEX-DOCID 514908], attachment to e-mail from Evette Saldana, Lehman, to HYCC members, Lehman, *et al.* (June 15, 2007) [LBEX-DOCID 494525].

[320] E-mail from Evette Saldana, Lehman, to HYCC members, Lehman, *et al.* (June 15, 2007) [LBEX-DOCID 494525]; Lehman Credit Facilitation Group, 2nd Quarter 2007 Review (June 2007), at p. 6 [LBEX-DOCID 514908], attached to e-mail from Evette Saldana, Lehman, to HYCC members, Lehman, *et al.* (June 15, 2007) [LBEX-DOCID 494525].

loans in 2004 to over 18% by 2007 industry-wide.[321] Lenders such as Lehman also abandoned certain contractual protections (*e.g.*, material adverse change provisions ("MACs"), up-front syndication, and joint liability) that were previously standard in the leveraged loan industry.[322] In some deals, Lehman was the only party to sign the legal documents, even though other banks were intended to commit to the loans; thus, Lehman initially bore all the risk.[323] As of March 2007, the rating agencies "perceived loosening of [Lehman's] risk standards – particularly in leveraged lending. . . ."[324] The Examiner has not investigated whether the contractual terms of Lehman's leveraged lending transactions were more aggressive than those of its competitors.

Between December 2006 and June 2007, Lehman participated in more than 11 leveraged buyout deals that each exceeded $5 billion.[325] By April 2007, Lehman had approximately 70 high yield contingent commitments in its pipeline – a record number

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[321] Eric Felder, Lehman, Credit Outlook Presentation (Apr. 16, 2008), at p. 48 [LBHI_SEC07940_393578], attached to e-mail from Christopher Wichenbaugn, Lehman, to DCMNY, Lehman (Apr. 16, 2008) [LBHI_SEC07940_393578]; Standard & Poor's and LSTA, Leveraged Loan Index, August 2008 Review (Sept. 3, 2008), at p. 84 [LBEX-DOCID 4404712], attached to e-mail from Kristen Vigletta, Lehman (Sept. 3, 2008) [LBEX-DOCID 4326914].

[322] Examiner's Interview of Madelyn Antoncic, Feb. 25, 2009, at p. 4.

[323] *Id*.

[324] Lehman, Credit Ratings Strategy Presentation (Mar. 1, 2007), at p. 13 [LBEX-DOCID 618355]; e-mail from Stephen Lax, Lehman, to James P. Seery, Jr. Lehman, *et al.* (Apr. 11, 2008) [LBEX-DOCID 444768].

[325] E-mail from Miriam Oh, Lehman, to Paul Parker, Lehman, *et al.* (July 5, 2007) [LBEX-DOCID 3197652]; Lehman, Big LBO Update (July 3, 2007), at p. 2 [LBEX-DOCID 3183564].

for it.[326] In June 2007, Lehman's lending pace had already doubled Lehman's 2006 record-setting year for high grade and high yield combined.[327]

When the market started to slow, Lehman suddenly found itself with a huge volume of commitments on its books and a risk profile that was well above its high yield business's risk appetite limits. At the end of the second quarter of 2007, approximately $36 billion of contingent commitments remained on Lehman's books.[328] FID was almost $20 billion over its net balance sheet limit for the quarter.[329] Relatedly, as described below, Lehman soon vastly exceeded its risk appetite limits for the high yield business.

(i) Relaxation of Risk Controls to Accommodate Growth of Lehman's Leveraged Loans Business

To accommodate the growth of Lehman's high yield lending activities, Lehman's management decided to loosen several of the firm's risk controls that otherwise would have limited the firm's ability to engage in many of these deals. Most significantly, as discussed above, Lehman's senior management approved a number of deals that exceeded the firm's single transaction limit.

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[326] E-mail from Stephen Lax, Lehman, to Alex Kirk, Lehman, *et al.* (Apr. 26, 2007) [LBEX-DOCID 259369].

[327] Lehman Credit Facilitation Group, 2nd Quarter 2007 Review (June 2007), at p. 13 [LBEX-DOCID 514908], attached to e-mail from Evette Saldana, Lehman, to HYCC members, Lehman, *et al.* (June 15, 2007) [LBEX-DOCID 494525].

[328] Alex Kirk, Lehman, Leveraged Finance Risk Presentation (June 2007) [LBEX-DOCID 158975], attached to e-mail from Olivia Lua, Lehman, to Christopher M. O'Meara, Lehman (June 21, 2007) [LBEX-DOCID 158975].

[329] Lehman Brothers, Balance Sheet Trend Presentation (Apr. 2007), at pp. 4-6 [LBEX-DOCID 251418], attached to e-mail from Kentaro Umezaki, Lehman, to Rebecca Miller, Lehman (May 3, 2007) [LBEX-DOCID 346520].

Many of the leveraged loans that Lehman funded in 2006 and 2007 were "way over the limit."[330] By July 2007, Lehman had committed to approximately 30 deals that exceeded the pre-existing $250 million loss threshold, nine deals that would have exceeded a newly proposed loss threshold of $400 million,[331] five deals that violated the notional limit of $3.6 billion, and four deals that would have violated the notional limit of $4.5 billion that was proposed during the fourth quarter of 2007.[332] Some of Lehman's commitments exceeded the loss threshold limit by a factor of six.[333] With respect to 24 of the largest high yield deals in which Lehman participated, Lehman committed roughly $10 billion more than the single transaction limit, if enforced, would have allowed.[334] These figures arguably understate the extent to which Lehman's leveraged loans exceeded the single transaction limit, since Lehman applied the single transaction limit only to the amount of the leveraged loan that Lehman "expected to fund," not the full amount of Lehman's commitment.[335]

To accommodate the growth of the high yield business, Lehman's management also relaxed the high yield business's risk appetite limits. Despite having increased the

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[330] E-mail from Joe Li, Lehman, to Paul Mitrokostas, Lehman (Aug. 30, 2007) [LBEX-DOCID 2547330].

[331] Joe Li, Lehman, STL Backtesting Excel Spreadsheet (July 25, 2007) [LBEX-DOCID 2506462], attached to e-mail from Joe Li, Lehman, to Fred S. Orlan, Lehman, *et al.* (July 25, 2007) [LBEX-DOCID 2563167].

[332] *Id.*

[333] *Id.*

[334] Lehman, Fixed Income Business Strategy, Single Transaction Limit Policy Proposed Improvements (Sept. 2007), at p. 3 [LBEX-DOCID 2563444].

[335] Lehman, Presentation to Lehman Executive Committee on Leveraged Finance Risk (Oct. 16, 2007), at p. 12 [LBEX-DOCID 506033], attached to e-mail from Blair Sieff, Lehman, to Steven Berkenfeld, Lehman, *et al.* (Oct. 16, 2007) [LBEX-DOCID 569915].

high yield business's risk appetite limit at the beginning of 2006 and again in early 2007, Lehman's increasing level of high yield commitments caused it to exceed the high yield business's risk appetite limit by significant amounts in 2007 and 2008.[336] By late April 2007, Lehman had exceeded its newly increased high yield risk appetite limit,[337] and starting in late July, the high yield business' usage consistently exceeded its limits.[338] As Lehman funded more of its commitments, the leveraged loan exposure soon doubled the limit amount.[339]

Lehman's management made a conscious decision to exceed the risk appetite limits on leveraged loans.[340] Even though the risk appetite limits were divided into subsidiary limits for the business lines of each division, the limits for each business line were flexible as long as the aggregate numbers "rolled-up" within the divisional limit.[341] One Lehman executive questioned whether the firm even had a high yield limit. In April 2007, Kentaro Umezaki, Head of Fixed Income Strategy, e-mailed Christopher M. O'Meara, Lehman CFO at the time, and several others, expressing concern that in a

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[336] Appendix: 9, comparing risk appetite and VaR usage versus limits.
[337] *Id.* at p. 3.
[338] *Id.* at p. 4.
[339] *Id.* at p. 4-9.
[340] Examiner's Interview of Kentaro Umezaki, June 25, 2009, at p. 13; Examiner's Interview of Jeffrey Goodman, Aug. 28, 2009.
[341] Examiner's Interview of Madelyn Antoncic, Mar. 27, 2009, at p. 12; Examiner's Interview of Madelyn Antoncic, Oct. 6, 2009, at p. 7.

recent firm-wide meeting, Fuld sent "inconsistent messages" by encouraging growth at the same time Lehman was near its risk limits.[342] Umezaki noted to O'Meara and others:

> the majority of the trading businesses focus is on revenues, with balance sheet, risk limit, capital or cost implications being a secondary concern. The fact that they haven't heard that those items matter [in] public forums from senior management recently reinforces this revenue oriented behavior implicitly. . . . Example which we've debated for years: was even a topic in [the Turnberry meeting in] FLA: **Do we or don't we have a limit on how much HY LBO related lending/commitment exposure we can have at any given time?** There has been no real "one firm" outcome to date in my opinion. I'm not the only one who has this view in FID.[343]

(c) Internal Opposition to Growth of Leveraged Loans Business

Lehman's FID, including Gelband, Kirk, and Umezaki, opposed a number of the leveraged loan deals to which Lehman committed during this period, because they believed that these individual deals were too risky to justify their limited returns.[344] Despite the opposition, the Executive Committee decided to proceed with many of the deals.[345]

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[342] E-mail from Kentaro Umezaki, Lehman, to Scott J. Freidheim, Lehman, *et al.* (Apr. 19, 2007) [LBEX-DOCID 210193].

[343] *Id.* (emphasis added); e-mail from Kentaro Umezaki, Lehman, to Ian T. Lowitt, Lehman (Apr. 18, 2007) [LBEX-DOCID 743931].

[344] Examiner's Interview of Kentaro Umezaki, June 25, 2009, at p. 10; Examiner's Interview of Michael Gelband, Aug. 12, 2009, at pp. 6-9; Examiner's Interview of Alex Kirk, Jan. 12, 2010, at p. 2; e-mail from Eric Felder, Lehman, to Michael Gelband, Lehman, *et al.* (Aug. 28, 2008) [LBEX-DOCID 822513]; *see also* e-mail from Steven Berkenfeld, Lehman, to Scott J. Freidheim, Lehman (May 11, 2007) [LBEX-DOCID 1379290]; e-mail from Bertrand Kan, Lehman, to Richard Atterbury, Lehman (Jan. 30, 2008) [LBEX-DOCID 1379129].

[345] Examiner's Interview of Kentaro Umezaki, June 25, 2009, at p. 3; Examiner's Interview of Michael Gelband, Aug. 12, 2009, at pp. 7-9; Examiner's Interview of Alex Kirk, Jan. 12, 2010, at pp. 2, 7; Examiner's Interview of Paul Shotton, June 5, 2009, at pp. 2, 6-7; Examiner's Interview of Hugh E. (Skip) McGee III, Aug. 12, 2009, at p. 9; Examiner's Interview of Fred S. Orlan, Sept. 21, 2009, at p. 4; e-mail from Eric

Some of the opposition to Lehman's increase in leveraged lending was focused on the bridge equity component of those deals.[346] Several former members of Lehman's senior management, including Nagioff, Antoncic, and Berkenfeld, expressed reservations regarding the firm's level of engagement in leveraged loan bridge equity activities.[347] The Examiner, however, also found that sponsors were aggressive in demanding equity bridge components to financing[348] and that the Investment Banking Division ("IBD") was in favor of providing bridge equity because it believed that Lehman needed to do so to stay competitive in the industry.[349] Despite various discussions among Lehman's management regarding whether the level of leveraged loan bridge equity was acceptable and sustainable, Lehman's management never put any limit on the business's leveraged loan bridge equity commitments.[350]

Felder, Lehman, to Michael Gelband, Lehman, *et al.* (Aug. 28, 2008) [LBEX-DOCID 822513]; *see also* e-mail from Steven Berkenfeld, Lehman, to LBEC Member, Lehman, *et al.* (May 11, 2007) [LBEX-DOCID 1379290]; e-mail from Larry Wieseneck, Lehman, to Alex Kirk, Lehman (Jan. 30, 2008) [LBEX-DOCID 1379129].

[346] E-mail from Roger Nagioff, Lehman, to Madelyn Antoncic, Lehman, *et al.* (June 29, 2007) [LBEX-DOCID 1467654); Examiner's Interview of Fred S. Orlan, Sept. 21, 2009, at p. 7.

[347] E-mail from Roger Nagioff, Lehman, to David Goldfarb, Lehman (June 1, 2007) [LBEX-DOCID 1581523]; e-mail from Madelyn Antoncic, Lehman, to David Goldfarb, Lehman, *et al.* (June 1, 2007).

[348] E-mail from Steven Berkenfeld, Lehman, to Robert D. Redmond, Lehman (Sept. 23, 2007) [LBEX-DOCID 1387569]; e-mail from Alex Kirk, Lehman, to [xxxxxxx]@archwireless.net (May 15, 2007) [LBEX-DOCID 1379297] (phone number redacted); e-mail from Steven Berkenfeld, Lehman, to LBEC Member, Lehman, *et al.* (May 11, 2007) [LBEX-DOCID 1379291].

[349] Examiner's Interview of Fred S. Orlan, Sept. 21, 2009, at p. 7.

[350] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 13; Examiner's Interview of Alex Kirk, Jan. 12, 2010, at p. 8; e-mail from Robert D. Redmond, Lehman, to Steven Berkenfeld, Lehman, *et al.* (May 19, 2007) [LBEX-DOCID 264270]; e-mail from Alex Kirk, Lehman, to Robert D. Redmond, Lehman, *et al.* (May 21, 2007) [LBEX-DOCID 174236]; e-mail from Steven Berkenfeld, Lehman, to David Goldfarb, Lehman, *et al.* (June 15, 2007) [LBEX-DOCID 859026].

By April 2007, the overall size of the firm's leveraged loan commitments became controversial.[351] Kirk and Gelband became concerned about Lehman's overall exposure. In April 2007, Kirk e-mailed Gelband:

> As a heads up our risk of mandated commits is up to 6mm a bp triple our previous high. Also the commits are coming in fast and furious I expect us to be well north of 30B this quarter. This is also unprecedented. In addition we are now seeing commitments that have crossed the risk tolerance so we may need your help with the bank in saying no to some key clients.[352]

At about the same time, Berkenfeld, who was head of the Commitment Committee that was charged with evaluating individual leveraged loans, noted in an e-mail: "The frenzy of the last month or so concerns me and I don't like being brought in at the very end and expected to make these decisions in less than 48 hours."[353]

Antoncic, the CRO, also opposed many of the transactions and the overall size of the business. She recalled a conversation in which she told Berkenfeld and Goldfarb that the firm's leveraged loan exposure was getting too large and that limits had to be imposed.[354] When Berkenfeld replied that he liked all of the deals that Lehman was considering, Antoncic responded that he could like one deal or another, but not all of them at once.[355]

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[351] Examiner's Interview of Kentaro Umezaki, June 25, 2009, at p. 10.
[352] E-mail from Alex Kirk, Lehman, to Michael Gelband, Lehman (Apr. 20, 2007) [LBEX-DOCID 2763976].
[353] E-mail from Steven Berkenfeld, Lehman, to Jean-Francois Astier, Lehman, *et. al.* (Mar. 30, 2007) [LBEX-DOCID 351370].
[354] Examiner's Interview of Madelyn Antoncic, Mar. 27, 2009, at p. 10.
[355] *Id.*

Fuld believed that FID and Gelband were not opposed to Lehman expanding its leveraged loan business.[356] Fuld believed that FID simply did not want the leveraged loans on its own balance sheet, because it received credit for only half of the income.[357] In contrast, IBD received credit for half of the income but bore no risk.[358] Fuld considered Gelband's concerns an "intramural P+L grab," which concerned him.[359]

(d) Growth of Lehman's Commercial Real Estate Business at The Start of the Subprime Crisis

At the same time that Lehman was rapidly growing its leveraged loan business, Lehman also dramatically increased its commercial real estate transactions. Lehman almost doubled GREG's balance sheet limit from $36.5 billion in the first quarter 2007 to $60.5 billion in the first quarter 2008, with GREG regularly exceeding its balance sheet limits.[360] For instance, GREG exceeded its balance sheet limit by approximately $600 million in the third quarter 2007 ($56.6 billion balance sheet usage); by approximately $3.8 billion in the fourth quarter 2007 ($64.3 billion balance sheet usage); and by approximately $5.2 billion in the first quarter 2008 ($65.7 billion balance sheet usage).[361]

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[356] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at pp. 5, 12, 13.

[357] *Id.* at p. 19.

[358] Examiner's Interview of Kentaro Umezaki, June 25, 2009, at p. 10.

[359] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 19.

[360] Lehman, FID-Balance Sheet Management Presentation (Sept. 2007), at p. 3 [LBEX-DOCID 4553137], attached to e-mail from Janet Marrero, Lehman, to Gerard Reilly, Lehman (Oct. 8, 2007) [LBEX-DOCID 4552976]; Lehman, FID-Balance Sheet Presentation (Jan. 17, 2008), at p. 3 [LBEX-DOCID 3363221], attached to e-mail from Sigrid Stabenow, Lehman, to Erik Addington, Lehman (Jan. 31, 2008) [LBEX-DOCID 3384762]; Lehman, Fixed Income Q3 Balance Sheet Targets [LBEX-DOCID 1742006], attached to e-mail from Kevin Horan, Lehman, to Clement Bernard, Lehman (June 27, 2009) [LBEX-DOCID 1698861].

[361] *Id.*

In addition, between the second quarter of 2006 and the second quarter of 2007, Lehman's real estate bridge equity positions in the United States increased ten-fold, from $116 million to $1.33 billion, and then doubled to more than $3 billion by the end of the second quarter of 2008.[362]

GREG's balance sheet growth was largely the result of a series of large transactions that Lehman concluded between May 2007 and November 2007. Each of the following deals increased the balance sheet by over $1 billion in the respective months:[363]

- May 2007, $2.0 billion – Lehman financing to Broadway Partners to acquire a sub-portfolio of Beacon Capital Strategic Partners III, LP.[364]
- May 2007, $1.3 billion – Lehman financing to Broadway Real Estate Partners to acquire 237 Park Avenue.[365]
- June 2007, $1.2 billion – Lehman financing to Apollo Investment Corp. for a take private of Innkeepers USA Trust;[366]
- June 2007, $1.1 billion – Lehman financing to Thomas Properties Group to acquire the EOP Austin portfolio;[367]

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[362] Ari Koutouvides, Lehman, Global Real Estate Group America's Portfolio Summary re the Second Quarter of 2007 (Oct. 24, 2007), at p. 2 [LBEX-DOCID 2501404], attached to e-mail from Jonathan Cohen, Lehman, to Paul Higham, Lehman (Oct. 24, 2007) [LBEX-DOCID 2558146]; Global Real Estate Group Americas Portfolio as of June 30, 2008, at p. 15 [LBEX-DOCID 1419825].

[363] The amounts listed were labeled as "[m]ovements onto the balance sheet" for the respective months. Unless otherwise noted in the source, these amounts are presumed to be amounts funded in that period. *See* Quarterly Real Estate Recap Third Quarter and Year-To-Date Presentation (Nov. 29, 2007), at pp. 118-25 [LBEX-DOCID 3504242], attached to e-mail from Paul Higham, Lehman, to Donald E. Petrow, Lehman (Nov. 29, 2007) [LBEX-DOCID 3625043].

[364] *Id.*

[365] *Id.*

[366] *Id.*

[367] *Id.*

- June 2007, $1.7 billion – Lehman financing for the acquisition of Northern Rock's commercial real estate portfolio;[368]
- July 2007, $1.5 billion – Lehman financing to ProLogis to acquire the Dermody industrial portfolio;[369]
- July 2007, $2.9 billion – Lehman financing for the acquisition of the Coeur Defense office building;[370]
- August 2007, $1.0 billion – Lehman financing for the acquisition of Northern Rock's commercial real estate portfolio;[371]
- October 2007, $1.5 billion – Lehman financing to Blackstone for its acquisition of Hilton Hotels;[372] and
- October 2007, $5.4 billion – Lehman financing for the acquisition of the Archstone Smith Trust.[373]

Because Lehman encountered subsequent difficulties in selling or securitizing portions of these deals, many of the above transactions remained among the largest exposures on Lehman's balance sheet as Lehman's financial condition deteriorated well into 2008.[374]

(i) Relaxation of Risk Controls to Accommodate Growth of Lehman's Commercial Real Estate Business

As with the growth of the leveraged loan business, the growth of the commercial real estate business was facilitated first by an increase in the risk limits and then by a decision to exceed those limits. In a May 9, 2006 e-mail to Umezaki, Paul A. Hughson,

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[368] *Id.*

[369] *Id.*

[370] *Id.*

[371] *Id.*

[372] Lehman, Commercial mortgages – Q2 2008 (Aug. 6, 2008), at pp. 5-14 [LBEX-DOCID 018868], attached to e-mail from Gerard Reilly, Lehman, to Ian T. Lowitt, Lehman (Aug. 7, 2008) [LBEX-DOCID 011867].

[373] *Id.*

[374] Lehman, Global Real Estate Group Update, at pp. 2-11 [LBEX-DOCID 019080] (listing top 10 risks as of May 31, 2008).

GREG's Head of Credit Distribution, inquired as to how risk limits meshed with GREG's plans to "expand our business in Asia, Europe and our bridge equity business globally. I specifically wanted to focus on how we can grow Asia and bridge equity, given the risk limits . . . ."[375] Several months later, in September 2006, in an e-mail to Walsh, Jeffrey Goodman, (senior-most risk manager for FID directly responsible for GREG) stated that he "wanted to followup on a conversation I had with [G]elband a while back concerning a push (from Goldfarb et al) to take on more risk in RE (double your size?) and get your view on what is realistic to expect and where you see this in the approval process internally."[376]

Lehman's risk appetite limit for the real estate business increased from $600 million in 2006 to $720 million in 2007.[377] But the real estate business quickly felt pressure from management to exceed its recently increased limit. In a June 2007 e-mail, Goodman told Antoncic that Hughson felt "trapped in that Roger [Nagioff] and other senior folks want[ed] them to keep growing the biz and hitting p/l budgets but on the other hand they [were] over [balance sheet] limits and risk limits."[378] Goodman advised

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[375] E-mail from Kentaro Umezaki, Lehman, to Paul A. Hughson, Lehman (May 9, 2006) [LBEX-DOCID 1776281].

[376] E-mail from Jeffrey Goodman, Lehman, to Mark A. Walsh, Lehman (Sept. 19, 2006) [LBEX-DOCID 1368068].

[377] E-mail from Paul A. Hughson, Lehman, to Thomas Pearson, Lehman, *et al.* (May 23, 2006) [LBEX-DOCID 1776282]; Lehman, Real Estate >> Risk Appetite / VaR >> Summary - COB 27 Aug 2007 Monday [LBEX-DOCID 2912096], attached to e-mail from Patricia Luken, Lehman, to Paul Higham, Lehman, *et al.* [LBEX-DOCID 2880146].

[378] E-mail from Jeffrey Goodman, Lehman, to Madelyn Antoncic, Lehman (June 29, 2007) [LBEX-DOCID 155724].

Hughson that Lehman's commercial real estate group "[could not] keep adding deals without a plan to reduce the risk somehow," and that there needed to be a discussion with Nagioff "as [to ask whether he could] cut risk in other areas (HY?) to free up some room or [whether he would] be willing to sit out some opportunities."[379] Management ultimately decided that GREG would not be held to any risk appetite limits.[380]

(ii) Internal Opposition to Growth of Commercial Real Estate Business

As with the leveraged loan business, some Lehman executives voiced concerns about the risk associated with Lehman's large concentration of commercial real estate positions on its balance sheet. But, again as with the leveraged loan business, Lehman's management decided to continue to grow the commercial real estate business notwithstanding those warnings, "because that was the strategic imperative of the firm."[381] For example, on May 7, 2007, Goodman e-mailed Antoncic about the Archstone transaction discussed below and said that O'Meara, then the CFO, "ha[d] significant concerns regarding overall size of [the real estate] book and how much of the firm's equity [was] tied up in such bridge equity deals."[382] Lehman's risk managers were also concerned with the real estate bridge equity deals in which Lehman was

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[379] *Id.*

[380] Examiner's Interview of Mark Walsh, Oct. 21, 2009, at pp. 4-5. Walsh told the Examiner that he was told to double the commercial real estate risk. *Id.* at p. 5.

[381] Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 3.

[382] E-mail from Jeffrey Goodman, Lehman, to Madelyn Antoncic, Lehman (May 7, 2007) [LBEX-DOCID 154953].

participating.[383] The bridge equity positions were considered particularly risky because Lehman's balance sheet would be directly affected by the declining market values of the underlying real estate if the firm failed to sell its bridge equity positions as planned.[384]

Nevertheless, by late 2007, Lehman acquired a number of substantial bridge equity positions, both in the United States and overseas, including: $2.3 billion in Archstone;[385] $574 million in ProLogis/Dermody portfolio;[386] €475 million ($655 million) in Coeur Defense;[387] $221 million in EOP Austin;[388] and $195 million in the acquisition of the 200 Fifth Avenue building.[389] As a result of these acquisitions, real estate bridge equity went from a negligible business to a multi-billion dollar exposure in approximately 18 months.

(iii) Archstone

a. Lehman's Commitment

The enormous growth of Lehman's commercial real estate balance sheet culminated in Lehman's commitment to participate in an approximately $22 billion

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[383] *Id.*; Examiner's Interview of Madelyn Antoncic, Mar. 27, 2009, at pp. 8-9; e-mail from Madelyn Antoncic, Lehman, to Roger Nagioff, Lehman, *et al.* (June 29 , 2007) [LBEX-DOCID 1478403]; e-mail from Paul A. Hughson, Lehman, to Thomas Pearson, Lehman, *et al.* (May 23, 2006) [LBEX-DOCID 1776282].

[384] Examiner's Interview of Madelyn Antoncic, Mar. 27, 2009, at pp. 8-9.

[385] Global Real Estate Group, Lehman, Updated Commitment Committee Memorandum for Archstone (May 22, 2007) [LBEX-DOCID 1350952]; Lehman, Lehman Brothers Bridge Equity Pipeline (July 3, 2007) [LBEX-DOCID 638275], attached to e-mail from Jeffrey Goodman, Lehman, to Donald E. Petrow, Lehman, *et al.* (July 11, 2007) [LBEX-DOCID 670845].

[386] Lehman, Top Real Estate Risk Summary (Dec. 12, 2007), at p. 2 [LBEX-DOCID 789172].

[387] *Id.*; Quarterly Real Estate Recap Third Quarter and Year-To-Date Presentation (Nov. 29, 2007), at p. 124 [LBEX-DOCID 3504242], attached to e-mail from Paul Higham, Lehman, to Donald E. Petrow, Lehman (Nov. 29, 2007) [LBEX-DOCID 3625043].

[388] *Id.* at p. 3.

[389] *Id.* at p. 4.

joint venture with Tishman Speyer for the acquisition of the publicly-held Archstone REIT.[390] Including units under construction, Archstone owned over 88,000 apartments, which were spread across more than 340 communities within the United States.[391] Mark Walsh was the driving force behind this deal, but Fuld and Gregory strongly supported it as well.[392]

On May 2, 2007, Lehman and Tishman Speyer provided a non-binding letter to acquire all outstanding shares of Archstone for $64 per share, subject to confirmatory due diligence.[393] After negotiating a price of $60.75 per share and executing a plan of merger,[394] the parties announced the deal publicly on May 29, 2007.[395] The deal was originally scheduled to close before August 31.[396]

Lehman's Executive Committee required Walsh to find partners to reduce Lehman's risk in the deal. Bank of America Corporation ("BofA") agreed to fund half

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[390] Lehman, Archstone Q2 2008 Update, at p. 14 [LBEX-DOCID 2929329], attached to e-mail from Leonard Cohen, Lehman, to Paul A. Hughson, Lehman (June 12, 2008) [LBEX-DOCID 2820780].

[391] Archstone-Smith Operating Trust, Annual Report for 2006 as of December 31, 2006 (Form 10-K) (filed on Mar. 1, 2007), at p. 6.

[392] Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at pp. 8-10; Examiner's Interview of Joseph Gregory, Nov. 13, 2009, at pp. 7-8; Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at pp. 3-4.

[393] James L. Dixson, Lehman, Archstone Transaction Timeline (June 20, 2007), at. p. 2 [LBEX-DOCID 2139993], attached to e-mail from James L. Dixson, Lehman, to Robert Ashmun, Lehman, *et al.* (June 20, 2007) [LBEX-DOCID 2139994].

[394] *Id.* at p. 5; Agreement and Plan of Merger Among Archstone-Smith Trust, Archstone-Smith Operating Trust, River Holding, LP, River Acquisition (MD), LP, and River Trust Acquisition, LP (May 28, 2007) [TSREV00000460-554].

[395] James L. Dixson, Lehman, Archstone Transaction Timeline (June 20, 2007), at. pp. 5, 6 [LBEX-DOCID 2139993], attached to e-mail from James L. Dixson, Lehman, to Robert Ashmun, Lehman, *et al.* (June 20, 2007) [LBEX-DOCID 2139994]; Agreement and Plan of Merger for Archstone-Smith and River Holding (May 28, 2007) [LBEX-DOCID 1759937], attached to e-mail from Kyle Krpata, Weil, Gotshal & Manges LLP, to David E. Shapiro, Wachtell, Lipton, Rosen & Katz, *et al.* (May 29, 2007) [LBEX-DOCID 1870993].

[396] E-mail from Chip Heflin, Lehman, to Loan Sales, Lehman (May 29, 2007) [LBEX-DOCID 1488757].

of the floating rate bank loan and junior mezzanine loan, and to purchase half the bridge equity.[397] Barclays Capital Inc. ("Barclays") signed a participation agreement to take 15% of the bridge equity and 15% of the debt in the Archstone deal, and then, on July 2, 2007, amended the agreement to take 25% of the debt.[398] Barclays' commitments came out of BofA's share of the debt and equity, and thus did not affect Lehman's exposure to Archstone.[399]

The Archstone deal was an enormous commitment by Lehman, both in terms of debt financing and equity. After bringing in BofA and Barclays, Lehman agreed to make a permanent equity investment of $250 million; agreed to purchase bridge equity of approximately $2.3 billion; and also agreed to fund various debt tranches totaling $8.5 billion.[400]

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[397] *Compare* Memorandum from Mark A. Walsh, Lehman, to Executive Committee of Lehman Board of Directors, Re: Project Easy Living (May 22, 2007) [LBEX-DOCID 1350952], attached to e-mail from Julia Atwood, Lehman, to HYCC Members, Lehman, *et al*. [LBEX-DOCID 1341648] *with* Memorandum from Mark A. Walsh, Lehman, to Exec. Committee of LBHI Board of Directors, re: Project Easy Living (May 7, 2007), at pp. 1, 3 [LBEX-DOCID 147230], attached to e-mail from Mark A. Walsh, Lehman, to Steven Berkenfeld, Lehman, *et al*. (May 8, 2007) [LBEX-DOCID 141217]; Letter from Scott M. Weiner, Barclays Investment Holdings, Inc., to Lehman, *et al.*, Red-line Commitment Letter for Archstone (June 11, 2007) [LBEX-DOCID 2073685]; Letter from Scott M. Weiner, Barclays Investment Holdings, Inc., to Lehman, *et al.*, Execution Copy of Commitment Letter for Archstone (June 11, 2007) [LBEX-DOCID 1451573].

[398] *Id*.

[399] Examiner's Interview of Mark A. Walsh, Oct. 21, 2009.

[400] Project Easy Living, Term Sheet (Sponsor) (May 28, 2007), at p. 1 [LBEX-DOCID 1624529], attached to e-mail from David Herman, Weil, Gotshal & Manges LLP, to Andrew Dady, Schulte Roth & Zabel LLP, *et al.* [LBEX-DOCID 1383842]; Project Easy Living, Term Sheet (Bridge Equity) (May 28, 2007), at p. 1 [LBEX-DOCID 1324526], attached to e-mail from David Herman, Weil, Gotshal & Manges LLP, to Andrew Dady, Schulte Roth & Zabel LLP, *et al.* [LBEX-DOCID 1383842]; River Holdings LP Senior Secured Facilities Commitment Letter (May 28, 2007), at p. 1 [LBEX-DOCID 2395952], attached to e-mail from Julian Chung, Cadwalader, Wickersham & Taft LLP, *et al.* (May 29, 2007) [LBEX-DOCID 2268458].

At the time the deal was presented to the Executive Committee, Lehman intended to sell all Archstone debt at closing.[401] Because Lehman had price flex on the Archstone debt, Lehman management was reasonably confident that it could distribute the debt without suffering a loss.[402] Price flex is a mechanism that facilitates syndication or sale of a loan by the initial lender without taking a loss.[403] As a mechanical matter, price flex may permit the initial lender to increase the interest rate to attract other lenders (in which case the borrower is required to pay its lenders a higher interest rate), or require the borrower to reimburse the debt holders for any loss they may suffer as a result of syndicating or selling the debt to a third party at a price less than par.[404] Because of the price flex on the Archstone debt, the risk in the Archstone commitment was heavily concentrated in Lehman's equity and bridge equity commitments.

Lehman planned to sell 50% of its remaining mezzanine debt and bridge equity positions within two to three weeks of closing (Lehman had already had two large financial institutions express an interest), and the rest would be sold off over the six

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[401] Lehman, Easy Living Talking Points for Executive Committee and Rating Agencies (May 18, 2007), at p. 2 [LBEX-DOCID 200792], attached to e-mail from Paolo R. Tonucci, Lehman, to Christopher M. O'Meara, Lehman, et al. (May 18, 2007) [LBEX-DOCID 215761].

[402] *Id.*

[403] Standard & Poor's, Guide to the Loan Market (Sept. 2009), at p. 8, http://www2.standardandpoors.com/spf/pdf/fixedincome/LoanMarketGuide_2009_Final.pdf (last visited (last visited on Feb. 1, 2010); Alicia Taylor & Alicia Sansone, THE HANDBOOK OF LOAN SYNDICATIONS AND TRADING 175 (McGraw-Hill 2007); Steven M. Vavaria, Standard & Poor's, *Syndicated Loans--A Rated Market, at Last!* (Feb. 12, 2002), http://leeds-faculty.colorado.edu/madigan/3020/Readings/Syndicated_Loans--A_Rated_Market_At_Last.pdf (last visited on Feb. 1, 2010).

[404] *Id.*

months following closing.[405] Insofar as Lehman's potential profits were concerned, Lehman forecast earning more than $1.3 billion over a ten-year period, including nearly $1 billion on Lehman's investment and substantial origination and asset management fees.[406]

b. Risk Management of Lehman's Archstone Commitment

Archstone was repeatedly considered by both the Commitment Committee and Executive Committee.[407] These committees mandated significant alterations to the deal structure, including, most importantly, requiring Walsh to bring in at least one partner – ultimately BofA – to reduce the size of Lehman's commitment.[408]

Notwithstanding Archstone's consideration by the senior management of the firm, Lehman's risk managers said that they had minimal input in the decision to acquire Archstone.[409] As a result, despite the extraordinary size and risk of Lehman's commitment to the transaction, Lehman's management did not conduct quantitative

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[405] Lehman, Easy Living Talking Points for Executive Committee and Rating Agencies (May 18, 2007), at p. 2 [LBEX-DOCID 200792], attached to e-mail from Paolo R. Tonucci, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (May 18, 2007) [LBEX-DOCID 215761].

[406] Memorandum from Mark A. Walsh, Lehman, to Executive Committee, Lehman, re Project Easy Living (May 7, 2007), at p. 3 [LBEX-DOCID 147230], attached to e-mail from Mark A. Walsh, Lehman, to Steven Berkenfeld, Lehman, *et al.* (May 8, 2007) [LBEX-DOCID 141217].

[407] Examiner's Interview of David S. Lazarus, Nov. 18, 2009, at pp. 6-7; Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 2; Examiner's Interview of Lisa Beeson, Oct. 23, 2009, at p. 4; Examiner's Interview of Kenneth Cohen, Oct. 20, 2009, at pp. 5-6.

[408] Examiner's Interview of Steven Berkenfeld, Oct. 5 & 7, 2009, at pp. 14-15; Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at pp. 22-23.

[409] Examiner's Interview of Jeffrey Goodman, Aug. 28, 2009; Examiner's Interview of Kentaro Umezaki, June 25, 2009, at p. 17; Examiner's Interview of Madelyn Antoncic, Feb. 25, 2009, at p. 5.

analyses of Lehman's exposure in advance of the risk Lehman was undertaking.[410] For example, it does not appear that Lehman systematically analyzed the effect that the commitment would have on the firm's risk appetite levels, or conducted stress testing on the firm's burgeoning commercial real estate exposures, in advance of committing to the transaction. Because of the extraordinary size of the transaction, however – including especially an unprecedented bridge equity commitment – it was clear from the beginning that the Archstone commitment would cause Lehman to exceed its risk appetite limits.[411]

The Office of Thrift Supervision ("OTS") criticized Lehman's decision to enter into the Archstone transaction in excess of its risk appetite limits.[412] During OTS's yearly review of Lehman in 2007, the OTS noticed that Lehman had exceeded its risk appetite limits and that the Archstone deal was largely responsible for that overage.[413] As a result, in 2008, OTS decided to conduct a targeted review of Lehman's commercial real estate business. After that targeted review, OTS issued a "negative" report, criticizing Lehman for being "materially overexposed" in the commercial real estate market and for entering into the Archstone deal without sound risk management

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[410] Examiner's Interview of Jeffrey Goodman, Aug. 28, 2009; Examiner's Interview of Madelyn Antoncic, Mar. 27, 2009, at p. 11.

[411] Examiner's Interview of Jeffrey Goodman, Aug. 28, 2009.

[412] Office of Thrift Supervision, Report of Examination, Lehman Brothers Holdings Inc. (Exam starting July 7, 2008), at p. 2 [LBEX-OTS 000392].

[413] Examiner's Interview of Ronald Marcus, Nov. 4, 2009, at pp. 7-8.

practices.[414] The report concluded that Lehman's breach of risk limits, caused largely by the Archstone deal, contributed to "major failings in the risk management process."[415]

By contrast, the SEC told the Examiner that it was aware of the risk appetite limit excesses, and that it did not second-guess Lehman's business decisions so long as the limit excesses were properly escalated within Lehman's management.[416]

(e) Nagioff's Replacement of Gelband as Head of FID

On May 1, 2007, Lehman announced that Gelband, the then-acting Global Head of FID, had "decided to leave the Firm to pursue other interests," and that Roger Nagioff would assume the top FID position at Lehman.[417] Internally, Lehman announced that the change was based on "philosophical differences" among Fuld, Gregory, and Gelband as to the direction to take to grow the business.[418]

Gelband was removed from the position for several reasons, including that he was not aggressive enough in growing the business in accordance with Fuld's long-

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[414] Examiner's Interview of Ronald S. Marcus, Nov. 4, 2009, at pp. 7-8; *accord* Office of Thrift Supervision, Report of Examination, Lehman Brothers Holdings Inc. (Exam starting July 7, 2008), at p. 2 [LBEX-OTS 000392].

[415] Office of Thrift Supervision, Report of Examination, Lehman Brothers Holdings Inc. (Exam starting July 7, 2008), at p. 2 [LBEX-OTS 000392].

[416] Examiner's Interview of the Securities and Exchange Commission, Aug. 24, 2009, at p. 8.

[417] Lehman Brothers Holdings Inc., Press Release: Lehman Brothers Names Roger B. Nagioff Global Head of Fixed Income (May 2, 2007), at p. 1 [LBEX-DOCID 1470086], attached to e-mail from Monique Wise, Lehman, to Jasjit (Jesse) Bhattal, Lehman, *et al*. (May 1, 2007) [LBEX-DOCID 1605828].

[418] Lehman Brothers, Talking Points & FAQs (May 1, 2007) [LBEX-DOCID 1470087], attached to e-mail from Monique Wise, Lehman, to Jasjit (Jesse) Bhattal, Lehman, *et al*. (May 1, 2007) [LBEX-DOCID 1605828].

term revenue targets.[419] Fuld and Gregory also clashed with Gelband with respect to growing the firm's energy business and its leveraged loan business.[420]

Fuld and Gregory chose Nagioff, then the CEO of Lehman Europe, to succeed Gelband, even though he had no direct experience in the fixed income business, and he lived in London, not New York.[421] Nagioff decided to commute from London for a portion of each month.[422]

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[419] Examiner's Interview of Joseph Gregory, Nov. 5, 2009; Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at pp. 5-6 (stating that Gregory informed him that Gelband was forced out because he was not willing to think creatively about growing Lehman's business and sharing his belief that Gelband's opposition to the Eagle Energy deal was the "last straw"); Examiner's Interview of Michael Gelband, Aug. 12, 2009, at pp. 15-16; *contra* Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 18; Examiner's Interview of Herbert H. (Bart) McDade III, Jan. 28, 2010, at p. 9.

[420] Examiner's Interview of Michael Gelband, Aug. 12, 2009, at pp. 2, 7, 15-16; Examiner's Interview of Joseph Gregory, Nov. 5, 2009; Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at pp. 5-6; Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 18; e-mail from Michael Gelband, Lehman to Richard S. Fuld, Jr., Lehman (Mar. 6, 2007) [LBEX-DOCID 2762454] ("[R]isk/reward is not good here so I'm trying to get out of as much illiquid risk as possible. . . . That is the strategy at the moment that all my managers are following. I need to have them be in a position to be able to operate and capitalize if we go through a period of stress.").

[421] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at pp. 5-6; Examiner's Interview of Hugh E. (Skip) McGee, Aug. 12, 2009, at p. 27 (McGee indicated that replacing Gelband with Nagioff was an unusual idea because Nagioff's experience was with European equities and McDade would have been a more logical choice to replace Gelband.); Examiner's Interview of Kentaro Umezaki, June 25, 2009, at p. 15 (Umezaki stated that many people, himself included, were surprised at Nagioff's promotion because Nagioff had no background in fixed income and was not located in the United States at a time when Lehman was dealing with an economic crisis located primarily within the United States and further that Alex Kirk or Andrew J. Morton would have been more logical selections but that Gregory had indicated that Nagioff would be good for the job because of his abundance of business experience and a willingness to take risks.).

[422] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 6 (Nagioff's commute would ultimately prove to be an unsustainable arrangement, as the strain it created on Nagioff's family caused him to leave the company in February 2008.).

(f) The Board of Directors' Awareness of Lehman's Increasing Risk Profile

In a June 19, 2007 Board meeting, O'Meara presented the second quarter results to the Board.[423] Lehman's management generally disclosed the firm's increased risk profile as well as the recently concluded Archstone deal. For example, O'Meara reported that the firm-wide quarterly average risk appetite usage for the second quarter of 2007 was $2.6 billion against a limit of $3.3 billion,[424] and the Board had an extended discussion concerning the fact that the increased risk usage was spread across the firm.[425] In June 2007, however, Lehman's daily risk systems reflected that the firm was almost at the $3.3 billion risk appetite limit, not including the Archstone transaction – well above the $2.6 billion quarterly average.[426]

The inclusion of the Archstone transaction was certain to put Lehman well over both its firm-wide risk appetite limit and its limit applicable to the real estate business.[427] While the Archstone transaction was discussed at the June meeting,[428]

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[423] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (June 19, 2007), at p. 3 [LBHI_SEC07940_026267].

[424] *Id.*; Lehman, Second Quarter 2007 Financial Information Presentation to Lehman Board of Directors (June 19, 2007), at p. 6 [LBHI_SEC07940_026226].

[425] Lehman, Second Quarter 2007 Financial Information Presentation to Lehman Board of Directors with Welikson's notes (June 19, 2007), at p. 6 [WGM_LBEX_01165].

[426] *See, e.g.*, Lehman, Daily Risk Appetite Report (June 19, 2007), at p. 1 [LBEX-DOCID 3296221], attached to e-mail from Rui Li, Lehman, to Manhua Leng, Lehman, *et al*. (June 19, 2007) [LBEX-DOCID 3295251].

[427] *See, e.g.*, *id.*; Mark Weber, Lehman, Chart Showing Risk Appetite Adjustment for Archstone (July 24, 2008) [LBEX-DOCID 425705], attached to e-mail from Mark Weber, Lehman, to PortfolioRisk Support, Lehman, *et al.* (July 24, 2008) [LBEX-DOCID 265567].

[428] Lehman's Board did not consider or approve the Archstone transaction in advance of the commitment. Examiner's Interview of Sir Christopher Gent, Oct. 22, 2009, at p. 3; *but cf.* Examiner's Interview of Michael L. Ainslie, Sept. 22, 2009, at p. 8 (stating that the Board never formally approved the Archstone

Lehman's management did not inform the Board until October 15, 2007 that Lehman had exceeded the firm-wide risk appetite limit for more than four months.

(3) Early Warnings: Risk Limit Overages, Funding Concerns, and the Deepening Subprime Crisis

From May to August 2007, the financial crisis that had previously been contained to the subprime residential mortgage market began to spread to other markets, including the commercial real estate and credit markets, where Lehman was particularly active. These concerns escalated in June and July 2007, when two Bear Stearns hedge funds imploded, leading to panic in the credit markets and concerns more generally that the subprime crisis would spill into the broader economy.[429] SEC Chairman Christopher Cox commented that "[o]ur concerns are with any potential systemic fallout."[430]

As a consequence of this gathering storm, in the first two weeks of July 2007, S&P placed $7.3 billion of residential mortgage related securities on negative ratings watch and announced a review of collateralized debt obligations ("CDOs") exposed to residential collateral; Moody's downgraded $5 billion of subprime mortgage bonds and

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acquisition or even discussed the transaction prior to Lehman's commitment to the deal); Examiner's Interview of John F. Akers, Apr. 22, 2009 (same); Examiner's Interview of Roger Berlind, May 8, 2009, at p. 10 (same); Examiner's Interview of Thomas Cruikshank, Oct. 8, 2009, at p. 3 (same); Examiner's Interview of Marsha Johnson Evans, May 22, 2009, at p. 14 (same); Examiner's Interview of Sir Christopher Gent, Oct. 22, 2009, at pp. 12-13 (same); Examiner's Interview of Roland A. Hernandez, Oct. 2, 2009 (same); Examiner's Interview of Dr. Henry Kaufman, May 19, 2009, at p. 15 (same); Examiner's Interview of John D. Macomber, Sept. 25, 2009, at p. 13 (same).

[429] Mark Pittman, *Bear Stearns Mortgage Fund Collapse Sends Shock Through CDOs (Update 2)*, Bloomberg, June 21, 2007.

[430] *Id*.

placed 184 mortgage backed CDO tranches on downgrade review; and Fitch placed 33 classes of structured finance CDOs on credit watch negative.[431] By the first week of August 2007, Germany's IKB announced major subprime-related losses and required a bailout, American Home Mortgage filed for Chapter 11 bankruptcy, and the French bank BNP Paribas froze redemptions on three of its funds, citing an inability to value them in the current market.[432]

Despite these events, Lehman went forward with a number of large investments, some previously committed, some new, until August 2007, when it drastically cut back on its leveraged lending, and later in 2007, when it stopped doing new commercial real estate deals.

This Section discusses the concerns of Lehman's managers about the state of the markets as early as April and May 2007 and management's actions with respect to the scale of its leveraged loan business. This Section also discusses the concerns among some Lehman managers in July and August 2007 that Lehman might be unable to fund all of its leveraged loan and real estate commitments, including Archstone, and Lehman managers' decision during this period not to increase the magnitude of Lehman's "macro hedges" on its leveraged loan and commercial real estate portfolio. Finally, this Section discusses management's decision to terminate its residential mortgage originations through BNC and Aurora.

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[431] Bank for International Settlements, 78th Annual Report (June 30, 2008), at p. 95.
[432] *Id.*

(a) Nagioff and Kirk Try to Limit Lehman's High Yield Business

Nagioff began to discuss rolling back the growth of the firm's leveraged loan business as soon as he became head of FID on May 2, 2007, but this decision was not fully effectuated until August 2007, by which time Lehman's leveraged loan exposure had grown to $35.8 billion as a result of $25.4 billion in new commitments.[433]

Nagioff learned about the size of Lehman's leveraged loan exposures from Kirk, then Head of Global Credit Products.[434] Lehman's leveraged loan business was "so gargantuan – the exposures jumped out at [him]."[435] Nagioff and Kirk believed that this was "banker business, not broker business," which Lehman did not have the balance sheet to support.[436] Nagioff also thought that the chance of a sudden market downturn was high, and that Lehman was making relatively small profits for taking increasingly

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[433] Lehman, Business and Financial Review Q2 2008 (Aug. 5, 2008), at p. 14 [LBHI_SEC07940_659768]; Lehman, Loan Portfolio Group Weekly Review (June 8, 2007), at pp. 3-8 [LBEX-DOCID 146379]; Lehman, Loan Portfolio Group Weekly Review (June 15, 2007), at pp. 3-8 [LBEX-DOCID 146375]; Lehman, Loan Portfolio Group Weekly Review (June 22, 2007), at pp. 3-8 [LBEX-DOCID 146376]; Lehman, Loan Portfolio Group Weekly Review (June 29, 2007), at pp. 3-8 [LBEX-DOCID 146377]; Lehman, Loan Portfolio Group Weekly Review (July 6, 2007), at pp. 3-8 [LBEX-DOCID 146348]; Lehman, Loan Portfolio Group Weekly Review (July 13, 2007), at pp. 3-8 [LBEX-DOCID 146358]; Lehman, Loan Portfolio Group Weekly Review (July 20, 2007), at p. 7 [LBEX-DOCID 146339]; Lehman, Loan Portfolio Group Weekly Review (July 27, 2007), at pp. 3-8 [LBEX-DOCID 146350]; Lehman, Loan Portfolio Group Weekly Review (Aug. 10, 2007), at pp. 3-8 [LBEX-DOCID 146341]; e-mail from Jeffrey Goodman, Lehman, to David N. Sherr, Lehman, *et al.* (June 22, 2007) [LBEX-DOCID 237094]. There is some evidence of inaccuracies in the LPG reports. *See, e.g.*, Gary J. Fox, Lehman, Lehman Brothers Top Exposure Report Lehman Papers Compared to LPG Data (June 25, 2007) [LBEX-DOCID 2461202], attached to e-mail from Gary J. Fox, Lehman, to Greg L. Smith, Lehman, *et al.* (June 26, 2009) [LBEX-DOCID 2461203]. The calculation excludes the commitment to TXU.

[434] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 8.

[435] *Id.* at p. 7.

[436] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 7.

large and illiquid risks.[437] Nagioff was concerned because the tail risk of Lehman's leveraged loan business totaled billions of dollars.[438]

Nagioff also had broader concerns about the state of the credit markets. These concerns were shared by others outside Lehman and by several of Nagioff's senior colleagues, who believed that Lehman was operating in a "credit bubble."[439] Months later, Antoncic, for example, reflected back on the general consensus that the markets were in trouble: "every one saw the train wreck coming. 64k question is why didn't anyone get out of the way???"[440]

Although Nagioff's concerns were shared by several others, Nagioff believed that it would be difficult to curtail Lehman's leveraged loan business, because McGee's IBD, which had championed expansion of this business from the start, had to authorize the change.[441] Moreover, Lehman had many deals in the pipeline, and those deals were supporting "100 bankers."[442] To make matters worse, Kirk believed that Gelband had been relieved of his position partly as a result of his opposition to the leveraged loan

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[437] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 8; e-mail from Gary Mandelblatt, Lehman, to Roger Nagioff, Lehman, *et al.* (Nov. 27, 2007) [LBEX-DOCID 156264].

[438] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 10.

[439] E-mail from Steven Berkenfeld, Lehman, to Roger Nagioff, Lehman (May 10, 2007) [LBEX-DOCID 140669]; e-mail from Roger Nagioff, Lehman, to Ian T. Lowitt, Lehman (May 10, 2007) [LBEX-DOCID 140666]; e-mail from Christopher M. O'Meara, Lehman, to Paulo R. Tonucci, Lehman (Apr. 6, 2007) [LBEX-DOCID 1349076]; e-mail from Christopher M. O'Meara, Lehman, to Ian T. Lowitt, Lehman (July 21, 2007) [LBEX-DOCID 211149].

[440] E-mail from Madelyn Antoncic, Lehman, to Jack Malvey, Lehman (Apr. 8, 2008) [LBHI_SEC07940_212356].

[441] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 10.

[442] *Id.*

business; Nagioff believed that he would only get one chance to convince Fuld that this business had to be stopped.[443]

Nagioff spoke to Fuld on May 31, 2007. Nagioff told Fuld that Lehman was too big in the leveraged lending business and could lose a lot of money in the tail risk.[444] Nagioff showed Fuld the numbers, which reflected a possible $3.2 billion loss under a stress scenario that was computed specifically for the purpose of this meeting.[445] Nagioff told Fuld that Lehman needed to reduce its forward commitments from $36 billion to $20 billion, impose rules on the amount of leverage in the deals, and develop a framework for limiting and evaluating this business.[446]

Fuld was surprised and concerned by the tail risk in the leveraged loan positions and authorized Nagioff to present his analysis to the Executive Committee to get authorization to move forward with a plan to limit the firm's leveraged loan exposures.[447]

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[443] E-mail from Roger Nagioff, Lehman, to Alex Kirk, Lehman (May 31, 2007) [LBEX-DOCID 173414]; Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 11; Examiner's Interview of Alex Kirk, Jan. 12, 2010, at p. 11 (Kirk stated that Nagioff thought that Gelband had been fired in part for opposing the leveraged loans business; thus, they had to move very slowly in obtaining authority to halt the business).

[444] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 11; e-mail from Jormen Vallecillo, Lehman, to Roger Nagioff, Lehman, *et al.* (June 8, 2007) [LBEX-DOCID 1620669]; Alex Kirk, Lehman, Leveraged Finance Risk Presentation (June 8, 2007) [LBEX-DOCID 1416503].

[445] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at pp. 11-12; e-mail from Jormen Vallecillo, Lehman, to Roger Nagioff, Lehman, *et al.* (June 8, 2007) [LBEX-DOCID 1620669]; Alex Kirk, Lehman, Leveraged Finance Risk Presentation (June 8, 2007), at p. 10 [LBEX-DOCID 1416503].

[446] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 12.

[447] *Id.*

Several weeks later, Nagioff discussed the leveraged loan exposure with the Executive Committee. After that conversation, on June 28, 2007, Nagioff was authorized by Fuld, Gregory, and McGee to conduct a "cross-firm initiative" to reduce commitments to $20 billion by the end of 2007.[448] The cross-firm initiative entailed developing more specific and effective limits on Lehman's high yield business (including single transaction limits) and bridge equity, and developing a plan for reducing the existing exposures.[449]

In the two months between Nagioff's conversation with Fuld on May 31 and the slowdown of Lehman's leveraged loan commitments in August 2007, the firm entered into another $25.4 billion in commitments.[450] For example, Lehman agreed on June 18, 2007 to commit $2.05 billion to the Sequa Corp deal; to commit $3.3 billion to the Home Depot Supply deal on July 19, 2007; to commit $2.4 billion to finance the Houghton Mifflin deal; and to commit $2.14 billion to finance the Applebee's deal on July 16,

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[448] E-mail from Steven Berkenfeld, Lehman, to Scott J. Freidheim, Lehman (June 26, 2007) [LBEX-DOCID 1819424]; Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 13.

[449] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 13.

[450] Lehman, Loan Portfolio Group Weekly Review (June 8, 2007), at pp. 3-8 [LBEX-DOCID 146379]; Lehman, Loan Portfolio Group Weekly Review (June 15, 2007), at pp. 3-8 [LBEX-DOCID 146375]; Lehman, Loan Portfolio Group Weekly Review (June 22, 2007), at pp. 3-8 [LBEX-DOCID 146376]; Lehman, Loan Portfolio Group Weekly Review (July 6, 2007), at pp. 3-8 [LBEX-DOCID 146348]; Lehman, Loan Portfolio Group Weekly Review (July 13, 2007), at pp. 3-8 [LBEX-DOCID 146358]; Lehman, Loan Portfolio Group Weekly Review (July 27, 2007), at pp. 3-8 [LBEX-DOCID 146350]; Lehman, Loan Portfolio Group Weekly Review (Aug. 10, 2007), at pp. 3-8 [LBEX-DOCID 146341]. The calculation excludes Lehman's commitment to TXU.

2007.[451] As a result, FID ended the quarter roughly $2 billion over its net balance sheet limit.[452] As Nagioff put it, it took time to "stop the machine;" a lot of deals were in the pipeline or under negotiation, and Lehman did not believe that it could abruptly terminate those deals.[453]

Nagioff was concerned that his efforts were too little too late: "Sadly in spite of killing BCE which was a 5!bn 'KKR disaster I am probably 3 months too late in the job….a big deal got pulled today and others are being restructured down….we are probably going to get punished for our stupidity."[454] Two days later, Nagioff also wrote: "I now have the thing under control . . . if I had the job 6 months earlier we would not be where we are . . . let's hope it is only scratches."[455]

(b) July-August 2007 Concerns Regarding Lehman's Ability to Fund Its Commitments

By July 2007, after the Bear Stearns' funds' implosion, some Lehman executives were concerned that Lehman might not be able to fund all of its commitments.[456] For

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[451] E-mail from Lehman Risk, Lehman, to Risk Limit Excess, Lehman (July 16, 2007) [LBEX-DOCID 230109]; Lehman, Loan Portfolio Group Weekly Review (July 20, 2007), at p. 7 [LBEX-DOCID 146339]; Lehman, Loan Portfolio Group Weekly Review (July 27, 2007), at pp. 6-7 [LBEX-DOCID 146350]; Appendix: 9, comparing risk appetite and VaR usage versus limits.

[452] Lehman, 2007 Balance Sheet Targets and Usage - Global (Oct. 17, 2007) [LBEX-DOCID 278229].

[453] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 10; Examiner's Interview of Alex Kirk, Jan. 12, 2009, at pp. 2-3; *accord* Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at pp. 10-11, 16-17.

[454] E-mail from Roger Nagioff, Lehman, to David Goldfarb, Lehman (June 26, 2007) [LBEX-DOCID 1585157]. For a fuller discussion of the effort to reduce the firm's high yield exposure, see Sections III.A.1.b.3 and III.A.1.b.4 of this Report.

[455] E-mail from Roger Nagioff, Lehman, to David Goldfarb, Lehman (June 28, 2007) [LBEX-DOCID 1585167].

[456] *See, e.g.*, e-mail from Paolo R. Tonucci, Lehman, to Sigrid M. Stabenow, Lehman (Mar. 14, 2007) [LBEX-DOCID 1342697]; e-mail from Christopher M. O'Meara, Lehman, to Paolo R. Tonucci, Lehman (Apr. 6,

example, Lehman had a maximum cumulative outflow funding model designed to ensure that Lehman had sufficient cash sources to meet the expected cash outflows in a stressed market environment.[457] Under that model, in July 2007, the firm's "[L]iquidity Pool one year forward position [was] short $(0.4) billion."[458]

The liquidity concerns were the result of several factors. First, as the credit markets froze, Lehman was unable to distribute its risk in certain leveraged loan and commercial real estate deals, including Archstone, leaving it with more exposure than it had previously anticipated.[459] In addition, the firm had "effectively been locked out of the capital markets."[460]

When Nagioff learned about these concerns, he wrote Ian T. Lowitt, Lehman's then Co-CAO: "Kirk and Ken [Umezaki] are panicky…. Are they over reacting."[461]

2007) [LBEX-DOCID 1349076]; Lehman, Chart Showing High Grade and High Yield Loan Commitments (July 19, 2007) [LBEX-DOCID 375444], attached to e-mail from Nahill Younis, Lehman, to Kentaro Umezaki, Lehman (July 19, 2007) [LBEX-DOCID 297877]; e-mail from Kentaro Umezaki, Lehman, to Ian Lowitt, Lehman (July 20, 2007) [LBEX-DOCID 717108]; e-mail from Ian T. Lowitt, Lehman, to Kentaro Umezaki, Lehman (July 20, 2007) [LBEX-DOCID 717108]; e-mail from Ian T. Lowitt, Lehman, to Paolo Tonucci, Lehman, *et al.* (July 11, 2007) [LBEX-DOCID 1901826].

[457] Lehman, Liquidity Management At Lehman Brothers (July 2008), at p. 13 [LBEX-DOCID 009007], attached to e-mail from Rowena T. Carreon, Lehman, to Robert Azerad, Lehman, *et. al.* (July 31, 2008) [LBEX-DOCID 067762].

[458] 3rd Quarter-to-Date MCO and Cumulative Outflow Analysis (July 11, 2007), at p. 1 [LBEX-DOCID 1681748], attached to e-mail from Nahill Younis, Lehman, to Paolo R. Tonucci, Lehman (July 11, 2007) [LBEX-DOCID 1901826].

[459] Examiner's Interview of Kentaro Umezaki, June 25, 2009, at p. 16; Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 9; Examiner's Interview of Alex Kirk, Jan. 12, 2010, at p. 12.

[460] E-mail from Nahill Younis, Lehman, to Paolo R. Tonucci, Lehman (July 11, 2007) [LBEX-DOCID 1901826].

[461] E-mail from Roger Nagioff, Lehman, to Ian T. Lowitt, Lehman (July 20, 2007) [LBEX-DOCID 175649].

Lowitt responded with a detailed explanation of the problem and his view of the root of the problem:

> If everything goes as badly as it could simultaneously it will be awful, but at least at the moment a lot of people have money they are willing to [l]end to us and if we close them quickly it will make a difference. I do think we need to get on a `war footing.' [James] Merli and the guys on the desk are panicky and that is feeding back into fid and outside the firm. Need people to be confident. I would describe my position based on what I know today as anxious but not panicky. *Also the discipline we had post 1998 about funding completely dissipated which adds to the alarm*.[462]

Nagioff responded: "Last paragraph applies to firm broadly."[463]

Lowitt traced Lehman's difficulty in funding its commitments directly to its failure to abide by its risk limits, as Lowitt wrote to O'Meara in a later e-mail on July 20, 2007: "In case we ever forget; this is why one has concentration limits and overall portfolio limits. Markets do seize up."[464]

To deal with these concerns on a "war footing," Lowitt, O'Meara, Kirk, Umezaki, and Paolo R. Tonucci, (Lehman's Global Treasurer), set up an Asset-Liability Committee ("ALCO") so that FID and Lehman's Treasury Department could "manage [the firm's] liquidity on a daily basis."[465] Prior to the formation of ALCO, Lehman's

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[462] E-mail from Ian T. Lowitt, Lehman, to Roger Nagioff, Lehman (July 20, 2007) [LBEX-DOCID 175646] (emphasis supplied).

[463] E-mail from Roger Nagioff, Lehman, to Ian T. Lowitt, Lehman (July 20, 2007) [LBEX-DOCID 175646].

[464] E-mail from Ian Lowitt, Lehman, to Christopher M. O'Meara, Lehman (July 20, 2007) [LBEX-DOCID 194066].

[465] E-mail from Ian Lowitt, Lehman, to Roger Nagioff, Lehman (July 20, 2007) [LBEX-DOCID 175646]; e-mail from Ian Lowitt, Lehman, to Herbert H. McDade III, Lehman, *et al.* (July 20, 2007) [LBEX-DOCID 175646].

Treasury Department relied on pipeline reports from the businesses.[466] ALCO convened frequent meetings from August 2007 through February 2008,[467] and began to track and monitor more closely the firm's monthly projections for cash capital and maximum cumulative outflow.

The cash capital model was a pillar of the firm's funding framework.[468] The sources of cash capital were equity and debt with a remaining life of greater than one year.[469] The firm always funded leveraged loans and commercial real estate with cash capital.[470] Although the firm could fund loans and commercial real estate on a secured basis, it assumed that secured finance would not be available under stressed market

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[466] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 9.

[467] *See e.g.*, Lehman, LBHI CC Projections (July 30, 2007) [LBEX-DOCID 214312], attached to e-mail from Paolo R. Tonucci, Lehman, to Christopher M. O'Meara, Lehman (July 30, 2007) [LBEX-DOCID 187182]; ALCO Summary Package (Aug. 2, 2007) [LBEX-DOCID 514844]; ALCO Summary Package (Aug. 7, 2007) [LBEX-DOCID 514847]; ALCO Summary Package (Aug. 16, 2007) [LBEX-DOCID 514851]; ALCO Summary Package (Sept. 4, 2007) [LBEX-DOCID 514862]; ALCO Summary Package (Sept. 5, 2007) [LBEX-DOCID 514863]; ALCO Summary Package (Sept. 6, 2007) [LBEX-DOCID 514865]; ALCO Summary Package (Sept. 7, 2007) [LBEX-DOCID 514866]; ALCO Summary Package (Sept. 10, 2007) [LBEX-DOCID 514867]; ALCO Summary Package (Sept. 12, 2007) [LBEX-DOCID 514869]; ALCO Summary Package (Sept. 13, 2007) [LBEX-DOCID 514870]; ALCO Summary Package (Sept. 14, 2007) [LBEX-DOCID 514871]; ALCO Summary Package (Sept. 18, 2007) [LBEX-DOCID 514873]; ALCO Summary Package (Sept. 21, 2007) [LBEX-DOCID 514875]; ALCO Summary Package (Oct. 25, 2007) [LBEX-DOCID 514887]; ALCO Summary Package (Dec. 4, 2007) [LBEX-DOCID 104102]; ALCO Summary Package (Feb. 12, 2008) [LBEX-DOCID 104040].

[468] Lehman, Implications for the Funding Framework (Aug. 6, 2007), at p. 2 [LBEX-DOCID 601971], attached to e-mail from Angelo Bello, Lehman, to Kentaro Umezaki, Lehman (Aug. 6, 2007) [LBEX-DOCID 720559].

[469] Lehman, Update on Risk, Liquidity, and Capital Adequacy Presentation to Standard and Poor's (Aug. 17, 2007), at p. 72 [LBEX-DOCID 2031705], attached to e-mail from Shaun K. Butler, Lehman, to Elizabeth R. Besen, Lehman (Aug. 28, 2007) [LBEX-DOCID 2374876].

[470] *Id.* at p. 67.

conditions.[471] It was the firm's policy always to have a cash capital surplus of at least $2 billion.[472]

On July 30, 2007, ALCO members exchanged an analysis showing that Lehman did not project having the usual surplus, and in fact projected large deficits of cash capital.[473] More specifically, Lehman's month end cash capital estimates for September, October, and November of the same year were -$11.4 billion, -$14.5 billion and -$9.4 billion.[474] This meant that Lehman did not anticipate being able to fund its long-term obligations with long-term assets.

Faced with this prospect, in early August 2007, Kirk, Lowitt and Nagioff decided to shut down the leveraged loan and commercial real estate businesses until the end of the third quarter of 2007. They convinced McGee and Berkenfeld to "kill everything" for the rest of the quarter.[475] Nagioff believed the Executive Committee should not have approved any large deals before the end of the quarter, saying: "Do not think any large deal can get thru exec[utive committee] pre qtr end . . . this cannot be expressed

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[471] *Id.*

[472] Lehman, Risk, Liquidity, Capital and Balance Sheet Update Presentation to the Finance and Risk Committee of Lehman Board of Directors on (Sept. 11, 2007), at p. 31 [LBEX-DOCID 505941], attached to e-mail from Paolo R. Tonucci, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Sept. 9, 2007) [LBEX-DOCID 552383].

[473] LBHI CC Projections (July 30, 2007), at p. 2 [LBEX-DOCID 214312], attached to e-mail from Paolo Tonucci, Lehman, to Christopher M. O'Meara, Lehman (July 30, 2007) [LBEX-DOCID 187182].

[474] *Id.*

[475] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 10.

publicly."[476] Kirk responded: "Good. We will need skip [McGee] to kill as much stuff as early as possible."[477]

At about the same time, the leveraged loan market generally collapsed, and new issues slowed to a trickle in the third quarter.[478] Lehman's leveraged loan commitments thus halted in early August 2007, three months after Nagioff first concluded that Lehman's exposure was already "gargantuan," and two months after Nagioff's first conversation with Fuld about the issue.

(c) Lehman Delays the Archstone Closing

Because of the funding concerns, Lehman delayed the closing on Archstone from the originally anticipated August 2007 closing date to October 5, 2007.[479] As the market crisis escalated in June and July 2007, Lehman attempted to syndicate its Archstone debt. But by late July 2007, the institutional market for commercial real estate was "virtually closed,"[480] and Lehman's attempts at selling Archstone bridge equity largely failed.[481]

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[476] E-mail from Roger Nagioff, Lehman, to Alex Kirk, Lehman (Aug. 7, 2007) [LBEX-DOCID 173496].

[477] E-mail from Alex Kirk, Lehman, to Roger Nagioff, Lehman (Aug. 7, 2007) [LBEX-DOCID 173496].

[478] Lehman, Loan Syndicate/Year-End Recap (Jan. 4, 2008), at p. 5. [LBHI_SEC07940_066190].

[479] E-mail from Randall B. Whitestone, Lehman, to Steven Berkenfeld, Lehman, *et al.* (Aug. 5, 2007) [LBEX-DOCID 988270]; Archstone-Smith Trust, Press Release: Archstone-Smith Amends Merger Agreement With Tishman Speyer Partnership (Aug. 6, 2007) [LBEX-DOCID 2140354]; e-mail from Chip Heflin, Lehman, to Loan Sales - 4th Floor, Lehman (May 29, 2007) [LBEX-DOCID 1488757].

[480] E-mail from Mark Walsh, Lehman, to Alex Kirk, Lehman, *et al*. (July 27, 2007) [LBEX-DOCID 174304].

[481] *See* Appendix *generally* e-mail from Paul A. Hughson, Lehman, to Mark A. Walsh, Lehman, *et al.*, (July 27, 2007) [LBEX-DOCID 155079] (reflecting the fact that on July 27, 2007, D.E. Shaw informed Lehman that "given the sell-off in the reit market and the volatility of the credit markets" its Risk Committee had rejected the deal); e-mail from Jonathan Cohen, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (July

In the midst of the market deterioration, an analyst at Citigroup issued an analyst report entitled "Archstone Smith Trust (ASN): Could the Buyers Cut Their Losses and Walk Away?"[482] The report suggested that Lehman, BofA, and Barclays might be better off walking away from the Archstone deal and paying the $1.5 billion breakup fee, rather than closing the deal at a significant loss.[483]

While the report and a Wall Street Journal article discussing it were widely read at Lehman,[484] Lehman never seriously considered walking away from the deal.[485] One reason Lehman was comfortable proceeding with the deal was that Lehman was ultimately able to sell approximately $2.09 billion in Archstone debt to Freddie Mac,[486] and another $7.1 billion of Archstone debt to Fannie Mae.[487] During the same time

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27, 2007) [LBEX-DOCID 1904232] (showing that by July 2007, Lehman began to worry that the market "implosion" might force Lehman to provide $9 billion in funding for the Archstone transaction, rather than the $6.8 billion it had previously assumed would be necessary.).

[482] Jonathan Litt, *Citigroup Global Markets Inc., Archstone Smith Trust (ASN): Could the Buyers Cut Their Losses and Walk Away?* (July 26, 2007) [LBEX-DOCID 1714588].

[483] *Id.* at pp. 1-2.

[484] *See e.g.*, e-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman (July 31, 2007) [LBEX-DOCID 2500559]; e-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman (Aug. 1, 2007) [LBEX-DOCID 210156]; e-mail from Stephen F. Rossi, Lehman, to Anna Yu, Lehman, *et al*. (Aug. 1, 2007) [LBEX-DOCID 3271158].

[485] Examiner's Interview of Lisa Beeson, Oct. 23, 2009, at p. 5; Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 9; Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 4; Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 3; Examiner's Interview of Sir Christopher Gent, Oct. 21, 2009, at p. 3; Examiner's Interview of John D. Macomber, Sept. 25, 2009, at pp. 13-14.

[486] Freddie Mac, Holdco Term Sheet (Sept. 5, 2007) [LBEX-DOCID 4452813]; Freddie Mac, Sellco Term Sheet (Sept. 5, 2007) [LBEX-DOCID 4452811]; Lehman, Project Easy Living Debt Funding Detail (Oct. 5, 2007), at p. 1 [LBEX-DOCID 598184].

[487] Examiner's Interview of Mark A. Walsh, Oct. 22, 2009, at p. 9; Examiner's Interview of Lisa Beeson, Oct. 23, 2009, at p. 8; Letter from Lehman Brothers Holdings Inc. to Fannie Mae re: Rate Lock Terms (Sept. 17, 2007), at p. 1. [LBEX-DOCID 2704241].

period, however, Lehman and its partners were able to sell only $71 million of the deal's $4.6 billion in bridge equity.[488]

The Archstone deal closed on October 5, 2007.[489] As of October 12, 2007, Lehman's total Archstone exposure was approximately $6 billion, $2.39 billion of which was in the riskiest equity portions of the deal (permanent equity and bridge equity portions):[490]

Permanent equity	$250 million
Bridge equity	$2.14 billion
Mezzanine loan	$240 million
Term loan	$2.47 billion
Senior debt	$850 million

When Secretary of the Treasury Henry M. Paulson, Jr. learned late in 2007 that Lehman had closed on Archstone, despite the shut-down in the securitization market, he questioned the wisdom of the decision and the direction in which Lehman was heading.[491]

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[488] Lehman, Archstone Smith Multifamily JV Debt and Equity Redemption Schedule (Jan. 3, 2008), at p. 1 [LBEX-DOCID 2502413], attached to e-mail from Keith Cyrus, Lehman, to Paul A. Hughson, Lehman, *et al.* (Jan. 1, 2008) [LBEX-DOCID 2646616].

[489] Lehman, Acquisition of Archstone-Smith Trust Corporate Closing Documents Table of Contents (Oct. 5, 2007), at p. 2 [LBEX-WGM 960404].

[490] Lehman, Lehman Expected Share of Real Estate Commitments (Oct. 17, 2007), at p. 2 [LBEX-DOCID 624620].

[491] Examiner's Interview of Henry Paulson, June 25, 2009, at p. 9.

(d) Lehman Increases the Risk Appetite Limit to Accommodate the Additional Risk Attributable to the Archstone Transaction

The risk in Lehman's book was dramatically increasing during 2007.[492] Lehman's management reacted to the increasing risk appetite usage by increasing its limit amounts.

Although Lehman ordinarily included the risk appetite usage attributable to a transaction immediately after entering into the commitment for the transaction, Lehman did not include the very substantial increase in risk appetite usage attributable to Archstone in the risk appetite calculation for almost three months.[493] At least one other real estate bridge equity transaction, Dermody/ProLogis, also was not included in risk appetite until that date.[494]

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[492] Some of the increase in risk usage, of course, was the result of market volatility and its effect upon existing assets; some was the result of decisions to close new deals. In any event, usage increased dramatically in 2007 and limits were raised accordingly, from $3.3 billion to $3.5 billion to $4.0 billion. *See* e-mail from Manhua Leng, Lehman, to Mynor Gonzalez, Lehman, *et al.* (Sept. 10, 2007) [LBEX-DOCID 262797]; e-mail from Christopher M. O'Meara, Lehman, to David Goldfarb, Lehman (Aug. 15, 2007) [LBEX-DOCID 211183]; Lehman, Material for Market Risk Control Committee Meeting (Jan. 14, 2008), at p. 33 [LBEX-DOCID 271352], attached to e-mail from Mark Weber, Lehman, to Paul Shotton, Lehman, *et al*. (Jan. 14, 2008) [LBEX-DOCID 223263]. As revenues increased, the capacity for risk increased; management calculated, albeit sometimes by adjusting the formula, that each increase was justified by anticipated revenues. *See* e-mail from Madelyn Antoncic, Lehman, to David Goldfarb, Lehman, *et al*. (Aug. 28, 2007) [LBEX-DOCID 193203]; *see* Appendix 10, showing the calculation of Lehman's increased $4.0 billion risk appetite limit.

[493] *See* e-mail from Mark Weber, Lehman, to Jeffrey Goodman, Lehman (June 4, 2007) [LBEX-DOCID 247960]; Mark Weber, Lehman, Chart Showing Risk Appetite Adjustment for Archstone (July 24, 2008) [LBEX-DOCID 425705], attached to e-mail from Mark Weber, Lehman, to PortfolioRisk Support, Lehman, *et al.* (July 24, 2008) [LBEX-DOCID 265567]; *see also* e-mail from Mark Weber, Lehman, to Laura M. Vecchio, Lehman (July 31, 2008) [LBEX-DOCID 264849].

[494] Lehman, VaR / Risk Appetite Restatements, (Nov. 12, 2007) at p. 17 [LBEX-DOCID 271334].

If Archstone (and the other transactions) had been included in the firm's risk appetite usage from the Archstone commitment date in late May 2007, consistent with the firm's usual practice, Lehman would have been over the firm-wide risk appetite limit for much of the intervening period.[495] Lehman would also have been over the risk appetite limits for FID and the real estate business by substantial margins.[496] As the summer of 2007 wore on, the volatility in the markets began to exacerbate the situation, and Lehman's risk appetite usage increased markedly, even though Lehman generally stopped entering into major new commitments after the third quarter of 2007.[497]

Archstone and Dermody/ProLogis were not included sooner in Lehman's risk appetite usage calculation because Lehman's risk managers were trying to calculate a stable usage amount for these bridge equity transactions. Initial calculations yielded

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[495] *Id.*

[496] *Id.*

[497] E-mail from Jeffrey Goodman, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Dec. 4, 2007) [LBEX-DOCID 251204]; e-mail from Paul Shotton, Lehman, to Christopher M. O'Meara, Lehman *et al.* (Dec. 6, 2007) [LBEX-DOCID 251204]; Examiner's Interview of Mark Weber, Aug. 11, 2009, at p. 9; Examiner's Interview of David Goldfarb, Sept. 21, 2009, at p. 8; Examiner's Interview of Madelyn Antoncic, Oct. 6, 2009, at p. 7; Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at p. 13; *but see* Lehman, September 2007 Financial Information Presentation to Lehman Board of Directors with Christopher M. O'Meara's handwritten notes (Oct. 15, 2007), at p. 6 [LEH_CMO_0000001] (attributing the increase in risk appetite to increased market volatility as well as increased leveraged finance and commercial real estate positions, particularly since the market environment had prevented the firm from selling those assets); e-mail from Joe Li, Lehman, to Madelyn Antoncic, Lehman (Sept. 11, 2007) [LBEX-DOCID 157247] (stating that 50% of the recent VaR increase for Global Capital Products was due to volatility and 50% was from the origination book); *see also* Lehman, Firm-wide Risk Driver (Oct. 22, 2007) [LBEX-DOCID 190147] (attributing the firm's rising risk appetite and VaR usage figures primarily to increased correlation across divisions).

varying risk appetite usage figures that Lehman's risk managers considered unreasonable.[498]

Once these positions were officially included in risk appetite usage in August 2007, it became clear to senior management that the firm had been exceeding the firm-wide risk appetite on a persistent basis for some time.[499] The firm's risk appetite usage started to be discussed more widely within the firm.[500]

Lehman raised its firm-wide risk appetite limit from $3.3 billion to $3.5 billion on September 7, 2007.[501] Lehman's risk managers questioned whether Lehman truly had increased risk-taking capacity, however. Two weeks after the firm first included the

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[498] Examiner's Interview of Jeffrey Goodman, Aug. 28, 2009; Examiner's Interview of Mark Weber, Aug. 11, 2009, at p. 4; *but cf.* Examiner's Interview of Madelyn Antoncic, Oct. 6, 2009, at p. 11 (reflecting statements that she was unaware that the bridge equity portion of the Archstone deal had been excluded from the firm's risk measurements and that she "hit the roof" when Jeffrey Goodman told her that the bridge equity had not been included in the firm's metrics).

[499] Examiner's Interview of Jeffrey Goodman, Aug. 28, 2009; Examiner's Interview of Paul Shotton, June 5, 2009, at p. 19; Appendix No. 9, comparing risk appetite and VaR usage versus limits; e-mail from Mark Weber, Lehman, to Laura M. Vecchio, Lehman (July 31, 2008) [LBEX-DOCID 264849]; Mark Weber, Lehman, Chart Showing Risk Appetite Adjustment for Archstone (July 24, 2008) [LBEX-DOCID 425705], attached to e-mail from Mark Weber, Lehman, to Portfolio Risk Support, Lehman, *et al.* (July 24, 2008) [LBEX-DOCID 265567]; e-mail from Madelyn Antoncic, Lehman, to David Goldfarb, Lehman, *et al.* (Aug. 14, 2007) [LBEX-DOCID 211183].

[500] *See* Lehman, September 2007 Financial Information Presentation to Lehman Board of Directors (Oct. 15, 2007), at p. 6 [LBHI_SEC07940_026377]; Lehman Brothers Holdings Inc., Minutes of Meeting of the Finance and Risk Committee of the Board of Directors (Sept. 11, 2007), at p. 2 [LBEX-AM 067018]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 11, 2007), at p. 3 [LBHI_SEC07940_026364]; e-mail from Madelyn Antoncic, Lehman, to David Goldfarb, Lehman, *et al.* (Aug. 14, 2007) [LBEX-DOCID 211183].

[501] E-mail from Manhua Leng, Lehman, to Mynor Gonzalez, Lehman, *et al.* (Sept. 10, 2007) [LBEX-DOCID 262797]; e-mail from Christopher M. O'Meara, Lehman, to David Goldfarb, Lehman (Aug. 15, 2007) [LBEX-DOCID 211183]. *But see* e-mail from Madelyn Antoncic, Lehman, to David Goldfarb, Lehman, *et al.* (Aug. 28, 2007) [LBEX-DOCID 193203] (showing that Antoncic did not believe that the decision to raise the limit had been made - "we did not close the loop on this. Robert worked up some numbers but I think we need to revisit the expected rev for Q4 given a slowdown").

Archstone and Dermody/ProLogis bridge equity positions in the firm's risk appetite usage calculation, Goldfarb e-mailed O'Meara and Antoncic: "I thought we increased [risk] appetite to reflect YTD performance?"[502] Antoncic replied that they "did not close the loop on this" because of concerns related to a fourth-quarter slowdown in revenues.[503] Under the methodology for calculating the risk appetite limit, a slowdown in revenues would have reduced Lehman's ability to take risk. Similarly, in an October 2007 CSE meeting, Goodman informed the SEC that Lehman had increased its risk appetite limit, but "admitted that they probably shouldn't have raised the limit to $3.5b when they did, given that they were almost there and there wasn't enough headroom."[504]

(e) Cash Capital Concerns

ALCO continued to have serious concerns about Lehman's cash capital and liquidity position. Until the final week of September 2007, Lehman did not expect its ending cash capital positions for the months of September, October, and November to meet the $2 billion minimum requirement.[505] The average ending cash capital positions

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[502] E-mail from David Goldfarb, Lehman, to Madelyn Antoncic, Lehman, *et al*. (Aug. 28, 2007) [LBEX-DOCID 193203].

[503] E-mail from Madelyn Antoncic, Lehman, to David Goldfarb, Lehman, *et al*. (Aug. 28, 2007) [LBEX-DOCID 193203].

[504] SEC, Notes from Lehman's Monthly Risk Review Meeting (Oct. 19, 2007), at p. 6 [LBEX-SEC 007438].

[505] Lehman, ALCO Summary Package (Sept. 4, 2007), at p. 2 [LBEX-DOCID 514862]; Lehman, ALCO Summary Package (Sept. 5, 2007), at p. 2 [LBEX-DOCID 514863]; Lehman, ALCO Summary Package (Sept. 6, 2007), at p. 2 [LBEX-DOCID 514865]; Lehman, ALCO Summary Package (Sept. 7, 2007), at p. 2 [LBEX-DOCID 514866]; Lehman, ALCO Summary Package (Sept. 10, 2007), at p. 2 [LBEX-DOCID 514867]; Lehman, ALCO Summary Package (Sept. 11, 2007), at p. 2 [LBEX-DOCID 514868]; Lehman, ALCO

for September, October, and November 2007 were projected to be $0.05 billion, -$2.15 billion and -$1.75 billion respectively.[506] The committee projected negative month end cash capital positions for the remainder of the year.[507]

On the day that Archstone closed, Tonucci informed O'Meara that Lehman was "looking at being $1-2 [billion] short [in equity]…should not really be surprised."[508] Moreover, the firm's cash capital projections for the end of October went negative immediately after the firm closed on Archstone.[509]

A draft presentation on the firm's equity adequacy dated October 2007 was prepared for the Executive Committee shortly after the exchange between O'Meara and Tonucci.[510] O'Meara was slated to be the presenter.[511] The presentation concluded that the firm's capital adequacy over the last five to six quarters had "materially

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Summary Package (Sept. 12, 2007), at p. 3 [LBEX-DOCID 514869]; Lehman, ALCO Summary Package (Sept. 13, 2007), at p. 3 [LBEX-DOCID 514870]; Lehman, ALCO Summary Package (Sept. 14, 2007), at p. 3 [LBEX-DOCID 514871]; Lehman, ALCO Summary Package (Sept. 17, 2007), at p. 3 [LBEX-DOCID 514872]; Lehman, ALCO Summary Package (Sept. 18, 2007), at p. 3 [LBEX-DOCID 514873]; Lehman, ALCO Summary Package (Sept. 19, 2007), at p. 3 [LBEX-DOCID 514874]; Lehman, ALCO Summary Package (Sept. 21, 2007), at p. 3 [LBEX-DOCID 514875]; Lehman, ALCO Summary Package (Sept. 24, 2007), at p. 3 [LBEX-DOCID 514876]; Lehman, ALCO Summary Package (Sept. 26, 2007), at p. 3 [LBEX-DOCID 514877].

[506] *Id.*

[507] *Id.*

[508] E-mail from Paolo R. Tonucci, Lehman, to Christopher M. O'Meara, Lehman (Oct. 5, 2007) [LBEX-DOCID 1360792].

[509] Lehman, ALCO Summary Package (Sept. 4, 2007), at p. 2 [LBEX-DOCID 514881].

[510] Lehman, Equity Adequacy Presentation to Executive Committee [Draft] (Oct. 26, 2007) [LBEX-DOCID 1698460], attached to e-mail from Ari Axelrod, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Oct. 26, 2007) [LBEX-DOCID 1912826].

[511] E-mail from Ari Axelrod, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Oct. 26, 2007) [LBEX-DOCID 1902541].

deteriorated."[512] Lehman was at the bottom of its peer range with respect to the regulatory requirement of a minimum 10% total capital ratio imposed by the SEC.[513] The equity adequacy framework illustrated how the firm's capital position decreased from a $7.2 billion surplus in the beginning of 2006 to a $42 million deficit at the end of the third quarter of 2007.[514] The Examiner was unable to find a final version of this presentation, and was unable to determine if the presentation ever was given. Fuld said that he was not aware of the information contained in the presentation, and if he had been, he would have been able to resolve the situation.[515]

The deterioration of Lehman's capital was also apparent from the decline in its total capital ratio from 18.2% in early 2006 to 10.5% in August 2007.[516] The industry high in August 2007 was 18.7%.[517] From August to November 2007, Lehman posted the lowest total capital ratio in the industry.[518] The firm was at or near its SEC-imposed 10%

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[512] Ari Axelrod, Lehman, Equity Adequacy Presentation Summary Page [Draft] (Oct. 25, 2007), at p. 1 [LBEX-DOCID 1696067], attached to e-mail from Ari Axelrod, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Oct. 26, 2007) [LBEX-DOCID 1902541].

[513] Lehman, Equity Adequacy Presentation to Executive Committee [Draft] (Oct. 26, 2007), at p. 1 [LBEX-DOCID 1698460], attached to e-mail from Ari Axelrod, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Oct. 26, 2007) [LBEX-DOCID 1912826].

[514] *Id.*

[515] Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at p. 5.

[516] Lehman, Monthly CSE Capital Reports for SEC (Mar. 2006), at p. 1 [LBEX-SEC 000303]; Lehman, Equity Adequacy Presentation to Executive Committee [Draft] (Oct. 26, 2007), at p. 5 [LBEX-DOCID 1698460], attached to e-mail from Ari Axelrod, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Oct. 26, 2007) [LBEX-DOCID 1912826].

[517] E-mail from Anna Yu, Lehman, to Erin M. Callan, Lehman, *et al.* (Dec. 9, 2007) [LBEX-DOCID 3761740].

[518] Lehman, CSE Methodology Impact Summary (Apr. 4, 2008), at p. 2 [LBEX-DOCID 382980].

requirement for six months in 2007-2008.[519] On three separate occasions, Lehman had at least a concern that the total capital ratio would fall below the 10% requirement.[520]

The SEC expected Lehman to notify it if the total capital ratio fell below or was expected to fall below the 10% requirement, but Lehman did not do so.[521] Tonucci told the SEC that Lehman was "comfortable" with landing close to the 10% limit at the end of the year "given how difficult it is to issue right now."[522]

The dominant cause for the rapid decline in Lehman's equity position was a shift in the firm's asset mix to illiquid assets, including high yield loans, real estate, and principal investments.[523] From November 2006 to August 2007, the firm's illiquid holdings grew by 72%, while "Tier 1 capital grew by only 26%."[524]

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[519] Lehman, CSE Methodology Impact Summary (Apr. 4, 2008), at p. 2 [LBEX-DOCID 382980].

[520] E-mail from Anna Yu, Lehman, to Paolo R. Tonucci, Lehman (Oct. 3, 2007) [LBEX-DOCID 1654567]; e-mail from Anna Yu, Lehman, to undisclosed recipients (Nov. 26, 2007) [LBEX-DOCID 638715]; e-mail from Anna Yu, Lehman, to Georges Assi, Lehman, *et al.* (Dec. 7, 2007) [LBEX-DOCID 307968].

[521] 17 C.F.R. § 240.15c3-1g (e) (1) (i); 17 C.F.R. § 240.17i-8 (a) (2) (2007); The Goldman Sachs Group Inc., Quarterly Report as of May 31, 2008 (Form 10-Q) (filed on July 7, 2008), at p. 90 ("Goldman Sachs 10-Q (filed on July 7, 2008)") ("Goldman Sachs is required to notify the SEC in the event that the Total Capital Ratio falls below 10% or is expected to do so within the next month"); Merrill Lynch & Co., Inc., Quarterly Report as of June 27, 2008 (Form 10-Q) (filed on Aug. 5, 2008), at p. 108 ("Merrill Lynch 10-Q (filed on Aug. 5, 2008)") ("Merrill Lynch is required to notify the SEC in the event that the Total Capital Ratio falls or is expected to fall below 10%"); Erik R. Sirri, SEC, *Testimony Concerning Lessons Learned in Risk Management Oversight at Federal Financial Regulators* Before the Subcommittee on Securities, Insurance and Investment Committee on Banking, Housing and Urban Affairs, United States Senate, Mar. 19, 2009 ("CSEs were also required to file an 'early warning' notice with the SEC in the event that certain minimum thresholds, including the 10% capital ratio, were breached or were likely to be breached"); Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at p. 13.

[522] SEC, Notes from Monthly Risk Meeting with Lehman (Nov. 15, 2007), at p. 2 [LBEX-SEC 007467].

[523] Lehman, Equity Adequacy Presentation to Executive Committee [Draft] (Oct. 26, 2007), at p. 7 [LBEX-DOCID 1698460], attached to e-mail from Ari Axelrod, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Oct. 26, 2007) [LBEX-DOCID 1912826].

[524] *Id.* at p. 6.

Thereafter, Lehman's cash capital and equity adequacy position temporarily improved. The improvement was the result of several factors. For one thing, the SEC changed the method of calculating the total capital ratio, and, as a result, Lehman picked up several percentage points and saved "roughly $4 billion in capital charges on average every month."[525] In addition, Lehman was able to sell some of its leveraged loan positions, thereby raising cash capital and reducing its illiquid holdings.[526]

(f) Lehman's Termination of Its Residential Mortgage Originations

During this same period, mid-August 2007, Lehman decided to close BNC and cease subprime originations entirely.[527] The anticipated turn in the residential mortgage market still had not arrived, and management could not justify Lehman's continued exposure to liability on the origination of subprime mortgages.[528] In January 2008, Lehman's Aurora subsidiary suspended its origination through wholesale and

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[525] E-mail from Anna Yu, Lehman, to Martin Kelly, Lehman, *et al.* (Feb. 6, 2008) [LBEX-DOCID 2799485].

[526] Lehman, ALCO Summary Package (Jan. 31, 2008), at p. 2 [LBEX-DOCID 527115].

[527] Lehman Brothers Holdings Inc., Press Release: Lehman Brothers Announces Closure of BNC Mortgage (Aug. 22, 2007) [LBEX-DOCID 880148]; Lehman, Subprime(r) (Sept. 6, 2007), at p. 14 [LBEX-DOCID 894656]; e-mail from Edward Grieb, Lehman, to Christopher M. O'Meara, Lehman (Aug. 22, 2007) [LBEX-DOCID 197143]; e-mail from Tasha Pelio, Lehman, to Jasjit (Jesse) Bhattal, Lehman, *et al*. (Aug. 22, 2007) [LBEX-DOCID 176893].

[528] Examiner's Interview of Lana Franks Harber, Sept. 23, 2009, at pp. 2, 10, 11; Examiner's Interview of David N. Sherr, Sept. 25, 2009, at pp. 2, 6, 8.

correspondent channels, which represented the bulk of the program.[529] Lehman had curtailed the flow of Mortgage Maker originations approximately five months earlier.[530]

(g) September, October, and November 2007 Meetings of Board of Directors

Lehman had a series of Board meetings in the fall of 2007. At these meetings, Lehman's management continued to report on the firm's elevated risk profile and concentration of real estate and leveraged loan risk, but did not present the Board with additional negative information concerning the firm's risk and liquidity profile.

(i) Risk Appetite Disclosures

At the September 11, 2007 Finance and Risk Committee meeting, the Finance and Risk Committee was shown a presentation disclosing that the firm's average risk appetite usage rose from $2.12 billion in November 2006 to $3.27 billion in August 2007.[531] In the presentation, the Committee was informed that while risk appetite usage had increased, Lehman still remained within its risk appetite limit.[532] The Committee

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[529] Lehman Brothers Holdings Inc., Press Release: Lehman Brothers Suspends Wholesale and Correspondent U.S. Residential Mortgage Origination Activities (Jan. 17, 2008) [LBEX-DOCID 156125].

[530] Dimitrios Kritikos, Lehman, Aurora Loan Services Risk Review January 2008 (Feb. 7, 2008), at p. 12 [LBEX-DOCID 394711].

[531] Lehman, Presentation on Risk, Liquidity, Capital and Balance Sheet Update to Finance and Risk Committee of Lehman Board of Directors (Sept. 11, 2007), at p. 2 [LBEX-AM 067167].

[532] Lehman Brothers Holdings Inc., Minutes of Meeting of Finance and Risk Committee of the Board of Directors (Sept. 11, 2007), at p. 3 [LBEX-AM 067018]; Lehman, Daily Risk Appetite Report (Sept. 6, 2007) [LBEX-DOCID 1340197], attached to e-mail from Christopher M. O'Meara, Lehman, to David Goldfarb, Lehman (Sept. 7, 2007) [LBEX-DOCID 1345985].

was informed of the recent increase in the risk appetite limit from $3.3 billion to $3.5 billion.[533]

Although it was correct that the firm's monthly average risk appetite for August 2007 was within the firm's risk appetite limit, by the time of the meeting, Lehman actually was over its newly increased limit by $97 million.[534] Additionally, Lehman had been over the $3.5 billion limit each business day that month except for September 3, 2007.[535] There is no evidence that the Board was informed that Archstone and at least one other bridge equity deal had been excluded from Lehman's risk appetite usage calculation for almost three months, or that Lehman would have been over its risk appetite limit for much of the period since June 1, 2007 if those bridge equity deals had been included in the calculation in a timely manner.

When the full Board met again on October 15, 2007, O'Meara disclosed that Lehman was over its firm-wide risk appetite limit. But O'Meara did not want the Board to conclude that Lehman was "out of bounds," so O'Meara edited the standard chart provided to the Board at each meeting.[536] Previously, that chart showed the firm's risk appetite usage and risk appetite limit in close proximity, so that the directors could

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[533] Lehman, Risk, Liquidity, Capital and Balance Sheet Update Presentation to Finance and Risk Committee of Lehman Board of Directors with Welikson's handwritten notes (Sept. 11, 2007), at p. 25 [WGM_LBEX_02248].

[534] Appendix No. 9, comparing risk appetite and VaR usage and limits.

[535] *Id.*

[536] Examiner's Interview of Christopher M. O'Meara, Aug. 14, 2009, at p. 11.

easily see how much below (or above) the usage was compared to the limit.[537] Before the October 2007 Board meeting, however, O'Meara directed that the limit information be removed from the final version of the chart.[538] He explained to the Examiner that management was not troubled by being over the limit and he preferred to explain the overage to the Board orally rather than through written materials.[539]

In addition, O'Meara informed the Board that Lehman's average daily risk appetite usage for the prior month was $3.7 billion, $200 million above the new risk appetite limit,[540] but he did not disclose that on the day of the Board meeting, Lehman's daily risk appetite usage was $4.269 billion, 22% (or $769 million) above the new risk appetite limit.[541] Moreover, at this October meeting, O'Meara also said he told the Board that Lehman had a higher "capacity" – the outside edge of the amount of risk that Lehman could absorb – than its actual risk appetite limit and that the capacity was at least $4.0 billion.[542]

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[537] Lehman, Second Quarter Financial Information Presentation to Lehman Board of Directors (June 19, 2007), at p. 6 [LBHI_SEC07940_026226]; Lehman, Estimated Third Quarter Financial Information Presentation to Lehman Board of Directors (Sept. 11, 2007), at p. 6 [LBHI_SEC07940_026288].

[538] Lehman, Presentation to Lehman Board of Directors on September 2007 Financial Information [Draft] (Oct. 8, 2007), at p. 6 [LBEX-DOCID 510227]; Lehman, Final Presentation to Lehman Board of Directors on September 2007 Financial Information (Oct. 15, 2007), at p. 6 [LBHI_SEC07940_026377]; Examiner's Interview of Christopher M. O'Meara, Sept. 23, 2009, at p. 4.

[539] *Id.*

[540] Lehman, Presentation to Lehman Board of Directors on September 2007 Financial Information (Oct. 15, 2007), at p. 6 [LBHI_SEC07940_026377].

[541] Lehman, Daily Firm-wide Risk Driver (Oct. 15, 2007) [LBEX-DOCID 147304], attached to e-mail from Jeffrey Goodman, Lehman, to Madelyn Antoncic, Lehman, *et al.* (Oct. 14, 2007) [LBEX-DOCID 155737].

[542] Examiner's Interview of Christopher M. O'Meara, Aug. 14, 2009, at pp. 10, 12.

O'Meara did not inform the Board that Lehman generally had been in excess of its firm-wide risk appetite limit since entering into the Archstone transaction in late May 2007; O'Meara attributed Lehman's limit excesses to recent changes in market conditions – specifically, the inability to securitize or syndicate risks that Lehman had previously expected to be able to distribute[543] – but did not mention other factors such as the addition of Archstone and other new deals.[544]

Many of Lehman's directors told the Examiner that this information about the extent and duration of any risk appetite limit excess would have been helpful for them to have received.[545] Some directors did not recall knowing that Lehman had ever been in breach of its risk appetite limits.[546] Although none of the directors said that they would have changed their views had they received that information, they did say that

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[543] Examiner's Interview of Christopher M. O'Meara, Sept. 23, 2009, at pp. 14-15; Lehman, Presentation on Risk, Liquidity, Capital and Balance Sheet Update to Finance and Risk Committee of Lehman Board of Directors (Sept. 11, 2007), at p. 2 [LBEX-AM 067167]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Oct. 15, 2007), at p. 6 [LBHI_SEC07940_026407].

[544] Lehman, September 2007 Financial Information Presentation to Lehman Board of Directors with Christopher M. O'Meara's handwritten notes (Oct. 15, 2007), at p. 6 [LEH_CMO_0000001]; Lehman, September 2007 Financial Information Presentation to Lehman Board of Directors with Jeffrey A. Welikson's handwritten notes (Oct. 15, 2007), at p. 6 [WGM_LBEX_00540].

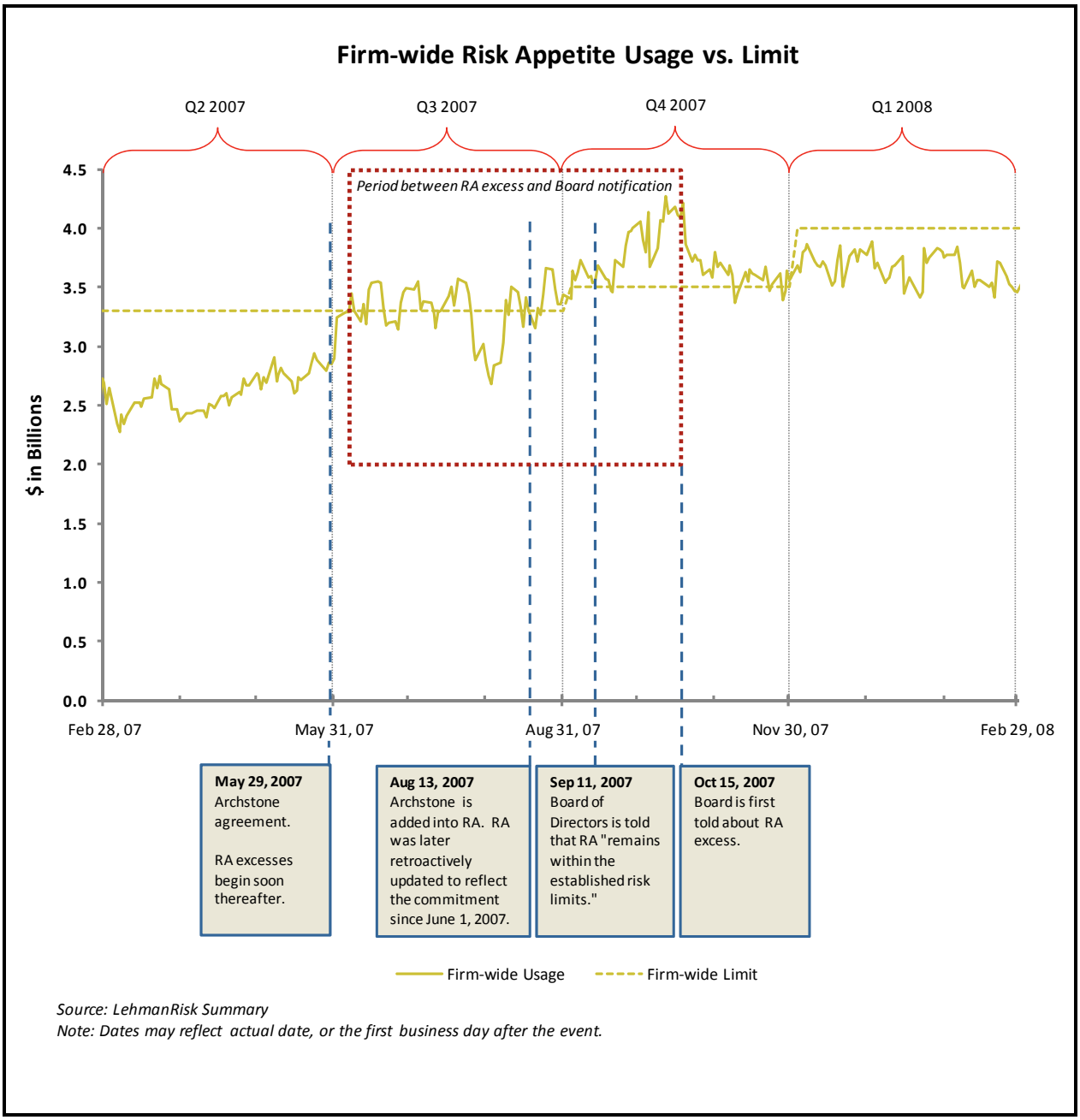
[545] Examiner's Interview of Roger Berlind, May 8, 2009, at p. 4; Examiner's Interview of Dr. Henry Kaufman, May 19, 2009, at p. 7; Examiner's Interview of Marsha Johnson Evans, May 22, 2009, at pp. 7-9; Examiner's Interview of John D. Macomber, Sept. 25, 2009, at p. 3; Examiner's Interview of Roland A. Hernandez, Oct. 2, 2009.

[546] Examiner's Interview of Roger Berlind, May 8, 2009, at p. 4; Examiner's Interview of John D. Macomber, Sept. 25, 2009, at p. 17; Examiner's Interview of Marsha Johnson Evans, May 22, 2009, at p. 9; Examiner's Interview of Sir Christopher Gent, Oct. 21, 2009, at p. 14; Examiner's Interview of Roland A. Hernandez, Oct. 2, 2009, at p. 10.

they would have wanted to have a conversation with management about the reason for the limit overages and management's strategy for resolving them.[547]

The following chart illustrates the lag between the beginning of the risk appetite limit overages and the notification of the Board. The straight dotted line represents the firm-wide risk appetite limit and the jagged solid line represents the firm-wide usage:

[547] Examiner's Interview of Roger Berlind, May 8, 2009, at p. 4; Examiner's Interview of John D. Macomber, Sept. 25, 2009, at p. 13; Examiner's Interview of Marsha Johnson Evans, May 22, 2009, at p. 7; Examiner's Interview of Sir Christopher Gent, Oct. 21, 2009, at p. 15; Examiner's Interview of Roland A. Hernandez, Oct. 2, 2009, at p. 10; Examiner's Interview of Dr. Henry Kaufman, May 19, 2009, at p. 7.



(ii) Leveraged Loan Disclosures

Both the Finance and Risk Committee and the full Board were apprised of Lehman's risk exposure to high yield bonds and leveraged loan.[548] O'Meara discussed

[548] Lehman Brothers Holdings Inc., Minutes of Meeting of Finance and Risk Committee of Lehman Board of Directors (Sept. 11, 2007), at pp. 1-2 [LBEX-AM 067018]; Lehman, Risk, Liquidity, Capital and Balance

with the Committee the "comprehensive risk framework for high-yield debt products" and referred to Lehman's "extensive risk controls," spanning the approval process through post-closing.[549] O'Meara told the Finance and Risk Committee that Lehman had a disciplined approach to risk mitigation through syndication, outright sales, sale through silent partner participation, and single-name and macro hedging.[550] A chart that accompanied his presentation shows that Lehman's "macro hedges" reduced Lehman's "HY Closed Loan Net Exposure" by approximately 20%.[551]

The Board was not informed that in 2007 Lehman's managers had decided not to increase the size of its macro hedges on the leveraged loans exposure to cover the remaining 80% of the closed loans or to cover any portion of Lehman's much greater volume of commitments because these exposures were considered potentially not capable of being hedged.[552] (Relatedly, there is no evidence that management disclosed the extent to which Lehman's commercial real estate investments were unhedged.)[553]

Sheet Update Presentation to Finance and Risk Committee of Lehman Board of Directors (Sept. 11, 2007), at p. 13 [LBEX-AM 067167]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 11, 2007), at p. 6 [LBHI_SEC07940_026364].

[549] Lehman Brothers Holdings Inc., Minutes of Meeting of Finance and Risk Committee of the Board of Directors (Sept. 11, 2007), at pp. 2-3 [LBEX-AM 067018].

[550] Lehman, Risk, Liquidity, Capital and Balance Sheet Update Presentation to Finance and Risk Committee of Lehman Board of Directors (Sept. 11, 2007), at p. 14 [LBEX-AM 067167].

[551] *Id.*

[552] Examiner's Interview of Paul Shotton, June 5, 2009, at pp. 7-8; Examiner's Interview of Kentaro Umezaki, June 25, 2009, at p. 17; Examiner's Interview of Fred Orlan, Sept. 21, 2009, at p. 6; Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 13; Examiner's Interview of Alex Kirk, Jan. 12, 2010, at p. 9; Lehman Brothers Holdings Inc., Minutes of Meeting of Finance and Risk Committee of the Board of Directors (Sept. 11, 2007), at pp. 2-3 [LBEX-AM 067018].

[553] Examiner's Interview of Marsha Johnson Evans, May 22, 2009, at pp. 3, 9-10; Examiner's Interview of Roger Berlind, May 8, 2009, at p. 7.

Some members of Lehman management were concerned that hedging the leveraged loans would be ineffective and could create a "double whammy" – simultaneous losses on the loans and the hedges.[554]

The Board was not informed that the risk appetite usage of Lehman's leveraged loan business was almost double the limit applicable to that business and that the usage had been over the limit almost continuously since July 19, 2007,[555] or that Lehman's management had approved at least 30 leveraged loans that exceeded Lehman's single transaction limit.[556] Some directors believed that the decision to exceed Lehman's high yield and single transaction limits should have been disclosed to the Board.[557]

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[554] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at pp. 3, 13; Examiner's Interview of Madelyn Antoncic, Mar. 27, 2009, at p. 10.

[555] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 11. 2007), at p. 6 [LBHI_SEC07940_263264]; Lehman, Update on Liquidity, Leveraged Loan Commitments and Mortgage Positions Presentation to Lehman Board of Directors with Welikson's handwritten notes (Sept. 11, 2007) [LBHI_SEC07940_026355]; Mynor Gonzalez, Lehman, Daily Risk Appetite and VaR Report (Sept. 11, 2007) [LBEX-DOCID 3296330], attached to e-mail from Mynor Gonzalez, Lehman, to Mark Weber, Lehman (Sept. 12, 2007) [LBEX-DOCID 3295527]; Appendix No. 9, comparing risk appetite and VaR usage versus limits.

[556] Lehman, Risk, Liquidity, Capital, and Balance Sheet Update Presentation to Finance and Risk Committee of Lehman Board of Directors (Sept. 11, 2007) [LBEX-AM 067167]; Lehman Brothers Holdings Inc., Minutes of Meeting of the Finance and Risk Committee of Board of Directors (Sept. 11, 2007) [LBEX-AM 067018]; e-mail from Joe Li, Lehman, to Fred Orlan, Lehman, *et al.* (July 25, 2007) [LBEX-DOCID 2563167].

[557] Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at p. 6 (noting importance of concentration limits); Examiner's Interview of John D. Macomber, Sept. 25, 2009, at pp. 6, 17 (stating that significant excesses ought to have been disclosed).

(iii) Leverage Ratios and Balance Sheet Disclosures

At these September 11, 2007 meetings, O'Meara also reported to the Finance and Risk Committee that Lehman's net leverage ratio was in line with Lehman's peers.[558] Management's presentation regarding the net leverage metric noted:

> In the past, leverage was the key measure of equity adequacy. Between 2003 and 2006 we significantly reduced leverage. Low leverage was positively viewed by rating agencies and contributed to our 2005 upgrades. In 2006 and 2007, we worked with the regulatory and rating agencies to implement more accurate adequacy measures. As a result, we are comfortable with allowing our leverage to increase.[559]

The new adequacy measures included a measurement for equity, the CSE capital ratios, and Lehman's internal equity adequacy framework.[560]

O'Meara did not disclose the firm's use of Repo 105 transactions to manage its net leverage ratio at this Board meeting or any other, and no director asked by the Examiner ever was aware of these off-balance sheet transactions.[561]

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[558] Lehman, Risk, Liquidity, Capital and Balance Sheet Update Presentation to Finance and Risk Committee of Lehman Board of Directors with Welikson's Handwritten Notes (Sept. 11, 2007), at pp. 2, 30 [WGM_LBEX_02247-02340]; Lehman Brothers Holdings Inc., Finance and Risk Committee Minutes (Sept. 11, 2007), at pp. 2-3 [LBEX-AM 067018].

[559] Lehman, Presentation on Risk, Liquidity, Capital and Balance Sheet Update to Finance and Risk Committee of Lehman Board of Directors (Sept. 11, 2007), at p. 50 [LBEX-AM 067167].

[560] *Id.* at p. 51.

[561] Examiner's Interview of Roger Berlind, Dec. 18, 2009, at p. 4; Examiner's Interview of Roland A. Hernandez, Oct. 2, 2009, at p. 22; Examiner's Interview of John D. Macomber, Sept. 25, 2009, at p. 20; Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at p. 21; Examiner's Interview of Michael L. Ainslie, Dec. 22, 2009, at p. 4; Examiner's Interview of Thomas Cruikshank, Oct. 8, 2009, at p. 2; Examiner's Interview of Sir. Christopher Gent, Jan. 20, 2010, at p. 4; Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 10; Lehman Brothers Holdings Inc., Minutes of the Board of Directors (Sept. 11, 2007), at p. 3 [LBHI_SEC07940_026364]; Lehman, Board of Directors Materials for Sept. 11, 2007 Board Meeting (Sept. 7, 2007) [LBHI_SEC07940-026282]; Lehman Brothers Holdings Inc., Minutes of the Board of Directors (Oct. 15, 2007), at p. 6 [LBHI_SEC07940_026407]; Lehman, Board of Directors Materials for Oct. 15, 2007 Board Meeting (Oct. 11, 2007) [LBHI_SEC07940-026371]; Lehman Brothers Holdings Inc.,

(iv) Liquidity and Capital Disclosures

Tonucci reported to the Board's Finance and Risk Committee that Lehman had record levels of liquidity and cash capital surplus at the end of the third quarter of 2007.[562] He also reviewed Lehman's "liquidity pool year-to-date and over the last four years, noting the conservative nature of the firm's liquidity pool as compared to its peers, which [had] been recognized by the leading credit rating agencies."[563]

The materials presented to the Board showed that Lehman had a third quarter "record" liquidity pool of $36 billion (an increase from $25.7 billion at the end of the second quarter 2007) and a cash capital position of $8.1 billion (an increase from $2.5 billion at the end of the second quarter) against a $2 billion policy minimum.[564] The materials stated that Lehman did not project the need to tap the capital markets because Lehman had "significant liquidity to fund these activities."[565] Management similarly emphasized to the full Board Lehman's conservative approach to funding its balance

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Minutes of the Board of Directors (Nov. 8, 2007), at p. 6 [LBHI_SEC07940_026650]; Lehman, Board of Directors Materials for Nov. 8, 2007 Board Meeting (Nov. 2, 2007) [LBHI_SEC07940-026520]; *see also* Section III.A.4 of this Report.

[562] Lehman Brothers Holdings Inc., Minutes of Meeting of Finance and Risk Committee of the Board of Directors (Sept. 11, 2007), at p. 3 [LBEX-AM 067018].

[563] *Id.*

[564] Lehman, Update on Liquidity, Leveraged Loan Commitments and Mortgage Positions Presentation to Lehman Board of Directors with Welikson's handwritten notes (Sept. 11, 2007), at p. 1 [LBHI_SEC07940_026355]; Lehman, Risk, Liquidity, Capital and Balance Sheet Update Presentation to Finance and Risk Committee of Lehman Board of Directors (Sept. 11, 2007), at p. 31 [LBEX-AM 067167].

[565] *Id.*

sheet and strong liquidity pool, but acknowledged that for the last two months liquidity had been more challenging to maintain.[566]

Management did not tell the Board or the Finance and Risk Committee about ALCO's concerns about Lehman's ability to fund its commitments, or that Lehman had nearly stopped entering into new deals in August 2007.[567] Some directors said that if any of Lehman's senior management had concerns about the firm's funding or capital adequacy, that is "clearly" something they would have wanted to know.[568]

On September 20, 2007, Lehman issued a press release announcing that O'Meara would replace Antoncic as Lehman's Global Head of Risk Management (or CRO) as of December 1, 2007.[569] The Examiner did not find any evidence to suggest that Antoncic's replacement was related to the risk limit or risk disclosure issues that had occurred during the prior three to four months. However, the SEC noted its concern that the risk

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[566] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 11, 2007), at p. 5 [LBHI_SEC07940_026364].

[567] Examiner's Interview of Kentaro Umezaki, June 25, 2009, at pp. 16-17; Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at pp. 9-10; e-mail from Roger Nagioff, Lehman, to Ian T. Lowitt, Lehman (July 20, 2009) [LBEX-DOCID 175646]; e-mail from Alex Kirk, Lehman, to Roger Nagioff, Lehman (Aug. 6, 2007) [LBEX-DOCID 173492]; e-mail from Alex Kirk, Lehman, to Roger Nagioff, Lehman (Aug. 7, 2007) [LBEX-DOCID 173496].

[568] Examiner's Interview of John D. Macomber, Sept. 28, 2009, at p. 16; Examiner's Interview of Dr. Henry Kaufman, Dec. 22, 2009 (saying it might have been appropriate to disclose liquidity concerns if they were more than short-lived).

[569] Lehman Brothers Holdings Inc., Press Release: Lehman Brothers Announces Management Changes (Sept. 20, 2007) [LBEX-DOCID 533362].

limit excesses occurred during a period when Lehman's CRO position was in transition.[570]

(4) Late Reactions: Lehman Slowly Exits Its Illiquid Real Estate Investments

The last quarter of 2007 and first quarter of 2008 – from September 2007 through February 2008 – was a crucial juncture for Lehman. Lehman's overall balance sheet had grown by 37% during 2007,[571] and much of the growth was concentrated in illiquid holdings that Lehman was already unable to sell without incurring significant losses.[572] As a result, without the accounting device of Repo 105 transactions, FID was already well over its balance sheet limit of approximately $230 billion by $18 billion.[573] Indeed, Lehman had been over its risk limits for the prior six months.[574] In hindsight, this quarter may have been Lehman's final opportunity to take decisive action to improve its balance sheet before the near collapse of Bear Stearns changed the rules of the road for Lehman and all of its peer investment banks.

Before Bear Stearns' near collapse in March 2008, Lehman had two basic ways of reducing its leverage: (1) selling assets, to reduce the numerator in the net leverage formula; or (2) raising equity, to increase the denominator in the net leverage formula.

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[570] SEC, Notes from Lehman's Monthly Risk Review meeting (Oct. 11, 2007), at p. 6 [LBEX-SEC 007438].

[571] Lehman, 2008 Financial Plan Presentation to Finance and Risk Committee of Board of Directors (Jan. 29, 2008), at p. 8 [LBHI_SEC07940_068559].

[572] Examiner's Interview of Herbert H. (Bart) McDade III, Sept. 16, 2009, at p. 3; Examiner's Interview of Treasury Secretary Timothy F. Geithner, Nov. 24, 2009, at p. 7.

[573] Andrew J. Morton, Notes: First Sixty Days (Apr. 7, 2008), at p. 6 [LBEX-DOCID 1734462].

[574] Appendix No. 9, comparing risk appetite and VaR usage versus limits.

But Lehman did not successfully take either of these tacks during the final quarter of 2007 or the first quarter of 2008: Lehman's net balance sheet was $23.7 billion higher at the end of the first quarter of 2008 than at the end of 2007.[575] Lehman did not raise substantial amounts of equity during this period.[576]

Lehman's failure to sell assets sooner was based partly on its previous decision to pursue a countercyclical growth strategy, which entailed a conscious acceptance of greater risk even while Lehman's peer investment banks were curtailing their risk-taking.[577] The countercyclical growth strategy continued to be reflected in Lehman's strategy in the first quarter of 2008.[578]

Fuld told the Examiner that he decided after the December 2007 holiday season to instruct his senior managers to reduce the firm's balance sheet.[579] However, documentary evidence shows that Lehman did not aggressively begin to sell assets until the second quarter of 2008.[580]

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[575] LBHI 10-Q (filed on Apr. 9, 2008), at p. 70.

[576] Lehman, 2008 Financial Plan Presentation to Finance and Risk Committee of Board of Directors (Jan. 29, 2008), at p. 16 [LBHI_SEC07940_068559]; Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at pp. 25-27.

[577] *See* Lehman, 2008 Financial Plan Presentation to Finance and Risk Committee of Board of Directors (Jan. 29, 2008), at p. 6 [LBHI_SEC07940_068559].

[578] *Id.*

[579] Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at p. 2.

[580] Lehman, Commercial Real Estate Update (Mar. 25, 2008), at p. 3 [LBHI_SEC07940_127250]; Lehman, Balance Sheet and Disclosure Scorecard For Trade Date April 21, 2008 (Apr. 22, 2008), at p. 3 [LBEX-DOCID 3187588], attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al*. (Apr. 22, 2008) [LBEX-DOCID 3187333]; e-mail from Gary Mandelblatt, Lehman, to Alex Kirk, Lehman (Jan. 15, 2008) [LBEX-DOCID 1600235]; e-mail from Erin M. Callan, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al*. (Apr. 3, 2008) [LBEX-DOCID 1538729]; e-mail from Paul A. Hughson, Lehman, to Mark

During the first quarter of 2008, Fuld also decided that Lehman would not raise equity unless it could do so at a premium.[581] While many of Lehman's competitors entered into strategic transactions to raise equity in late 2007 and early 2008,[582] Lehman did not want to signal weakness by raising equity at a discount,[583] and, unlike its peers, had not yet suffered losses that might have signaled a more urgent need for such action.

(a) Fiscal 2008 Risk Appetite Limit Increase

In October 2007, the firm-wide risk appetite usage continued to increase, and for several days was more than $500 million over the limit; the limit excess peaked at almost 22% of the limit amount.[584] The limit excess was partly the result of Lehman's decision to enter into several significant commercial real estate and leveraged loan transactions in May, June, and July 2007, which were gradually being funded and thus

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Walsh, Lehman (Apr. 1, 2008) [LBEX-DOCID 1866761]; Lehman, Balance Sheet and Disclosure Scorecard For Trade Date August 12, 2008 (Aug. 13, 2008), at p. 7 [LBEX-SIPA 006539].

[581] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 8; Examiner's Interview of Jeremy Isaacs, Oct. 1, 2009, at p. 3.

[582] *See, e.g.*, Merrill Lynch & Co., Inc., Annual Report for 2007 as of Dec. 28, 2007 (Form 10-K) (filed on Feb. 25, 2008), at p. 23 ("Merrill Lynch 2007 10-K") (stating that Merrill Lynch issued $6.2 billion in common stock during the fourth quarter of 2007, and $6.6 billion of mandatory convertible preferred stock during the first quarter of 2008); Morgan Stanley, Annual Report for 2007 as of Nov. 30, 2007 (Form 10-K) (filed on Jan. 29, 2008), at pp. 178-79 ("Morgan Stanley 2007 10-K") (stating that Morgan Stanley sold equity units to the Chinese Investment Corporation for approximately $5.579 billion in December 2007); Citigroup Inc., Annual Report for 2007 as of Dec. 31, 2007 (Form 10-K) (filed on Feb. 22, 2008), at p. 77 ("Citigroup 2007 10-K") (stating that Citigroup sold $7.5 billion of equity units to the Abu Dhabi Investment Authority on December 3, 2007); UBS AG, Annual Report for 2007 as of Dec. 31, 2007 (Form 20-F) (filed on Mar. 18, 2008), at pp. 276-77 ("UBS AG 2007 20-F") (stating that UBS issued shares corresponding to approximately 13.4% of the then current share capital on February 27, 2008); *see* Section III.A.3 of this Report.

[583] E-mail from David Goldfarb, Lehman, to Richard S. Fuld, Jr., Lehman, *et al*. (Jan. 9, 2008) [LBHI_SEC07940_670045].

[584] Appendix No. 9, comparing risk appetite and VaR usage versus limits.

increasing Lehman's risk appetite usage; partly the result of Lehman's inability to securitize or syndicate those and other transactions; and partly the result of increased volatility in the market.[585]

Lehman increased the firm-wide risk appetite limit for fiscal 2008. Approval for the increase was given on January 14, 2008, when Lehman raised the limit from $3.5 billion to $4 billion, "with [the] increase [being] backdated to December 3, 2007."[586] The limit increase had the effect of eliminating any firm-wide limit excesses from that date forward.[587]

To arrive at the $4 billion risk appetite limit figure, Lehman's officers made significant changes to the limit calculation as compared to prior years' calculations. The Examiner's financial advisors calculate that if the same assumptions used for the 2007 risk appetite limit had been used to determine the limit for 2008, the 2008 limit would have been approximately $2.5 billion rather than $4.0 billion.[588]

The 2008 risk appetite limit also was based on a very aggressive projected revenue figure. Lehman's projected revenues were the starting point for setting the limit, and perhaps the single most important input to the formula. Lehman used a $21

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[585] SEC, Notes from Lehman's Monthly Risk Review Meeting (Aug. 17, 2007), at p. 7 [LBEX-SEC 007383]; e-mail from Jeffrey Goodman, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Dec. 4, 2007) [LBEX-DOCID 251204].

[586] Lehman, Material for Market Risk Control Committee Meeting (Jan. 14, 2008), at p. 33 [LBEX-DOCID 271352], attached to e-mail from Mark Weber, Lehman, to Paul Shotton, Lehman, *et al*. (Jan. 14, 2008) [LBEX-DOCID 223263].

[587] Appendix No. 9, comparing risk appetite and VaR usage versus limits.

[588] For a more detailed explanation of the changes in the risk appetite calculation, *see* Appendix 10, describing calculation of increased $4.0 billion risk appetite limit.

billion projected revenue figure in calculating the $4 billion limit amount.[589] Despite the difficulties in the market, this amount constituted a 9% increase over 2007 revenues. Contemporaneous external analyst reports projected 2008 revenues of only about $19.2 billion – a figure that would have resulted in a much lower risk appetite limit for the year.[590]

(b) January 2008 Meeting of Board of Directors

On January 29, 2008, the Finance and Risk Committee and the entire Board met. During these meetings, management discussed the difficult market, but believed that it presented opportunities for Lehman to grow.[591] Lehman's senior officers told the Board: "[The market environment] presents an opportunity for the firm to pursue a countercyclical growth strategy, similar to what it did during the 2001-2002 downturn, to improve its competitive position and, over time, generate superior returns for our shareholders."[592]

Management provided the Finance and Risk Committee with an overview of Lehman's net assets and leverage levels and told the Committee that Lehman's balance

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[589] Paolo R. Tonucci, Lehman, 2008 Financial Plan Presentation (Jan. 29, 2008), at p. 1 [LBHI_SEC07940_068559].

[590] *E.g.*, Douglas Sipkin, Wachovia Capital Markets, L.L.C., Tough Year Ahead - Sowing Seeds for Share Gains (Jan. 15, 2008), at p. 1 [LBEX-DOCID 095883]; Appendix 10, describing calculation of increased $4.0 billion risk appetite limit.

[591] Lehman, 2008 Financial Plan Summary (Jan. 29, 2009), at p. 5 [LBHI_SEC07940_027374].

[592] *Id.*

sheet continued to grow across almost all asset classes and businesses.[593] At the full Board meeting, Kaufman reported to the Board on Lehman's balance sheet growth and Lehman's year end increase in net leverage.[594] Callan discussed Lehman's target leverage ratio with the Board and said that it would come back down.[595]

At the Finance and Risk Committee meeting, management reviewed Lehman's monthly stress tests and scenario analyses.[596] Stress tests indicated a worst-case loss of $3.2 billion.[597] Management did not inform the Committee of a new "Credit Crunch" scenario that was added to Lehman's portfolio of stress testing scenarios in October 2007 that predicted the worst loss of all the scenarios, with a loss of $3.99 billion (although early drafts of the presentation did include the scenario).[598]

At these January meetings, Lehman's management also recommended the new risk appetite limit to the Board.[599] The directors were generally not aware or did not

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[593] Lehman Brothers Holdings Inc., Minutes of Meeting of Finance and Risk Committee of the Board of Directors (Jan. 29, 2008), at pp. 2-3 [LBEX-AM 067022]; Lehman, Additional Materials for the Finance and Risk Committee (Jan. 29, 2008), at p. 3 [LBEX-AM 067260].

[594] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Jan. 29, 2008), at p. 3 (LBHI_SEC07940_027446].

[595] *Id.* at p. 8; Lehman, December 2007 Presentation to Lehman Board with Welikson's handwritten notes (Jan. 29, 2008), at p. 6 [WGM_LBEX_00708].

[596] Lehman, 2008 Financial Plan Presentation to Finance and Risk Committee of the Board of Directors (Jan. 29, 2008), at p. 18 [LBHI_SEC07940_068559].

[597] *Id.* at p. 19.

[598] Lehman, Monthly Risk Review Package (Oct. 11, 2007), at p. 10 [LBEX-SEC 007438] (noting Lehman "added a new stress test, called the Credit Crunch which is essentially Summer 2007"); Lehman, 2008 Financial Plan Presentation to Lehman Board of Directors [Draft] (Jan. 2008), at p. 5 [LBEX-DOCID 384192], attached to e-mail from Mark Weber, Lehman, to Jennifer Bale, Lehman, *et al*. (Jan. 16, 2008) [LBEX-DOCID 306708].

[599] Lehman, 2008 Financial Plan Summary (Jan. 29, 2008), at p. 11 [LBHI_SEC07940_027374].

recall any discussion regarding the adjustments of the risk appetite calculation.[600] Two of the directors said that they would have wanted to know about significant changes in the methodology.[601] However, Lehman's managers told the Board that the $21 billion revenue projection was "very aggressive," and the Board had an extended discussion of the impact of potentially lower revenues on Lehman's business.[602]

(c) Executive Turnover

In January 2008, Nagioff decided for personal reasons to resign as global head of FID.[603] In addition, that month, Alex Kirk, co-chief operating officer of FID since October 2007, left Lehman. Kirk agreed with Fuld that he would leave Lehman at about the same time.[604]

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[600] Examiner's Interview of Sir Christopher Gent, Oct. 21, 2009, at p. 16; Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at p. 2; Examiner's Interview of Roland A. Hernandez, Oct. 2, 2009, at p. 14; Examiner's Interview of John D. Macomber, Sept. 25, 2009, at p. 18.

[601] Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at p. 2; Examiner's Interview of John Macomber, Sept. 25, 2009, at p. 2.

[602] Jeffrey A. Welikson, Lehman, Notes from the 2008 Financial Plan Presentation (Jan. 29, 2008), at p. 1 [WGM_LBEX_03249].

[603] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 20; Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 22 (Fuld indicated that Nagioff's decision to step down was entirely voluntary and was the result of Nagioff's frustration with his commute from London); Examiner's Interview of Sir Christopher Gent, Oct. 21, 2009, at p. 5 (Gent explained that, based on conversations with Nagioff, he believed Nagioff's resignation was entirely due to the logistical disruption of Nagioff's family life on account of his commute); Examiner's Interview of Hugh E. (Skip) McGee III, Aug. 12, 2009, at p. 13 (McGee denied that Nagioff's resignation had anything to do with Lehman's cessation of residential mortgage originations, and tied Nagioff's decision to the difficulty of Nagioff's commute); Examiner's Interview of John F. Akers, Apr. 22, 2009, at p. 2 (Akers expressed the belief that Nagioff left voluntarily and that his departure was mutual between him and management, but also noted that along with the commute from London, difficulty also arose because Nagioff failed to meet Fuld's expectations); Examiner's Interview of Eric Felder, May 21, 2009, at p. 6 (Felder indicated that Nagioff left Lehman voluntarily).

[604] Transcript of deposition testimony of Alex Kirk, *In re Lehman Brothers Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 31, 2009, at pp. 7-8.

(d) Commercial Real Estate Sell-Off: Too Little, Too Late

Although Lehman ultimately took aggressive action to reduce its balance sheet and thus its net leverage, Lehman's management did not make a firm-wide decision to reduce these figures until well after the beginning of the risk appetite and balance sheet limit overages in mid-2007. Moreover, even after Lehman's senior officers directed the business lines to reduce their balance sheets, it took several months for the reduction to be effectuated, particularly with respect to Lehman's illiquid holdings of commercial real estate assets.

Although the firm persistently was over its balance sheet limits, and had been over the risk appetite limit since about June 1, 2007, the first written indication that the Risk Committee considered the risk limit overage was in October 2007.[605] On October 2, 2007, O'Meara noted in an e-mail that the Risk Committee agreed to "temporarily approve the Risk Appetite limit overage, due to the unusual circumstances in the marketplace today / recently, especially concerning Leveraged Finance and Real Estate businesses."[606] Thus, Lehman's management decided not to reduce its risk position aggressively at that time.

Later in October, in advance of a planned conversation with the Executive Committee, O'Meara proposed formulating "specific recommendations about where to

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[605] E-mail from Christopher M. O'Meara, Lehman, to Paul Shotton, Lehman, *et al.* (Oct. 2, 2007) [LBEX-DOCID 155020].

[606] E-mail from Christopher M. O'Meara, Lehman, to Paul Shotton, Lehman, *et al.* (Oct. 2, 2007) [LBEX-DOCID 155020].

make the cuts" to bring down risk appetite.[607] Goodman expressed a willingness to "take some losses" to achieve this goal.[608] In a November 2007 presentation to Fuld, the commercial real estate group recommended reducing its global balance sheet by $15 billion.[609]

When Erin M. Callan became CFO on December 1, 2007, one of her objectives was to reduce balance sheet, particularly in the areas of residential and commercial real estate.[610] Fuld decided during the December 2007 holiday season that it was time to pursue an aggressive reduction of Lehman's risk profile.[611]

Lehman did not aggressively pursue these reductions for several months, however. According to Callan, she had discussions with Fuld and Gregory about reducing balance sheet in January and February 2008, but "didn't get traction quickly on it."[612] Between the fourth quarter of 2007 and the first quarter of 2008, Lehman's gross and net assets actually increased from $691 billion to $786 billion, and from $373

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[607] E-mail from Jeffrey Goodman, Lehman, to Mark Weber, Lehman, *et al.* (Oct. 22, 2007) [LBEX-DOCID 318367].

[608] *Id.*

[609] Global Real Estate Group, Lehman, Global Real Estate Update (Nov. 6, 2007), at pp. 1, 2 [LBEX DOCID 514264], attached to e-mail from Jeffrey Goodman, Lehman, to Madelyn Antoncic, Lehman, *et al.* (Nov. 6, 2007) [LBEX DOCID 531492]; e-mail from Jonathan Cohen, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Nov. 3, 2007) [LBEX DOCID 523669] (indicating that Fuld was the intended audience of the presentation).

[610] Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at pp. 10-13.

[611] Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at p. 10.

[612] Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at pp. 10-13.

billion to $397 billion, respectively.[613] In addition, FID exceeded its balance sheet limit in the fourth quarter of 2007 by $11.17 billion, with overages concentrated in securitized products and real estate.[614] In the first quarter of 2008, FID was over the balance sheet limit by $18 billion with nearly 50% of the overages concentrated in securitized products and real estate.[615] Lehman's Treasurer at the time, Paolo Tonucci, was comfortable with FID's balance sheet overages in the first quarter of 2008.[616] At the end of the first quarter of 2008, Tonucci did not require FID to sell off more assets.[617]

It was not until February 26, 2008 that Gregory instructed Walsh to "get balance sheet down quickly,"[618] and GREG set out to reduce its global balance sheet by $5 billion by March 18, 2008.[619] Even after that, Callan told the Examiner that she pleaded with Fuld and Gregory to reduce the balance sheet and finally persuaded them to add the issue to the Executive Committee's March 20, 2008 agenda after the near collapse of

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[613] Lehman, Q2 2008 Update (June 18, 2008), at p. 5 [LBEX-DOCID 1302959], attached to e-mail from Anu Jacob, Lehman, to Dennis Rodrigues, Lehman, *et al*. (July 8, 2008) [LBEX-DOCID 1326944].

[614] Andrew J. Morton, Notes: First Sixty Days (Apr. 7, 2008), at p. 6 [LBEX-DOCID 1734462], attached to e-mail from Gary Mandelblatt, Lehman, to Andrew J. Morton, Lehman, *et al.* (Apr. 7, 2008) [LBEX-DOCID 1834937].

[615] *Id.* at p. 4.

[616] E-mail from Clement Bernard, Lehman, to Andrew J. Morton, Lehman, *et al*. (Feb. 27, 2008) [LBEX-DOCID 1849839].

[617] *Id.*

[618] E-mail from Mark A. Walsh, Lehman, to Andrew J. Morton, Lehman (Feb. 26, 2008) [LBHI_SEC07940_115814].

[619] E-mail from Paul A. Hughson, Lehman, to Mark Gabbay, Lehman, *et al.* (Feb. 27, 2008) [LBEX-DOCID 1869265] (discussing the schedule for the $5 billion reduction target); e-mail from Paul A. Hughson, Lehman, to Mark Gabbay, Lehman, *et al.* (Mar. 7, 2008) [LBEX-DOCID 1723168] (Hughson gives update on sales progress and asks for updates from others on their progress towards the $5 billion reduction target).

Bear Stearns.[620] McDade was made the firm's "balance sheet czar" in mid-March and was given authority to enforce firm-wide balance sheet targets.[621] Fuld intended to reduce all of Lehman's positions, including commercial real estate and leveraged loans positions.[622] Balance sheet reduction targets were not sent out to Lehman's businesses until after the Executive Committee meeting on March 20, 2008.[623]

On May 13, 2008, two weeks before the end of the second quarter, Callan urged Gregory and Fuld to "deliver on the balance sheet reduction this quarter" and not give "any room to FID for slippage."[624] GREG's overseas businesses in particular were slow to reduce their positions in the first and second quarters of 2008,[625] but GREG's U.S. business met its balance sheet reduction targets, despite continuing to engage in some originations.[626]

Some witnesses believed that GREG was not aggressive enough in selling off its portfolio, holding on to positions in a belief that the market would eventually

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[620] Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at pp. 10, 11.

[621] *Id.* at p. 12; Examiner's Interview of Andrew J. Morton, Sept. 21, 2009, at p. 11.

[622] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 26.

[623] Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at pp. 11-12.

[624] E-mail from Erin M. Callan, Lehman, to Joseph Gregory, Lehman, *et al.* (May 13, 2008) [LBHI_SEC07940_034732].

[625] Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 5; Lehman, Balance Sheet and Disclosure Scorecard for Trade Date June 23, 2008 (June 24, 2008), at p. 10 [LBEX-DOCID 1742000], attached to e-mail from Michael McGarvey, Lehman, to Paul Mitrokostas, Lehman, *et al.* (June 25, 2008) [LBEX-DOCID 1856557]; e-mail from Paul A. Hughson, Lehman, to Kentaro Umezaki, Lehman, *et al*. (Oct. 2, 2007) [LBEX-DOCID 1809381]; e-mail from Paul A. Hughson, Lehman, to Jonathan Cohen, Lehman (July 20, 2007) [LBEX-DOCID 1426881].

[626] Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at pp. 10-11 (stating that he and Gregory realized at the time that halting originations was not as easy as flipping a switch).

rebound.[627] In one memorandum, Lehman's Head of Global Strategy expressed the concern that "the team responsible for selling down these positions is the same one that originated them."[628] But several witnesses denied there was any incentive not to sell down the portfolio because they knew that no one in GREG would be getting a 2008 bonus.[629]

Regardless of the reasons for Lehman's slow reaction to its oversized commercial real estate holdings, the fact remains that Lehman's balance sheet did not decline until the end of the second quarter of 2008, after Bear Stearns had already nearly collapsed.

(e) Lehman's Compensation Practices

The Examiner considered, in the course of determining whether the officers and directors of Lehman breached their fiduciary duties, the impact that Lehman's compensation practices may have had on Lehman's conduct such as the expansion into potentially highly profitable, but riskier, lines of business, as discussed above.

Lehman's compensation policy was designed, in theory, to penalize excessive risk taking. At times, FID businesses that exceeded balance sheet limits and breached

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[627] Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at p. 13; Examiner's Interview of Mark Weber, Aug. 11, 2009, at pp. 8-9.

[628] Memorandum from Timothy Lyons, Lehman, to David Goldfarb, Lehman, Strategic Imperatives for the Firm (July 3, 2008), at p. 1 [LBEX-DOCID 1377945].

[629] Examiner's Interview of David O'Reilly, Oct. 26, 2009, at p. 3; Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 11; Examiner's Interview of Kenneth Cohen, Oct. 20, 2009, at p. 11; Examiner's Interview of Andrew J. Morton, Sept. 21, 2009, at pp. 19-20 (Morton notes that Walsh knew by February 2008 that he would receive only a straight salary for 2008, with no bonus, thus Walsh had no compensation-based incentive to inflate his marks). For a more detailed discussion of the effect of Lehman's officers' compensation structure on the incentive to take risks, see Appendix 11, Compensation.

risk limits faced diminution of their compensation pool.[630] At other times, FID used a "Compensation Scorecard" that included risk-weighted metrics such as return on risk equity and return on net balance sheet to determine compensation pool allocations.[631] The FID Compensation Committee assessed performance against VaR, balance sheet usage, and risk appetite.[632]

But in practice, Lehman rewarded its employees based upon revenue with minimal attention to risk factors in setting compensation. None of these risk-related adjustments was applied rigorously or consistently. Ken Umezaki, then Head of FID Strategy, noted after a firm-wide speech by Fuld:

> [T]he majority of the trading businesses focus is on revenues, with balance sheet, risk limit, capital or cost implications being a secondary concern.[633]

To calculate revenue for its compensation pool, Lehman included revenue not yet recognized but recorded based on mark-to-market positions.[634] In theory, therefore, traders and business units were incented to enter into transactions for short-term profits, even if those transactions created long-term risks for the firm.[635]

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[630] Examiner's Interview of Kentaro Umezaki, June 25, 2009, at pp. 8-9; Lehman, Global Consolidated Balance Sheet (May 31, 2007) [LBEX-DOCID 276740]; e-mail from Kentaro Umezaki, Lehman, to Kaushik Amin, Lehman, *et al.* (July 10, 2007) [LBEX-DOCID 252873].

[631] Lehman, 2004 Fixed Income Division Compensation Scorecard (Undated) [LBEX-DOCID 1748807].

[632] Lehman, COMPMETRICS Excel Spreadsheet (Undated), at pp. 1-9 [LBEX-LL 1054327]; Lehman, 2007 FID Forecast Budget Support Excel Spreadsheet (Undated), at pp. 1-11 [LBEX-BARCMP 0000001].

[633] E-mail from Kentaro Umezaki, Lehman, to Scott J. Freidheim, Lehman, *et al.* (Apr. 19, 2007) [LBEX-DOCID 318475].

[634] Examiner's Interview of John D. Macomber, Sept. 25, 2009, at pp. 5, 22; Examiner's Interview of James Emmert, Oct. 9, 2009, at p. 2-3.

[635] *See* Section III.A.1.b.1.2 of this Report. The Examiner finds that Lehman's assumption of ever-increasing business risk did not come from the bottom up but rather from the top down. Similarly

Lehman's mark-to-market accounting also incented Lehman to value investments at the high end to generate higher net revenues. Lehman had procedures to control such valuations, however, and in practice, the Examiner found no evidence to support a finding that any improper valuations were taken to affect compensation.

A more detailed description of Lehman's compensation practices may be found at Appendix 11.

c) Analysis

The Examiner investigated three potential claims in connection with Lehman's management of its risks: (1) whether any Lehman officer breached the fiduciary duty of care to the firm by assuming excessive risk with respect to Lehman's investments, or by failing to follow the firm's risk management policies; (2) whether any Lehman officer breached the fiduciary duty of good faith and candor by not providing the Board with material information concerning risk issues; and (3) whether any Lehman director breached the fiduciary duty of good faith to monitor Lehman's risk management.

Lehman's senior officers – Fuld and Gregory in particular – had sizeable holdings of Lehman stock and may have been more incented to increase Lehman's long-term stock price than to generate short-term revenues.

(1) The Examiner Does Not Find Colorable Claims That Lehman's Senior Officers Breached Their Fiduciary Duty of Care by Failing to Observe Lehman's Risk Management Policies and Procedures

(a) Legal Standard

To assert a colorable duty of care claim concerning corporate conduct, the plaintiff must first overcome the protection of the business judgment rule. Under the traditional business judgment rule as it applies to directors, there is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[636] Thus, "a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.'"[637]

The business judgment rule has rarely been applied to officers. However, based upon a recent decision by the Delaware Supreme Court[638] holding that the fiduciary duties of directors and officers are identical, the Examiner concludes that Delaware courts will likely hold, at a minimum, that officers are protected by the business judgment rule whenever they act under an express delegation of authority from the Board; the Delaware courts are also likely to hold that officers are protected by the rule

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[636] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)) (internal quotation marks omitted).
[637] *Id.* (*quoting Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)); *see* the discussion of Delaware corporate fiduciary law in Appendix 1, Legal Issues.
[638] *Gantler v. Stephens*, 965 A.2d 695, 709 (Del. 2009).

whenever they act within the scope of their discretion even if not pursuant to express delegation by the Board.[639]

The Examiner concludes that the Delaware courts are likely to hold that an officer can be stripped of the protection of the business judgment rule only in fairly narrow circumstances not presented here.[640]

If the evidence overcomes the presumption of the business judgment rule, the plaintiff must then prove a violation of the duty of care.[641] The standard of proof for a duty of care claim for corporate misconduct is generally defined as gross negligence.[642] Gross negligence means "reckless indifference to or a deliberate disregard" of the corporation's interests, or "actions which are without the bounds of reason."[643]

Overcoming the business judgment rule and establishing gross negligence are particularly difficult when a plaintiff is challenging the risk-taking of a financial institution. As a court applying Delaware law has recently noted, taking risks is at the heart of a financial institution's business, and decisions about what risks to take are

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[639] *Cf. id.* (holding that the fiduciary duties of officers and directors are identical).

[640] *See, e.g., McMullin v. Beran*, 765 A.2d 910, 922 (Del. 2000); *see also Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985), *overruled on other grounds by Gantler*, 965 A.2d at 713 n.54; *Aronson*, 473 A.2d at 812, *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000). *Ryan v. Gifford,* 918 A.2d 341, 354 (Del. Ch. 2007); *Massaro v. Vernitron Corp*, 559 F. Supp. 1068, 1080 (D. Mass. 1983); *Omnibank of Mantee v. United S. Bank*, 607 So. 2d 76, 84-85 (Miss. 1992) *Cf. Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1279 (Del. 1989) ("[J]udicial reluctance to assess the merits of a business decision ends in the face of illicit manipulation of a board's deliberative process by self-interested corporate fiduciaries.").

[641] Unlike the directors, Lehman's officers are not immunized by Lehman's articles of incorporation from personal liability for breaching the duty of care. *See* Lehman Brothers Holdings Inc., Certificate of Incorporation, at § 10.1, *Limitation of Liability of Directors.*

[642] *Van Gorkom*, 488 A.2d at 873.

[643] *Tomczak v. Morton Thiokol, Inc.*, No. 7861, 1990 WL 42607, at *12 (Del. Ch. Apr. 5, 1990).

inherently protected by the business judgment rule from hindsight challenge.[644] Therefore, a plaintiff asserting a breach of the duty of care by Lehman's senior managers would face significant burdens.

(b) Background

The Examiner finds insufficient evidence to support a claim that any Lehman officer breached the fiduciary duty of care in connection with managing the risks associated with the more aggressive business strategy Lehman adopted in 2006.

As mentioned above, Lehman's business strategy in 2006 and 2007 was premised on using more of its balance sheet to increase its principal investments. In addition to the risks in the proprietary investments themselves, many of the firm's proprietary investments entailed a commitment by Lehman to a much larger amount of debt or equity than Lehman ultimately expected to retain for itself. Although these bridge equity and bridge debt transactions were risky, Lehman's management decided to engage in these transactions because they were profitable in their own right, because they helped Lehman participate in more and larger deals, and because they helped Lehman to develop long-term client relationships.

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[644] *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 126 (Del. Ch. 2009) ("The essence of the business judgment of managers and directors is deciding how the company will evaluate the trade-off between risk and return. Businesses – and particularly financial institutions – make returns by taking on risk; a company or investor that is willing to take on more risk can earn a higher return.").

Lehman's officers were entitled under Delaware law to pursue this aggressive high-risk strategy, and the Examiner does not question their business decision to do so; decisions of this type are at the core of the business judgment rule.

Although its management was entitled to pursue a business strategy of increasing its principal investments and engaging in substantial bridge debt and equity transactions, Lehman's own policies required management to consider and analyze the risks of that strategy in a systematic manner. The Examiner has found evidence that raises questions whether Lehman's senior management disregarded Lehman's risk management framework, including its risk appetite limits, its single transaction limits, its stress testing, its balance sheet limits, and the advice of the risk managers. As one former risk manager put it, "whatever risk governance process we had in place was ultimately not effective in protecting the Firm. . . . The function lacked sufficient authority within the Firm. Decision-making was dominated by the business."[645] Indeed, there is substantial evidence that after Lehman adopted a more aggressive business strategy in 2006, its risk management policies and limits were not a major factor in the firm's investment decisions, even though management continued to tell the

[645] E-mail from Vincent DiMassimo, Lehman, to Christopher M. O'Meara, Lehman (Sept. 1, 2008) [LBEX-DOCID 203219].

Board, the rating agencies, and regulators that Lehman was prudently managing risk through its risk management system.[646]

The evidence that Lehman disregarded its risk controls is particularly strong with respect to bridge equity and bridge debt. In several important contexts, Lehman excluded bridge equity and bridge debt commitments entirely from its risk metrics. These exclusions were apparently based on management's assumption that it would be able to distribute the equity and debt successfully to other parties. When the subprime crisis erupted into the credit markets generally, this expectation proved to be erroneous.

However, the Examiner does not find that the decisions by Lehman's officers were not entitled to the protection of the business judgment rule. Although Lehman's senior officers chose to disregard indications from Lehman's risk management systems that the firm was undertaking excessive risk, the Examiner did not find evidence that Lehman's management entered into financial transactions without informing themselves of the basic facts of the transactions, as would be necessary to strip them of the business judgment rule's protection and prove gross negligence. Lehman's officers were entitled to set and decide to exceed risk limits, which were merely tools to assist

[646] *E.g.*, SEC, Lehman Monthly Risk Review Meeting Notes (July 19, 2007), at p. 5 [LBEX-SEC 007363] ("Jeff [Goodman] told us that . . . VaR is just one measure that Lehman uses, and is more of a speed bump/warning sign than a true, hard limit -- that role falls to RA [(i.e. risk appetite)]. [….] He said that Madelyn [Antoncic], Dave [Goldfarb], and the executive committee tend to look more at RA. As an aside, Madelyn came in after Jeff's explanation and gave virtually the same speech.").

them in their investment decisions, not legal restraints on their authority. They made considered business decisions to do so because of profit-making opportunities.

Nor does the Examiner find that Lehman's officers exceeded the scope of their authority by pursuing an aggressive countercyclical growth strategy. Lehman's management was entitled to calculate that the subprime crisis offered Lehman the opportunity to become a dominant residential mortgage originator, to expand its already powerful commercial real estate franchise, and to use large leveraged loans as a means towards developing its investment banking business. Although management's disclosures to the Board on the risks of this strategy were not as detailed or as objective as they might have been, the Examiner does not find that management's disclosures were so lacking as to deprive the officers of the protection of the business judgment rule.

Even if the business judgment rule did not apply to the officers' pursuit of a countercyclical growth strategy, the Examiner would not find gross negligence sufficient to establish a breach of the duty of care. Gross negligence requires proof that the officer made decisions that were irrational or reckless. Lehman's senior officers decided to make business decisions primarily based on their intuitive understanding of the markets and their evaluation of the risks and rewards of entering into certain transactions. Their decision to use their practical business experience rather than rely

on certain quantitative risk limits and other metrics cannot be considered irrational or reckless.

The decisions by Lehman's management must also be considered in context. In many respects, Lehman's transactions were no different from those conducted by other market participants, and were, in some respects, less aggressive than those of their competitors. For example, several financial institutions suffered catastrophic losses on investments in CDOs and credit default swaps; Lehman prudently limited its exposure in these areas. Lehman's officers would argue that an analysis of their management of Lehman's risks should consider the risks that Lehman prudently avoided along with the risks that Lehman unsuccessfully took.

Moreover, a breach of the duty of care claim would rely heavily on the testimony and e-mail communications of Lehman's risk managers and financial controllers. But risk managers and controllers are by definition more risk-averse than "risk-takers" – the business people who actually make the decisions on behalf of the enterprise. Indeed, risk managers and controllers are naturally inclined to see limits and controls as "harder" and less susceptible to judgment than businesspersons. Lehman's officers would have a compelling argument that the risk managers' opposition to various strategies and transactions must be considered in this context.

(i) Countercyclical Growth Strategy with Respect to Residential Mortgage Origination

The Examiner does not find that Lehman's countercyclical growth strategy with respect to its residential mortgage origination gives rise to a colorable duty of care claim. Lehman's management took significant steps to curtail and control its origination of subprime mortgages, including discontinuing certain mortgage programs, installing improved risk management systems, and replacing management of its subprime originator. Lehman's management also successfully hedged its subprime mortgage risk, at least until early 2008, and avoided some of the catastrophic investments that other financial institutions made in the mortgage market, for example in CDOs.

Lehman's management can be second-guessed, perhaps, for its decision to continue originating Alt-A mortgages through its Aurora subsidiary even as it was curtailing the origination of subprime mortgages through its BNC subsidiary, and for failing to curtail its subprime mortgage originations more quickly. As described above, however, these business decisions were part of Lehman's strategy to benefit from a consolidation in the mortgage origination industry. In 2007, Lehman curtailed origination of riskier segments of its Alt-A production after it became evident that these riskier segments were performing as poorly as subprime loans.

The business judgment rule shields from judicial review the foregoing decisions by Lehman concerning its Alt-A and subprime originations. The Examiner does not

find that Lehman's management should be deprived of that protection, or that these business decisions were irrational or reckless.

(ii) Lehman's Concentration of Risk in Its Commercial Real Estate Business

As described above, Lehman entered into large commercial real estate transactions during the course of 2007, including transactions that left Lehman with a substantial investment in bridge equity. The most significant of these transactions was Archstone.

Lehman entered into these commercial real estate bridge equity transactions at a precarious time in the financial markets. After the onset of the subprime mortgage crisis in December 2006 or January 2007, there was a risk of contagion to the commercial real estate market. Lehman's officers recognized this risk but concluded that it was manageable.[647] Although in hindsight this conclusion was wrong, the Examiner cannot conclude that at the time it was reckless or irrational.

Lehman's officers exercised judgment to pursue commercial real estate opportunities, and to override indicators from the firm's risk systems. Before Lehman entered into the Archstone transaction, Lehman's Real Estate group was already near its risk limits. And the risk in the Archstone commitment and several contemporaneous real estate bridge equity deals was enormous – perhaps as large as or larger than

[647] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at pp. 14-15; Examiner's Interview of Joseph Gregory, Nov. 13, 2009, at pp. 7-8; Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at pp. 7-9.

Lehman's entire pre-existing real estate book put together.[648] Thus, it was obvious that entering into Archstone and these other transactions would put Lehman well over its real estate risk appetite limit. Several witnesses, including Jeffrey Goodman, the risk manager primarily responsible for GREG, said in their interviews that the commercial real estate group was not subject to its risk appetite limits.[649] Similarly, Mark Walsh, the head of GREG, said he was informed that GREG was allocated excess risk appetite from other business divisions.[650]

The risk appetite limit applicable to an individual business line may be viewed as a type of concentration limit. Concentration limits are important to ensure that a firm does not take too much risk in a single, undiversified business or area. By exceeding the concentration limits applicable to Lehman's real estate business, Lehman's officers took the risk that the firm would over-concentrate its capital in commercial real estate investments.

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[648] *See* Mark Weber, Lehman, Chart Showing Risk Appetite Adjustment for Archstone (July 24, 2008) [LBEX-DOCID 425705], attached to e-mail from Mark Weber, Lehman, to PortfolioRisk Support, Lehman, *et al.* (July 24, 2008) [LBEX-DOCID 265567] (showing that as a result of the inclusion of the Archstone positions into the firm's risk measurements, GREG's risk appetite usage increased from $689 million to $1.233 billion); e-mail from Madelyn Antoncic, Lehman, to Roger Nagioff, Lehman, *et al.* (June 29, 2007) [LBEX-DOCID 1478403]; e-mail from Jeffrey Goodman, Lehman, to Mark A. Walsh, Lehman, *et al.* (June 29, 2007) [LBEX-DOCID 2538925] (same).

[649] Examiner's Interview of Jeffrey Goodman, Aug. 28, 2009; Examiner's Interview of David S. Lazarus, Nov. 18, 2009, at p. 4; Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 4; Examiner's Interview of Kenneth Cohen, Oct. 20, 2009, at p. 6; Examiner's Interview of Mark Weber, Aug. 11, 2009, at p. 3.

[650] Examiner's Interview of Mark Walsh, Oct. 21, 2009, at p. 5.

The risk attributable to Archstone and at least one other bridge equity transaction was excluded from Lehman's risk appetite usage calculation for almost three months after the May 2007 commitment date for Archstone.[651] These two transactions were not included in the firm's risk appetite calculation until August 13, 2007.[652] After the exclusion was acknowledged in August 2007, Lehman retroactively corrected its risk appetite figures to include the previously omitted risks.[653] The retroactive calculation shows that if these transactions had been included in the risk appetite usage, Lehman would have been over its firm-wide and real estate risk appetite limits almost continuously from the date of the Archstone commitment.

Although Lehman's decision to concentrate heavily in real estate bridge equity was unwise in retrospect, and excluding major transactions from Lehman's risk usage calculation was a breach of risk management protocol, the fact remains that Lehman's management seriously considered the risks in the Archstone transaction in a series of

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[651] Mark Weber, Lehman, Chart Showing Risk Appetite Adjustment for Archstone (July 24, 2008) [LBEX-DOCID 425705], attached to e-mail from Mark Weber, Lehman, to PortfolioRisk Support, Lehman, *et al.* (July 24, 2008) [LBEX-DOCID 265567]; *accord* Examiner's Interview of Jeffrey Goodman, Aug. 28, 2009; e-mail from Mark Weber, Lehman, to Laura Vecchio, Lehman, *et al.* (July 31, 2008) [LBEX-DOCID 264849]; Lehman, Market Risk Control Committee Meeting Agenda (Nov. 12, 2007), at p. 17 [LBEX-DOCID 271334], attached to e-mail from Mark Weber, Lehman, to Paul Shotton, Lehman, *et al.* (Nov. 12, 2007) [LBEX-DOCID 265289].

[652] Mark Weber, Lehman, Chart Showing Risk Appetite Adjustment for Archstone (July 24, 2008) [LBEX-DOCID 425705], attached to e-mail from Mark Weber, Lehman, to PortfolioRisk Support, Lehman, *et al.* (July 24, 2008) [LBEX-DOCID 265567]; *see also* e-mail from Mark Weber, Lehman, to Laura Vecchio, Lehman, *et al.* (July 31, 2008) [LBEX-DOCID 264849]; Lehman, Market Risk Control Committee Meeting Agenda (Nov. 12, 2007), at p. 17 [LBEX-DOCID 271334], attached to e-mail from Mark Weber, Lehman, to Paul Shotton, Lehman, *et al.* (Nov. 12, 2007) [LBEX-DOCID 265289].

[653] Mark Weber, Lehman, Chart Showing Risk Appetite Adjustment for Archstone (July 24, 2008) [LBEX-DOCID 425705], attached to e-mail from Mark Weber, Lehman, to PortfolioRisk Support, Lehman, *et al.* (July 24, 2008) [LBEX-DOCID 265567].

Executive Committee and Commitment Committee meetings over a period of weeks, modified the transaction in several important ways to try to manage the risk, and ultimately decided that the rewards from the transaction outweighed the risk. Moreover, Lehman's management plainly was aware of the risk associated with the Archstone transaction during this period. In fact, Lehman's management was focused on trying to distribute the Archstone debt and equity and reduce the firm's risk in advance of the closing of that transaction.

The Examiner thus concludes that there is no colorable claim of breach of fiduciary duty on the part of Lehman's officers. Lehman management's decision to exceed its limit for this business and invest heavily in commercial real estate is protected by the business judgment rule. That rule does not operate retroactively to judge a business decision based on its ultimate failure, but instead focuses on the reasons for making that decision as of the time and in the context in which it was made. The officers' decision not to follow the guidance of its internal and voluntary risk management system does not give rise to a breach of the duty of care.

(iii) Concentrated Investments in Leveraged Loans

As described above, Lehman's principal investment strategy also included participating in leveraged loan transactions. This business grew spectacularly in 2006 and the first half of 2007. Many of these loans were made to private equity firms, or sponsors, who were purchasing companies as part of leveraged buy-outs. These

transactions were risky for Lehman because they consumed tremendous amounts of capital, were made on terms that strongly favored the borrowers, and often involved bridge equity or bridge debt that Lehman hoped to distribute to other financial institutions (but was committed to keep for itself if it was unable to do so).

The evidence is that during the first eight months of Lehman's fiscal 2007, Lehman's leveraged loan business, like its commercial real estate business, was not subject to any limits. Between August 2006 and July 2007, Lehman entered into approximately 30 leveraged loans that exceeded the single transaction limit that had previously been adopted for these transactions, often by significant margins.[654] The chart below demonstrates the magnitude of these overages:

[654] Joe Li, Lehman, STL Backtesting Excel Spreadsheet (July 25, 2007) [LBEX-DOCID 2506462], attached to e-mail from Joe Li, Lehman, to Fred S. Orlan, Lehman, *et al.* (July 25, 2007) [LBEX-DOCID 2563167].

Leveraged Finance Deals with Single Transaction Loss ("STL") in Excess of Limit[1]
(July 2007 Analysis, Deals between August 2006 and July 2007) ($ in Millions)

Deal Name	Original Commitment Date[2]	"Old Framework" STL for deals with STL over $250MM[3]	"New Framework" STL for deals with STL over $400MM[3]
Intelsat	-	2,090	1,045
Weatherford	4/30/2007	2,030	1,015
Houghton Mifflin Riverdeep Group	7/16/2007	1,389	694
TXU Corp	2/26/2007	1,368	684
First Data Corporation	4/2/2007	1,203	601
Alcoa Inc.	5/24/2007	1,200	600
Home Depot Supply	6/19/2007	971	486
CDW Corporation	5/29/2007	909	455
Dollar General	3/1/2007	882	441
Harman International Industries	4/25/2007	692	346
US FoodService	-	651	326
CVS	1/16/2007	600	300
BCE	6/29/2007	553	277
BAWAG PSK	3/1/2007	550	275
Tognum AG	-	515	258
ProSiebenSat.1 Media AG	1/31/2007	500	250
CBS Corporation	-	476	238
West Corp	-	465	232
IBM International Group BV	-	440	220
Sequa Corp	6/18/2007	431	216
Tesoro	4/10/2007	431	215
Alliance Data	5/31/2007	424	212
Applebee's International, Inc.	7/16/2007	403	202
Allison Transmission	5/21/2007	390	195
Dockwise	-	388	194
Univision Communications	7/14/2006	387	193
PHH Corporation	3/15/2007	386	193
Formula One Group	-	378	189
United Rentals, Inc.	7/22/2007	372	186
Thermo Electron Corp.	5/7/2006	360	180
National Beef Packing Co.	5/11/2007	335	168
Bulgarian Telecommunications	3/28/2007	327	164
Endemol Holdings	5/11/2007	322	161
Linde Material Handling Group	-	293	146
Pinnacle Foods	2/10/2007	277	138
The Klockner Pentaplast Group	-	276	138
Guitar Center, Inc.	6/20/2007	263	132

Note: *Highlighted cells indicate transactions with STL in excess of the limit conditions described below*:

[1] Table includes all deals from August 2006 to July 2007 that are in excess of $900M and also have a calculated STL of > $250M under the loss calculation methodology in place July 2007 (See "Old Framework" STL column). Highlighted deals have an STL in excess of the applied limit stated in column title. Transactions in excess of the Limits would have required Executive Committee approval (LBEX-DOCID 2170674).

[2] "Original commitment" indicates earliest known date on which a deal was committed to by Lehman, as presented in the LPG Weekly Reviews.

[3] All deal data is from an Excel spreadsheet (LBEX-DOCID 2506463) attached to a July 25, 2007 Joe Li email (LBEX-DOCID 2563148) stating: "Previously we have used a loss limit of 250mm to 350mm. We would like to propose a 400mm as the Firm's revenue has increased." In addition to changing the limit, it was proposed that risk factors be adjusted to exclude default risk, leaving only systematic risk as the Single Transaction Loss. This proposed change had the effect of halving the STL (calculated risk of the position), and simultaneously increasing the limit. **Items highlighted in the "Old Framework" column are STL numbers calculated under the methodology in place in July 2007 that exceed the $250M loss limit in place at the time. Highlighted items in the "New Framework" column represent STL numbers calculated under the proposed methodology (which halved the STL amount) that exceed the proposed $400M Limit.** Please note that a September 2007 presentation on STL (LBEX-DOCID 194075) stated that the current limit was $250 and proposed that the limit be increased to $300M. A leveraged finance risk presentation to the Executive Committee one month later recommended that the limit be increased to $400M (LBEX-DOCID 569902).

Lehman's decision to exceed the single transaction limit proved to be unwise. Just as Lehman was entering into a particularly large volume of commitments, Lehman won a huge volume of deals, and the credit markets froze, causing Lehman to be left with tremendous risk on its books. Before long, Lehman's high yield book showed a risk appetite usage almost double the limit for those exposures – an enormous concentration of risk in a single, illiquid asset class.

As a result of this high volume of commitments, some in Lehman's management became concerned, as early as July 2007, that the firm would not be able to fund all of its commitments. As Ian Lowitt, then the CAO, wrote in an e-mail dated July 20, 2007: "In case we ever forget; this is why one has concentration limits and overall portfolio limits. Markets do seize up."[655]

Although Lehman's decision to enter into huge illiquid transactions during a recognized "credit bubble"[656] was unwise, the large leveraged loan transactions were considered and approved by Lehman's Executive Committee, which was entitled to increase or override the single transaction limit, just as it was entitled to increase or override the risk appetite limits. Such decisions are subject to the business judgment rule.

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[655] E-mail from Ian T. Lowitt, Lehman, to Christopher M. O'Meara, Lehman (July 20, 2007) [LBEX-DOCID 194066].

[656] E-mail from Christopher M. O'Meara, Lehman, to Paulo R. Tonucci, Lehman (Apr. 6, 2007) [LBEX-DOCID 1349076].

(iv) Firm-Wide Risk Appetite Excesses

The Examiner also considered whether Lehman's handling of its overall risk limits was a breach of the duty of care. As described above, Lehman's management decided to treat the firm's risk appetite limit as a soft limit rather than as a meaningful constraint on management's assumption of risk.

Lehman decided to exceed the firm-wide risk appetite limit at several junctures. First, though Lehman dramatically increased the limit for fiscal 2007, Lehman nevertheless approached the new limit by May 2007. Lehman entered into Archstone and several other bridge equity transactions notwithstanding the obvious fact that those transactions would immediately put Lehman over its firm-wide risk appetite limits.[657]

Several months later, with Lehman's firm-wide risk usage actually in excess of the limit, Lehman decided to increase the limit again, even as one of its senior risk managers admitted to the SEC that Lehman did not in fact have increased risk-taking capacity.[658]

Then, in early October 2007, when Lehman's risk appetite excesses were at their peak, at least some members of Lehman's senior management discussed the limit breaches and decided to grant a temporary reprieve from the limits based on the difficult conditions in the real estate and leveraged loan markets. For the most part,

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[657] Examiner's Interview of Jeffrey Goodman, Aug. 28, 2009.

[658] SEC, Notes from Lehman's Monthly Risk Review meeting (Oct. 11, 2007), at p. 6 [LBEX-SEC 007438].

Lehman did not pursue aggressive risk reduction strategies until sometime in 2008, particularly with respect to commercial real estate.

Rather than reduce its risk usage, Lehman cured its risk appetite overages by increasing the firm-wide risk appetite limit yet again.[659] There is evidence which raises the question whether Lehman's risk-taking capacity had in fact increased. The increased limit amount was calculated by substantially changing the assumptions previously used in calculating the risk appetite limit, and by using a very aggressive 2008 budgeted revenue figure. If Lehman had used the same assumptions as it had previously used for calculating the risk appetite limit, and a more realistic revenue figure, it would likely have concluded that it was necessary to reduce its risk appetite limit to take account of its diminished profitability relative to its equity base. Such a conclusion might have impelled management more urgently to sell assets, reduce the firm's risk profile, and reduce the firm's leverage.

Although Lehman's risk appetite limits ultimately provided little or no limiting function at all, the Examiner does not find that the decision to exceed or disregard these limits gives rise to a colorable claim of breach of fiduciary duty. These internal limits were intended only for the guidance of Lehman's own management; they did not put

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[659] Examiner's Interview of Christopher M. O'Meara, Aug. 14, 2009, at p. 10; Lehman's Material for Market Risk Control Committee Meeting (Jan. 14, 2008), at p. 33 [LBEX-DOCID 271352], attached to e-mail from Mark Weber, Lehman, to Paul Shotton, Lehman, *et al*. (Jan. 14, 2008) [LBEX-DOCID 223263]; Estimated Third Quarter 2007 Financial Information Presentation to Lehman Board of Directors (Sept. 11, 2007), at p. 6 [LBHI_SEC07940_026288].

any legal constraints on the scope of management's authority. And because business in general and investment banking in particular is an inherently risky enterprise, Lehman's management was entitled to pursue a countercyclical growth strategy based on its evaluation of the markets and of Lehman's business, even if that strategy necessarily posed a risk to the firm. Moreover, Lehman's risk appetite limit overages were reported to the SEC. The Examiner does not find that management's decision to increase and then exceed Lehman's risk appetite levels gives rise to a colorable claim for breach of fiduciary duties.

(v) Firm-Wide Balance Sheet Limits

Lehman also failed to apply its balance sheet limits in late 2007. Application of these limits would also have restricted Lehman's risk-taking. Instead, Lehman dramatically increased the size of its balance sheet, and used increasingly large volumes of Repo 105 transactions to create the appearance that the firm's net leverage ratio remained within a reasonable range of such ratios established by the rating agencies.[660]

(vi) Stress Testing

As described above, Lehman's stress tests suffered from a significant flaw. Although Lehman made a strategic decision in 2006 to take more principal risk, Lehman did not modify its stress tests to include the risks arising from many of its principal investments – including its real estate investments other than commercial mortgage-

[660] For further detail regarding the Repo 105 transactions, see Section III.A.4 of this Report.

backed securities ("CMBS"), its private equity investments, and, during a crucial period, its leveraged loan commitments.[661] Thus, Lehman's management pursued its countercyclical growth strategy, including an increasing concentration of risk in illiquid assets, without availing itself of a common risk management technique for evaluating the potential risk to the firm from that strategy.

But stress tests, like risk limits, are an instrument available for use of management as it deems appropriate; Lehman's management was not legally required to make business decisions based on the results of stress testing.[662] Moreover, the SEC was aware that Lehman's stress tests excluded untraded investments and did not question the exclusion, because historically it had been the norm to limit stress tests only to traded positions.[663] Based on these facts, the Examiner does not find that Lehman management's use of the stress tests gives rise to a colorable claim for a breach of the duty of care.

(vii) Summary: Officers' Duty of Care

The Examiner reviewed extensive evidence concerning Lehman's senior officers' decision to disregard the guidance provided by Lehman's risk management system as they implemented the firm's aggressive business strategy in 2006 and 2007. That

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[661] E-mail from Melda Elagoz, Lehman, to Stephen Lax, Lehman, *et al.* (June 21, 2007) [LBEX-DOCID 2546617]; Examiner's Interview of Paul Shotton, Oct. 16, 2009, at pp. 4-5.

[662] Lehman was required to conduct certain stress testing as part of its participation in the CSE program. *See* 17 C.F.R. 240.15c3-1 (2007).

[663] Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at p. 12; Examiner's Interview of Paul Shotton, Oct. 16, 2009, at pp. 4-5; Examiner's Interview of Jeffrey Goodman, Aug. 28, 2009.

evidence goes to the heart of Lehman's ultimate financial failure because the illiquid investments acquired during that period could not be sold off sufficiently quickly, and Lehman's liquidity and confidence suffered as a result. When the run on Lehman began in September 2008, Lehman lacked the liquidity to survive. Thus, Lehman's collapse can be traced in part to Lehman management's adoption of a countercyclical growth strategy in 2006 and 2007. Although management turned out to be wrong in their business judgments, the evidence does not establish that management's actions and decisions were so reckless and irrational as to give rise to a colorable claim of breach of fiduciary duty.

> [B]usiness failure is an ever-present risk. The business judgment rule exists precisely to ensure that directors and managers acting in good faith may pursue risky strategies that seem to promise great profit. If the mere fact that a strategy turned out poorly is in itself sufficient to create an inference that the directors who approved it breached their fiduciary duties, the business judgment rule will have been denuded of much of its utility.[664]

(2) The Examiner Does Not Find Colorable Claims That Lehman's Senior Officers Breached Their Fiduciary Duty to Inform the Board of Directors Concerning the Level of Risk Lehman Had Assumed

The Examiner also does not find a colorable claim that, during the period from May 2007 through January 2008, Lehman's senior officers breached their duty of candor with respect to their disclosures to the Board of Directors concerning Lehman's risk

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[664] *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 193 (Del. Ch. 2006), *aff'd sub nom. Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438 (Del. 2007).

management system. Lehman's management gave the Board regular reports concerning the state of the firm's business, including reports containing quantitative risk, balance sheet, revenue, and other metrics. Lehman's management also discussed market conditions and their potential impact on the firm with the Board. The Examiner did not find evidence that managers knowingly made false statements to the Board.

In light of the Board's limited role in supervising the risk management of the enterprise, and the absence of authority mandating greater disclosure to the Board, the Examiner does not believe that the officers had a legal duty to provide the Board with additional negative information. The Examiner does not find that the evidence gives rise to a colorable claim for a breach of the duty of candor.

Lehman's management repeatedly disclosed to the Board that Lehman intended to grow its business dramatically, increase its risk profile, and embrace risk even in declining markets. The Board undoubtedly understood and approved of Lehman's growth strategy.

During 2007, there were a number of instances in which management did not provide information to the Board. For example, management did not disclose its decision to exceed or disregard the various concentration limits applicable to the leveraged loan business and to the commercial real estate businesses, including

especially the single transaction limit, contrary to representations to the Board that management took steps to "avoid [] over-concentration in any one area."[665]

In hindsight, various Board members stated that it would have been helpful to have had more information. For example, some directors said that if the risk limit breaches were sufficiently large and long-lasting;[666] if management's liquidity concerns were more than a "single incursion";[667] or if the exclusions from the stress testing were sufficiently significant;[668] they would have wanted to know about these facts.[669]

On the other hand, the Board did not explicitly direct management to provide it with this information, and there is no evidence that the Board asked questions that management did not answer, or answered inaccurately. Moreover, as discussed above, management was not required by any regulatory authority or by Delaware common law to provide such detailed information to the Board of Directors.

Although Lehman's management did not provide the Board with all available information concerning the risks faced by the firm during 2007 and early 2008, that fact is not surprising given the Board's limited role in overseeing the firm's risk management, and the extraordinarily detailed information available to management.

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[665] David Goldfarb, *et al*, Managing the Firm Presentation to Lehman Board of Directors (May 15, 2007), at p. 20 [LBHI_SEC07940_026136]

[666] Examiner's Interview of Roger Berlind, May 8, 2009, at p. 4; Examiner's Interview of Marsha Johnson Evans, May 22, 2009, at p. 6; Examiner's Interview of Roland A. Hernandez, Oct. 2, 2009, at p. 10; Examiner's Interview of John D. Macomber, Sept. 25, 2009, at p. 17. Examiner's Interview of Dr. Henry Kaufman, May 19, 2009, at p. 17.

[667] Examiner's Interview of Dr. Henry Kaufman, Dec. 22, 2009.

[668] Examiner's Interview of John D. Macomber, Sept. 25, 2009, at pp. 6, 17.

[669] *See* III.A.1.b of this Report.

After reviewing this evidence, the Examiner finds insufficient evidence to support a colorable claim that Lehman's management was either grossly negligent or intentionally deceptive in providing information to the Board concerning risk management.

First, the Examiner has found no colorable claim that Lehman's senior managers violated their fiduciary duty of care through their handling of risk issues. Management's disclosure of the risk appetite excesses to the SEC supports the view that management did not believe it was acting imprudently, much less violating the law, by taking on a higher level of risk than was consistent with the firm's pre-existing risk policies and limits. Under these circumstances it would take very substantial evidence of management's intent to mislead the Board in order to lay a sufficient foundation for a claim that Lehman's senior officers breached their duty of candor.

Establishing a violation of the duty of candor with respect to risk management is particularly difficult. As the Delaware Chancery Court recently explained in connection with directors' monitoring of risk decisions by management: "It is almost impossible for a court, in hindsight, to determine whether the directors of a company properly evaluated risk and thus made the 'right' business decision. . . . Business decision-makers must operate in the real world, with imperfect information, limited resources, and an uncertain future."[670]

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[670] *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 126 (Del. Ch. 2009).

Management's duty of candor concerning risk management adds another level of complexity beyond the issues raised by the duty of care. Risk limits, policies, and metrics were designed for use by management, not the board. Absent express direction from the board as to what information concerning risk management it should be given (and there was no such direction here), management must make the determination of what level of detail the board needs to fulfill its obligation to monitor risk decisions.

Applying the standard of proof requiring at least gross negligence and perhaps intentional deception to establish a breach of the duty of candor means that senior managers may make a good-faith mistake by not providing material information to the board without violating their fiduciary duties. Although it can be fairly debated whether Lehman's management should have provided its Board with more information and more timely information concerning the firm's risk usage, stress test results, and liquidity, the Examiner does not find that any mistake by management in this regard constituted gross negligence or intentional deception.

(3) The Examiner Does Not Find Colorable Claims That Lehman's Directors Breached Their Fiduciary Duty by Failing to Monitor Lehman's Risk-Taking Activities

(a) Lehman's Directors are Protected From Duty of Care Liability by the Exculpatory Clause and the Business Judgment Rule

Corporate directors' duty of care is a duty of informed decision making.[671] It involves the process by which directors make business decisions, not the content of those decisions.[672] However, directors are generally afforded additional protection by the business-judgment rule, a judicial presumption that a court should "not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.'"[673]

Lehman, like many Delaware corporations, immunized its directors from claims of breaching the duty of care. Lehman's certificate of incorporation provides:

> A director shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director; provided that this sentence shall not eliminate or limit the liability of a director (i) for any breach of his duty of loyalty to the Corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under Section 174 of [the Delaware General Corporation Law], or (iv)

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[671] *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985), *overruled on other grounds, Gantler v. Stephens*, 965 A.2d 695, 713 n.54 (Del. 2009).

[672] *In re Caremark Int'l. Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996).

[673] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)). For a more detailed discussion of Delaware law governing corporate directors' fiduciary duties, see Appendix 1, Legal Issues.

> for any transaction from which the director derives an improper personal benefit.[674]

The wording of this clause is nearly identical to that in Section 102(b)(7) of the Delaware General Corporate Law, which authorizes a corporation to exculpate its directors from personal liability for breaches of fiduciary duties, except in the four exceptions stated in the statute: conduct violating the directors' duty of *loyalty*; acts or omissions *not in good faith*; *intentional misconduct*; and *knowing violations of law*.[675] Courts uphold such a clause to protect directors from liability provided that the conduct in question does not violate their duty of loyalty.[676] In addition, Delaware protects directors from personal liability to the extent their decisions are based on information provided to them by management.[677]

Therefore, Delaware has chosen to impose personal liability only on those directors who have handled their responsibility in a reckless or irrational manner:

> Directors' decisions must be reasonable, not perfect. "In the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties." . . . Only if they knowingly and completely

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[674] Lehman Brothers Holdings Inc., Certificate of Incorporation, at § 10.1, *Limitation of Liability of Directors.*

[675] *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2009).

[676] *See Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 367 (Del. 2006) ("Such a provision can exculpate directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith or a breach of the duty of loyalty.").

[677] *See* DEL. CODE ANN. tit. 8, § 141(e) (2009); *see also Brehm v. Eisner*, 746 A.2d 244, 261 (Del. 2000); *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 132 & n.86 (Del. Ch. 2009).

failed to undertake their responsibilities would they breach their duty of loyalty.[678]

(b) Lehman's Directors Did Not Violate Their Duty of Loyalty

A director's duty of loyalty "[e]ssentially . . . mandates that the best interest of the corporation and its shareholders take precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally."[679] The duty of loyalty chiefly involves situations in which directors utilize their positions to confer special benefits onto themselves or majority stockholders.[680] These situations are frequently referred to as "self-dealing" or "interested" situations.[681] "A director is considered interested when he will receive a personal financial benefit from a transaction that is not equally shared by the stockholders."[682] Directors are also considered interested where their motivations in executing a business decision appear to be subservient to the interests of a majority stockholder.[683]

The Examiner has found no evidence of self-dealing by Lehman's directors, and Lehman did not have a majority stockholding interest.

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[678] *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 243-44 (Del. 2009) (quoting *In re Lear Corp. S'holder Litig.*, 967 A.2d 640, 654-55 (Del. Ch. 2008)).

[679] *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993), *modified on other grounds*, 636 A.2d 956 (Del. 1994).

[680] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds, Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000).

[681] *See id*.

[682] *Globis Partners, L.P. v. Plumtree Software, Inc.*, No. 1577-VCP, 2007 WL 4292024, at *5 (Del. Ch. Nov. 30, 2007).

[683] *See, e.g.*, *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001); *Tooley v. AXA Fin., Inc.*, No. 18414, 2005 WL 1252378, at * 5 (Del. Ch. May 13, 2005).

(c) Lehman's Directors Did Not Violate Their Duty to Monitor

Under Delaware law, directors have a fiduciary duty to monitor management's compliance with corporate reporting and control systems. The Delaware Supreme Court has adopted the *Caremark* standard "for assessing director oversight liability."[684] Under *Caremark*, the fiduciary duty to monitor management is breached if "(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[685] The Delaware Supreme Court stressed, however, that a director can be held liable only for a "conscious" failure to fulfill the oversight function:

> [I]mposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.[686]

(i) Application of *Caremark* to Risk Oversight: *In re Citigroup Inc.*

In the *Citigroup* case, the Delaware Chancery Court rejected a claim that Citigroup's current and former directors and officers had "breached their fiduciary duties by failing to properly monitor and manage the risks the Company faced from

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[684] *Stone*, 911 A.2d at 364-65.

[685] *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 123 (Del. Ch. 2009) (quoting *Stone*, 911 A.2d at 370).

[686] *Stone*, 911 A.2d at 370 (internal citations omitted).

problems in the subprime lending market and for failing to properly disclose Citigroup's exposure to subprime assets."[687] The complaint alleged various theories of liability including a breach of the duty to monitor under *Caremark*. Plaintiffs based their claim on several "red flags" that allegedly "should have given defendants notice of the problems that were brewing in the real estate and credit markets."[688] Noting that the supposed red flags "amount[ed] to little more than portions of public documents that reflected the worsening conditions in the subprime mortgage market and in the economy generally," the Court found the allegations legally insufficient "to show that the directors were or should have been aware of any wrongdoing at the Company or were consciously disregarding a duty somehow to prevent Citigroup from suffering losses."[689]

The Court also held that a *Caremark* claim involving risk management must be consistent with the business judgment rule:

> It is almost impossible for a court, in hindsight, to determine whether the directors of a company properly evaluated risk and thus made the "right" business decision.
>
> . . .
>
> To impose liability on directors for making a 'wrong' business decision would cripple their ability to earn returns for investors by taking business risks.[690]

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[687] *Citigroup*, 964 A.2d at 111.
[688] *Id.*
[689] *Id.* at p. 128.
[690] *Id*. at p. 126.

The Court held that plaintiffs had failed to tie the *Caremark* claim to a failure of the corporate risk management system:

> [P]laintiffs' allegations do not even specify how the board's oversight mechanisms were inadequate or how the director defendants knew of these inadequacies and consciously ignored them. Rather, plaintiffs seem to hope the Court will accept the conclusion that since the Company suffered large losses, and since a properly functioning risk management system would have avoided such losses, the directors must have breached their fiduciary duties in allowing such losses.[691]

The Court emphasized that "red flags" sufficient to state a *Caremark* claim must go beyond "signs in the market that reflected worsening conditions and suggested that conditions may deteriorate even further. . . ."[692] The Court was protective of directors facing personal liability because the risk assumed by their corporation resulted in losses:

> Oversight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to properly evaluate business risk.[693]

(ii) Application of *Caremark* and *Citigroup* to Lehman's Directors

The Examiner does not find that Lehman's directors breached their *Caremark* duty to monitor management's compliance with the law.

First, the Examiner does not find that "the directors utterly failed to implement any reporting or information system or controls."[694] As explained above, the Board

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[691] *Id.* at 128.

[692] *Id*. at 130.

[693] *Citigroup*, 964 A.2d at 131.

received regular information at every Board meeting concerning the firm's risk, liquidity, and balance sheet situation. The Board also created a Finance and Risk Committee to receive considerably more detailed information about these topics. Moreover, the Board received regular reports about the firm's risk management systems and controls. The directors plainly implemented a sufficient reporting system and controls.

Second, the Examiner does not find that the directors "consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[695] As explained above, the Examiner has not found colorable claims that Lehman's senior officers breached their fiduciary duties through the manner in which they managed risk. To the contrary, management's conduct is protected from liability by the business judgment rule. There is also insufficient evidence that Lehman's management violated any legal requirements or obligations relating to risk management. The risk limits, policies, metrics, and stress tests that Lehman developed were intended to be used internally and did not constitute legal obligations. Because Lehman management's handling of risk did not violate the law, the directors cannot be liable for a breach of their duty to monitor management to prevent such violations.

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[694] *Id.* at p. 123.
[695] *Id.*

Moreover, there is no evidence, as Delaware law requires, that Lehman's directors "consciously disregarded" violations by Lehman's senior officers of their fiduciary or other legal duties through their decisions concerning the amount of risk that Lehman assumed and their management of that risk. The directors were not presented with "red flags" of such misconduct. And in monitoring risk issues, the Board justifiably relied entirely on information provided by management. Under Delaware law, the directors are thereby immunized from personal liability.[696]

[696] *See* DEL. CODE ANN. tit. 8, § 141(e) (2009).

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	Chapter 11 Case No.
LEHMAN BROTHERS HOLDINGS INC., *et al.*,	:	08-13555 (JMP)
	:	(Jointly Administered)
Debtors.	:	

REPORT OF ANTON R. VALUKAS, EXAMINER

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March 11, 2010

VOLUME 2 OF 9

Section III.A.2: Valuation

Section III.A.3: Survival

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REPORT OF EXAMINER ANTON R. VALUKAS

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2. Valuation

a) Executive Summary

Under GAAP, Lehman was required to report the value of its financial inventory at fair value.[697] Beginning in the first quarter of 2007,[698] Lehman adopted SFAS 157, which established the fair value of an asset as the price that would be received in an orderly hypothetical sale of the asset.[699]

To increase consistency and comparability in fair value measurements, SFAS 157 created a broad, three-level, fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value.[700] Generally, this hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1), followed by observable inputs other than quoted prices (Level 2) and the lowest priority to unobservable inputs (Level 3).[701] To the extent that the value of an asset cannot be determined by reference to observable data based on transactions between parties in the market, other than data from distressed sales, SFAS 157 requires the reporting entity to

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[697] Fin. Accounting Standards Bd., SFAS No. 107, ¶¶ 10-11. In addition, Lehman owned positions within its financial inventory that were classified as held for sale, which were reported at the lower of carrying amount or fair value.

[698] SFAS 157 became mandatory for financial statements issued for fiscal years beginning after November 15, 2007, and FASB encouraged early adoption. Fin. Accounting Standards Bd., SFAS No. 157, ¶ 36.

[699] Lehman Brothers Holdings Inc., Quarterly Report as of Feb. 28, 2007 (Form 10-Q) (filed on Apr. 9, 2007), at p. 14 ("LBHI 10-Q (filed Apr. 9, 2007)") ("We elected to early adopt SFAS 157 beginning in our 2007 fiscal year . . . ."). SFAS 157 and fair value measurements are discussed further in Appendix 1, Legal Issues, Section VII.A.

[700] SFAS No. 157, ¶ 22.

[701] *Id.* at ¶¶ 22-30.

use its judgment to determine fair value, taking into account its view as to the assumptions that market participants would use in pricing the asset.[702]

As the level of market activity declined in late 2007 and 2008 — resulting in valuation inputs becoming less observable — and certain of Lehman's assets became increasingly less liquid, Lehman progressively relied on its judgment to determine the fair value of such assets.[703] In light of the dislocation of the markets and its impact on the information available to determine the market price of an asset, investors, analysts and the media focused on Lehman's mark-to-market valuations.[704] Lehman devoted a

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[702] *Id.* at ¶¶ 22, 30.

[703] Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009, at pp. 4, 6-8. *See* Lehman, Valuation & Control Report – Fixed Income Division (Feb. 2008), at p. 27 [LBEX-WGM 002260] (noting that to compensate for the lack of sales data, "[p]roduct control is having continuous discussions with Front Office going through deals in more detail and trying to obtain market color using recent syndications, bids, offers and any other market information.") Lehman reported an increasing amount of Level 2 and Level 3 assets in its financial statements from the end of the fourth quarter for its 2007 fiscal year to the end of the first quarter of 2008. *See* Lehman Brothers Holdings Inc., Annual Report as of Nov. 30, 2007 (Form 10-K), at p. 41 (filed on Jan. 29, 2008) ("LBHI 2007 10-K") ("During the 2007 fiscal year, our Level 3 assets increased, ending the year at 13% of Financial Instruments and other inventory positions owned."); Lehman Brothers Holdings Inc., Quarterly Report as of Feb. 29, 2008 (Form 10-Q), at p. 23 (filed on Apr. 9, 2008) [LBEX DOCID 1024435] ("LBHI 10-Q (filed Apr. 9, 2008)") (showing an increase in the amount of Level 2 and Level 3 assets on a quarter-over-quarter basis from the end of the 2007 fiscal year). Although by the end of the second quarter of 2008 the aggregate amount of Lehman's financial inventory considered Level 2 or Level 3 decreased on a quarter-over-quarter basis, the majority of this decrease occurred in the Level 2 asset category, and due to an even more substantial decrease in the amount of Level 1 assets over the same time period, the proportion of Lehman's financial inventory that was categorized as Level 2 and Level 3 increased on a quarter-over-quarter basis. *See* Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2008 (Form 10-Q), at pp. 29-30 (filed on July 10, 2008) ("LBHI 10-Q (filed July 10, 2008)").

[704] *See* Andrew Bary, *Apartment-House Blues*, Barron's, Jan. 21, 2008, *available at* http://online.barrons.com/article/SB120070919702802265.html#articleTabs_panel_article%3D1 (noting that "based on current REIT prices, the value of the Archstone equity could be zero."); *see also* David Einhorn, Greenlight Capital, Presentation to the Value Investing Congress, A Few Thoughts About Risk (Nov. 29, 2007) [LBEX-DOCID 2490444]; Transcript of Speech by David Einhorn, Presentation to Grant's Spring Investment Conference, Private Profits and Socialized Risk (Apr. 8, 2008), at p. 9, *available at*

considerable part of its earnings calls for the first and second quarters of 2008 to explain the values it had determined for a wide range of its assets and the methodologies it had employed in doing so.[705] Notwithstanding such disclosures, it is apparent that Lehman's valuations, or its "marks," for its illiquid assets, were being questioned by market participants.[706]

For example, David Einhorn of Greenlight Capital, who at the time held short positions in Lehman, stated in an April 8, 2008 speech:

> There is good reason to question Lehman's fair value calculations. . . . Lehman could have taken many billions more in write-downs than it did. Lehman had large exposure to commercial real estate. . . . Lehman does not provide enough transparency for us to even hazard a guess as to how they have accounted for these items. . . . I suspect that greater transparency on these valuations would not inspire market confidence.[707]

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http://www.foolingsomepeople.com/main/mroom/Grants%20Conference%2004-08-2008.pdf (last visited Feb. 2, 2010); Transcript of Speech by David Einhorn, Presentation to Ira W. Sohn Investment Research Conference, Accounting Ingenuity (May 21, 2008), at pp. 3-4, *available at* http://www.foolingsomepeople.com/main/TCF%202008%20Speech.pdf.

[705] Transcript of Lehman Brothers Holdings Inc. Second Quarter 2008 Earnings Call (June 16, 2008); Transcript of Lehman Brothers Holdings Inc. First Quarter 2008 Earnings Call (March 18, 2008).

[706] Jonathan Weil, *Lehman's Greatest Value Lies In Lessons Learned*, Bloomberg.com (June 11, 2008), available at http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_weil&sid=aLvc47iu_Re0 ("Lehman's market capitalization, at $19.2 billion, is now almost $7 billion less than the company's $26 billion book value, or assets minus liabilities. That suggests that the market believes Lehman hasn't fully cleaned up its balance sheet and that the worst is still to come, management's assurances notwithstanding.").

[707] Transcript of Speech by David Einhorn, Presentation to Grant's Spring Investment Conference, Private Profits and Socialized Risk (Apr. 8, 2008), at p. 9, *available at* http://www.foolingsomepeople.com/main/mroom/Grants%20Conference%2004-08-2008.pdf. *See also* Transcript of Speech by David Einhorn, Presentation to Ira W. Sohn Investment Research Conference, Accounting Ingenuity (May 21, 2008), at pp. 3-4, *available at* http://www.foolingsome people.com/main/ TCF%202008%20Speech.pdf ("The issue of the proper use of fair value accounting isn't about strict versus permissive accounting. . . . The cycle has exposed the investments to be more volatile and in many cases less valuable than they thought. The decline in market values has forced these institutions to make a tough decision. Do they follow the rules, take the write-downs and suffer the consequences whatever they may be? Or worse, do

Einhorn's skepticism was also reflected in the financial press. On March 20, 2008, *Portfolio.com* published an article titled "The Debt Shuffle," which asked: "What actually happened to Lehman's balance sheet in the first quarter? Assets rose. Leverage rose. Write-downs were suspiciously miniscule. And the company fiddled with the way it defines a key measure of the firm's net worth."[708] Lehman's Head of U.S. Global Credit Products, Eric Felder, forwarded this article to Ian Lowitt, Lehman's Co-Chief Administrative Officer, with the note, "bunch of people looking at this article," to which Lowitt replied, "[d]oesn't help."[709] Firms such as Lehman required the confidence of the market to assure its sources of short term financing that they would be repaid; and the market's confidence in Lehman was publicly questioned.[710]

According to the SEC, one of the reasons that the market lost confidence in Lehman was that the market had little confidence in the asset values that Lehman was reporting.[711] This lack of confidence was evident in the performance of Lehman's stock price, which dropped to near historic lows following Lehman's June 9, 2008 preliminary

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they take the view that they can't really value the investments in order to avoid writing them down? Or, even worse, do they claim to follow the accounting rules, but simply lie about the values?")

[708] Jesse Eisinger, *The Debt Shuffle: Wall Street cheered Lehman's earnings, but there are questions about its balance sheet*, Portfolio.com (Mar. 20, 2008), *available at* http://www.portfolio.com/news-markets/top-5/2008/03/20/Lehmans-Debt-Shuffle.

[709] *See* e-mail from Eric Felder, Lehman, to Ian T. Lowitt, Lehman (Mar. 23, 2008) [LBHI_SEC07940_625905]; e-mail from Ian T. Lowitt, Lehman, to Eric Felder, Lehman (Mar. 23, 2008) [LBHI_SEC07940_625905]. There is substantial evidence that the market lost a significant degree of confidence in Lehman in the summer of 2008. In June 2008, S&P, Fitch and Moody's each issued ratings downgrades for Lehman, and Lehman's stock price plummeted following its earnings announcement for the second quarter of 2008. *See* Section III.B.3.d.2.e of this Report.

[710] Examiner's Interview of SEC staff, Aug. 24, 2009, at p. 14.

[711] *Id.*

earnings announcement.[712] The decline in Lehman's stock price resulted in Lehman having a market capitalization of $19.2 billion, which was nearly $7 billion below Lehman's book value. According to Bloomberg.com's Jonathan Weil, the decline in stock price "suggest[ed] that the market believes Lehman hasn't fully cleaned up its balance sheet and the worst is still to come, management's assurances notwithstanding."[713]

The lack of confidence in Lehman's valuations was also evident in the demands for collateral made by Lehman's clearing banks throughout 2008 to secure risks they assumed in connection with clearing and settling Lehman's triparty and currency trades, and other extensions of credit.[714] To continue the provision of clearing services and intraday credit that Lehman relied upon for day-to-day operations, Lehman's

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[712] *See* Section III.B.3.d.2.e of this Report for further discussion of the market's lack of confidence in Lehman in summer of 2008. From the beginning of 2008 through the end of the second quarter of 2008, Lehman's common stock traded in range between a high of $66 per share on February 1, 2008 to a low of $31.75 on March 17, 2008, immediately after the near collapse of Bear Stearns. Starting in June 2008, Lehman's share price was approaching its 52-week low, would soon fall below $30 per share and would not again return to that level. The last time Lehman's stock had traded below $30/share was in September and October 1998 — in the aftermath of the collapse of Long-Term Capital Management and the Russian Sovereign Debt Crisis. On June 12, 2008, Lehman's stock opened at $21.35/share, and closed at $21.17/share — lows that Lehman had not reached since 1996 — and the volume on trading of Lehman's shares reached an all-time high of over 173 million — a level of trading that would only be eclipsed in Lehman's final week prior to the bankruptcy filing. All historical pricing information is publicly available from sites such as Yahoo! Finance.

[713] Jonathan Weil, *Lehman's Greatest Value Lies In Lessons Learned*, Bloomberg.com (June 11, 2008), *available at* http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_weil&sid=aLvc47iu_Re0. Notably, Robert Azerad, Lehman's Global Head of Asset and Liability Management, forwarded this article to Paolo Tonucci, Lehman's Global Treasurer, and described this article as "[r]epresentative of the tone of the market." E-mail from Robert Azerad, Lehman, to Paolo Tonucci, Lehman (June 11, 2008) [LBHI_SEC07940_517806-809]

[714] *See* Section III.A.5. of this Report for a discussion of the collateral demands made by Lehman's clearing banks.

clearing banks began demanding collateral.[715] In response, Lehman pledged, or attempted to pledge, Lehman-structured instruments, such as certain collateralized loan obligations, to Citigroup and JPMorgan – two of its principal settlement banks.[716] Citigroup rejected the assets proposed by Lehman, due to their illiquid characteristics and the inability to establish reliable marks for such assets.[717] While JPMorgan accepted Lehman's structured instruments, that bank demanded additional cash collateral after conducting analyses showing that the collateral was likely not worth the par values assigned by Lehman.[718] JPMorgan's collateral call was one of the contributing factors to the liquidity problems that hastened Lehman's bankruptcy.[719]

Further, the lack of confidence in Lehman's valuation of its CRE assets was a principal reason why Lehman sought to shed its illiquid CRE assets in a spin-off

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[715] *See* Section III.A.5. of this Report, which discusses the importance of Lehman's secured lenders in general, and Sections III.A.5.b.-d., which discuss Lehman's dealings with JPMorgan, Citigroup and HSBC, which were three of Lehman's most important clearing and settlement banks. Each bank requested collateral from Lehman in the summer of 2008.

[716] *See* Section III.A.5.c.1.c.ii of this Report, which discusses Lehman's proposed pledge of securities to Citi; and *see also* Sections III.A.5.b.1.e and III.A.5.b.1.k of this Report which discusses JPMorgan's concerns with securities pledged by Lehman as collateral.

[717] *See* Section III.A.5.c.1.c.ii of this Report, which discusses Lehman's proposed pledge of securities to Citi.

[718] *See* Sections III.A.5.b.1.e and III.A.5.b.1.l, of this Report, which discuss JPMorgan's concerns over Lehman collateral, and certain of JPMorgan's valuation analyses of Lehman's collateral. *See* Section III.A.5.b.1.k of this Report, which notes that JPMorgan's concerns over the value of Lehman's pledged assets, at least in part, led the bank to ask for a pledge of cash collateral.

[719] *See* Section III.A.6 of this Report which discusses the effect of clearing bank collateral demands on Lehman's liquidity.

company that would not be required to report the fair value of such assets pursuant to SFAS 157.[720]

The uncertainly as to the fair value of Lehman's assets also played a role in the negotiations between BofA and Lehman regarding a potential acquisition of Lehman by BofA. Lewis told the Examiner that for BofA, the question of whether or not it was a good deal was "based entirely on the numbers."[721] BofA put together a diligence team at some point around September 10 or 11, 2008, and it became quickly apparent to them that, without substantial government assistance, the deal would not be beneficial to BofA.[722] The sticking point for BofA was what Lewis described as a "$66 billion hole" in Lehman's valuation of its assets.[723] Although Lewis stated that he did not think that the assets were completely worthless, BofA did not want those $66 billion in assets at any price, and wanted them off the books.[724] Lewis stated that he thought Lehman's marks were "out of line with BofA's."[725] Once it became apparent to Lewis that government assistance was not forthcoming, BofA effectively ended its negotiations with Lehman.[726]

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[720] Examiner's Interview of SEC staff, Aug. 24, 2009, at p. 14. For a discussion of SpinCo, see Section III.A.5.c.4 of this Report.
[721] Examiner's Interview of Kenneth D. Lewis, Oct. 9, 2009, at p. 4.
[722] *Id.*
[723] *Id.* at p. 5.
[724] *Id.*
[725] *Id.*
[726] *Id.* at p. 6.

(1) Scope of Examination

To address the tasks in the Examiner's Order, the Examiner evaluated the reasonableness of Lehman's mark-to-market valuations in two distinct but related different contexts. The Examiner considered the reasonableness of Lehman's mark-to-market valuations for two reasons. First, in connection with the Examiner's analysis as to whether LBHI or any LBHI Affiliates were insolvent, the Examiner considered whether there was sufficient evidence that Lehman's valuations for a particular asset class were unreasonable such that the court could adjust, or even disregard, such valuations in determining the solvency of these debtors. Second, where there was sufficient evidence to demonstrate that valuations were unreasonable, the Examiner considered whether such valuations were the product of actions of a Lehman officer that would support a colorable claim of breach of fiduciary duty.

The Examiner's inquiry into the reasonableness of Lehman's valuation focused on Lehman's U.S. assets. The Examiner determined that, in light of the composition of the LBHI Affiliates' assets, the relative inaccessibility of information regarding the valuation and price testing of Lehman's non-U.S. assets and the time and expense necessary to obtain and analyze such information, an assessment of Lehman's non-U.S. assets was not a prudent use of resources. Accordingly, unless otherwise noted, any reference to an asset class or a particular Lehman business unit in this Section is to U.S. assets or a Lehman U.S. business unit.

The Examiner analyzed Lehman's valuation of the following asset categories: commercial real estate ("CRE"), residential whole loans ("RWLs"), residential mortgage-backed securities ("RMBS"), collateralized debt obligations ("CDOs"), derivatives, corporate debt and corporate equity. The Examiner selected these asset categories due to the relative size of each asset class and the risk of a valuation error in light of deteriorating market conditions. Given that the primary purpose of the valuation was to support the solvency analysis, the Examiner focused the valuation analysis on the second and third fiscal quarters of 2008,[727] except with respect to Lehman's valuations of its Archstone positions, which are addressed beginning with the Archstone acquisition in October 2007.

Across all asset classes, the asset values Lehman reported were those determined by its business desk, subject to revision pursuant to a price testing process performed by its Product Control Group.[728] Even within a single asset class, the valuation methodologies employed by the business desk differed, and the Product Control

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[727] LBHI's market capitalization was approximately $28.1 billion as of the end of its first fiscal quarter on February 29, 2008. *See* LBHI Form 10-Q (filed April 9, 2008), at p. 6. The Examiner focused on the dates May 31, 2008, and August 31, 2008, because these were the last days of Lehman's second and third quarters, respectively. While Lehman did not file a quarterly report for the third quarter of 2008, the business desks did value their positions and the Product Control Group performed price testing for this period. In light of the primary purpose of the valuation analysis, the Examiner determined that it was not a prudent use of resources to examine the reasonableness of Lehman's valuations (other than Archstone) prior to the second quarter of 2008. With respect to Archstone, given the substantial analyst and media focus on this transaction and the nature of Lehman's participation, the Examiner determined it would be prudent to begin the valuation analysis with the Archstone acquisition in the fourth quarter of 2007 to provide appropriate context in which to consider the reasonableness of Lehman's valuations during later periods.

[728] Lehman, Price Verification Policy: Global Capital Markets 2008 [Draft], at p. 4 [LBHI_SEC07940_2965994].

Group's price testing served as a standardized check on the valuation process. For this reason, the investigation focused on the role played by the Product Control Group and the methods employed in the price testing process.

(2) Summary of Applicable Legal Standards

The standard for determining the fair value of an asset pursuant to SFAS 157 is closely aligned with the standard courts have applied in determining the value of a debtor's assets for purposes of a solvency determination.[729] The Bankruptcy Code defines "insolvent" in relevant part as the "financial condition such that the sum of the entity's debts is greater than all of such entity's property, at a fair valuation[.]"[730] When assessing the fair value of a debtor's assets, courts consider "the fair market price of the debtor's assets that could be obtained if sold in a prudent manner within a reasonable period of time to pay the debtor's debts."[731] In this manner, both the SFAS 157 standard for mark-to-market valuation and the courts' solvency analysis are predicated on the price that could be obtained for the asset in the marketplace as of the applicable measurement date.

Given that "valuation is, to a great extent, a subjective exercise,"[732] courts have assessed the reasonableness of a debtor's valuation or projection of future cash flows in

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[729] *See* Appendix 1, Legal Issues, Section VII.A, for a discussion of the applicable valuation standards under SFAS 157 and for a solvency determination under the Bankruptcy Code.

[730] 11 U.S.C. § 101(32)(A) (definition applicable to entities other than a partnership or municipality).

[731] *In re Roblin Industries, Inc.*, 78 F.3d 30, 35 (2d Cir. 1996).

[732] *In re Iridium Operating LLC*, 373 B.R. 283, 348 (Bankr. S.D.N.Y. 2007).

light of information available at the time the valuation was undertaken. As the Third Circuit has explained with respect to the analysis of a debtor's cash flow projections, "far from 'hindsight' or 'post-hoc' analysis, a court looks at the circumstances as they appeared to the debtor and determines whether the debtor's belief that a future event would occur was reasonable. The less reasonable a debtor's belief, the more a court is justified in reducing the assets (or raising liabilities) to reflect the debtor's true financial condition at the time of the alleged transfers."[733] Accordingly, the Examiner has considered the reasonableness of Lehman's asset values in light of contemporaneous information available to Lehman and with the understanding that valuation of illiquid assets requires the application of considerable judgment.

With respect to the fiduciary duty analysis, a corporate fiduciary would have breached such duty if the fiduciary caused Lehman to improperly value an asset intentionally or with "conscious recklessness — *i.e.*, a state of mind approximating actual intent, and not merely a heightened form of negligence."[734] In order for there to be a colorable claim, the facts need to support a finding that the corporate fiduciary had the necessary scienter.

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[733] *Mellon Bank, N.A. v. Official Committee of Unsecured Creditors of R.M.L., Inc.*, 92 F.3d 139, 157 (3d Cir. 1996).

[734] *See, e.g.*, *Desimone v. Barrows*, 924 A.2d 908, 934-35 & n.89 (Del. Ch. 2007). *See* Appendix 1, Legal Issues, Section II, for a discussion regarding the legal standards for breach of fiduciary duty. *See also South Cherry Street, LLC v. Hennessee Group LLC*, 573 F.3d 98, 109 (2d Cir. 2009).

(3) Summary of Findings and Conclusions

The Examiner finds insufficient evidence to support a finding that Lehman's valuations of its RWL, RMBS, CDO or derivative positions were unreasonable during the second and third quarters of 2008. Although the Examiner identifies, and discusses below, certain problematic issues related to the price testing of these asset classes, these problems either did not impact the ultimate asset values determined or the resulting valuation errors were immaterial.

Because an assessment of the reasonableness of Lehman's asset values for corporate debt and corporate equity would require an expensive and time consuming asset-by-asset analysis, the Examiner determined that such an assessment was not a prudent use of resources. The Examiner considered Lehman's valuations of the largest corporate debt and corporate equity positions and identified issues that may warrant further review by parties in interest.

With respect to commercial real estate, the Examiner finds insufficient evidence to conclude that Lehman's valuations of its Commercial portfolio were unreasonable as of the second and third quarters of 2008. The Examiner determines that there is sufficient evidence to conclude that certain of the Principal Transactions Group ("PTG") real estate assets were not reasonably valued during these quarters. Furthermore, the Examiner finds sufficient evidence to support a finding that Lehman's valuations of its

Archstone bridge equity investment were unreasonable as of the first, second and third quarters of 2008.[735]

The Examiner did not find sufficient evidence to support a colorable claim for breach of fiduciary duty in connection with any of Lehman's valuations. In particular, in the third quarter of 2008 there is evidence that certain executives felt pressure to not take all of the write-downs on real estate positions that they determined were appropriate; there is some evidence that the pressure actually resulted in unreasonable marks. But, as the evidence is in conflict, the Examiner determines that there is insufficient evidence to support a colorable claim that Lehman's senior management imposed arbitrary limits on write-downs of real estate positions during that quarter.

b) Overview of Valuation of Lehman's Commercial Real Estate Portfolio

This Section addresses Lehman's valuation of its CRE portfolio, principally during the second and third quarters of 2008,[736] and provides an overview of Lehman's CRE portfolio and Lehman's valuation process across the CRE portfolio. In order to put Lehman's valuation process and decisions in context, this overview summarizes the

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[735] This analysis also pertains to the permanent equity (*i.e.*, general partner interest) which was valued at $246 million at closing. *See* Lehman, Archstone Monthly Exposure as of July 2008 revised.xls [LBEX-BARFID 0013113].

[736] As is the case with each of the other asset classes that were the focus of the investigation as to Lehman's valuation of assets, the Examiner determined that it would not be a prudent use of resources to conduct an investigation of Lehman's valuation of its non-U.S. CRE assets. With the exception of LCPI, which owned certain European debt and Coeur Defense positions (located in Paris, France), the LBHI Affiliates did not directly own material CRE positions in respect of real estate located outside of the U.S. *See* Section III.B.3.c.3.a of this Report, which discusses the Examiner's finding that LCPI was either insolvent or borderline solvent during the period beginning September 2007.

changes in Lehman's CRE portfolio beginning in 2006 and Lehman's response to the changing market conditions throughout 2007 and 2008, including the write-downs Lehman took in 2008. This Section concludes by addressing the SEC's review of Lehman's price verification processes for its CRE portfolio and the quarterly review performed by E&Y of Lehman's CRE valuations in 2008.

Following the overview, the Examiner discusses the role played by Lehman senior management in the valuation process and, in particular, addresses whether senior managers set predetermined limits on the amount of CRE write-downs for the second and third quarters of 2008. This Report continues with an analysis of the valuation of the CRE assets within each of Global Real Estate Group's ("GREG's") business units — Commercial, Principal Transactions Group ("PTG") and Bridge Equity.[737] The Report, in separate subsections, describes the assets in the PTG and Commercial portfolios, Lehman's Archstone investments,[738] the methodologies employed by Lehman to value such assets and the procedures used to price test those values. Each subsection includes the Examiner's analysis as to whether there is

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[737] Lehman, GREG Update (Aug. 7, 2008), at p. 2 [LBHI_SEC_07940_ICP_003590]. According to this presentation, the three business units of GREG were Commercial Whole Loans and CMBS (which were referred to as "Commercial"), PTG and Real Estate Advisory. *Id.* Real Estate Advisory "provide[d] comprehensive advisory and capital raising services" but did not "utilize [Lehman's] balance sheet," which means that positions originated from this business unit were not owned by LBHI or the debtors. *Id.; see also* Lehman, Real Estate Update Presentation to S&P (Oct. 2007), at p. 3 [LBHI_SEC07940_126498].

[738] The Examiner's analysis of the Bridge Equity unit's valuation focuses on Lehman's valuation of its Archstone bridge equity position because this single position represented over 50% of the value of Lehman's bridge equity portfolio.

sufficient evidence to support a finding that Lehman's valuations of these assets were unreasonable.[739]

(1) Overview of Lehman's CRE Portfolio

(a) Summary of Portfolio

The Commercial portfolio ("Commercial Book") was comprised of debt instruments, such as commercial mortgage loans and Commercial Mortgage-Backed Securities ("CMBS").[740] These assets were backed by real estate properties that were generating cash flow and Lehman's intention was to syndicate, securitize and/or sell these assets to investors within a few months after their origination or acquisition.[741]

PTG assets were typically highly leveraged debt or equity investments in real estate assets that Lehman intended to hold for its own account while a developer improved or developed the underlying asset.[742] As a general matter, Lehman's strategy

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[739] While Lehman did not file a quarterly report for the third quarter of 2008, it did value its CRE assets and perform price testing for this period. Lehman publicly disclosed its preliminary third quarter results. Lehman, Press Release: Lehman Brothers Announces Preliminary Third Quarter Results and Strategic Restructuring [LBHI_SEC07940_028677].

[740] Wyatt de Silva, E&Y, Memorandum to Files: Lehman Commercial Real Estate FAS 157 Adoption (Jan. 28, 2008), at pp. 2-4 [EY-LE-LBHI-KEYPERS 2025661]; Lehman, Global Real Estate Product Control Real Estate Americas Price Verification Presentation [Draft] (Feb. 2008), at p. 4 [LBEX-WGM 916015]; Lehman, GREG University: START Analysts & Associates Deep Dive Training Presentation (Sept. 2007), at p. 50 [LBHI_SEC_07940_ICP_007982]. In addition, Lehman would sell whole loans to institutional investors.

[741] Lehman, GREG Update (Aug. 7, 2008), at p. 2 [LBHI_SEC_07940_ICP_003590]; *see also* E&Y Workpaper, Lehman Brothers Holdings Inc. 6 Month Period Ending May 31, 2008, Mortgage Capital Team: Principal Transactions P&L Review, at p. 3 [EY-SEC-LBHI-MC-GAMX-08-138373] ("Commercials are primarily composed of conduit and large loans with a principal exit strategy, historically of sale, namely securitization.")

[742] Lehman, Global Real Estate Product Control Real Estate Americas Price Verification Presentation [Draft] (Feb. 2008), at p. 4 [LBEX-WGM 916018] (describing PTG assets as "High Leveraged debt and equity investments in commercial real estate properties").

was to monetize a PTG investment in connection with a sale of the underlying real estate asset after such development or improvement was completed.[743]

Lehman would provide bridge equity, together with debt financing, to a real estate company in connection with its acquisition of particular properties, or to the acquirer of a real estate company through a leveraged buyout.[744] Lehman intended to sell bridge equity positions it originated over the short-term to medium-term to institutional investors.

As of May 31, 2008, GREG valued its global CRE portfolio at $49.3 billion,[745] which consisted of $28.0 billion in the U.S., $12.5 billion in Europe and $8.9 billion in Asia.[746] As of that date, GREG valued its U.S. CRE positions as follows: Commercial —

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[743] Wyatt de Silva, E&Y, Memorandum to Files: Lehman Commercial Real Estate FAS 157 Adoption (Jan. 28, 2008), at p. 5 [EY-LE-LBHI-KEYPERS 2025665] ("Lehman's exit strategy for PTG Investments is through sale of the underlying asset or refinance of the debt/equity positions."); Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 7-8.

[744] Lehman, GREG University: START Analysts & Associates Deep Dive Training Presentation (Sept. 2007), at p. 85 [LBHI_SEC_07940_ICP_007982]; Lehman, GREG Approval Policies and Procedures Manual (May 2008 ed.), at § 1 [LBEX-OTS 000245]. *See* Section I.B.2.c, which discusses Lehman's strategy with respect to bridge equity investments.

[745] These amounts refer to Lehman's balance sheet at risk and do not include the value of certain real estate assets held by entities (such as voting-interest entities and variable-interest entities) in which Lehman made debt and equity investments. LBHI 10-Q (filed July 10, 2008) at p. 26 ("[Lehman] considers itself to have economic exposure only to its direct investments to these entities; the Company does not have economic exposure to the total underlying assets in these entities.") The Examiner did not perform a forensic review of Lehman's accounting records. Lehman reported its valuations according to GAAP asset class (*e.g.*, Real Estate Held for Sale) but managed its business according to business unit. The Examiner used data created by Lehman in the ordinary course in connection with this valuation analysis.

[746] Lehman, Global Real Estate Inventory Spreadsheet as of May 31, 2008 (Aug. 8, 2008) [LBEX-DOCID 2077095]. The Examiner's financial advisor has determined that the amounts in this spreadsheet for Commercial Mortgages ($29.4 billion) and Real Estate Held for Sale ($10.4 billion) GAAP asset classes reconcile with Lehman's financial disclosures in its SEC filing for the second quarter of 2008. LBHI 10-Q (filed July 10, 2008) at p. 71. Although the Examiner has limited the investigation into Lehman's CRE

$15.1 billion; PTG — $8.5 billion; and Bridge Equity — $3.1 billion.[747] For assets that were subject to SFAS 157,[748] substantially all of the Commercial positions were classified as Level 2, while the PTG and Bridge Equity positions were generally classified as Level 3.[749]

As of August 31, 2008, GREG valued its global CRE portfolio at $41.3 billion, which consisted of $23.4 billion in the United States, $10.1 billion in Europe and $7.8 billion in Asia.[750] As of that date, GREG valued its U.S. CRE positions as follows: Commercial — $11.9 billion; PTG — $7.8 billion; and Bridge Equity — $2.8 billion.[751] For assets that were subject to SFAS 157, substantially all of the Commercial positions

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portfolio to the U.S. positions, some portions of the Report will, at times, refer to GREG's global holdings in order to provide context.

[747] Lehman, Global Real Estate Inventory Spreadsheet as of May 31, 2008 (Aug. 8, 2008) [LBEX-DOCID 2077095]. GREG's assets in the U.S. also included $0.8 billion that was classified as "Other." For purposes of analysis and presentation, this Report also reclassifies $0.4 billion of SunCal positions from PTG into the "Other" category.

[748] Real Estate Held for Sale was reported at the lower of its cost basis and fair value, so therefore the valuation analysis is the same for these assets and FAS 157 for the purposes of this Report.

[749] *Id.* GREG reported the following amounts as of May 31, 2008: Level 1 - $57 million; Level 2 - $26.1 billion; Level 3 - $12.8 billion; Real Estate Held for Sale - $10.4 billion.

[750] Lehman, Global Real Estate Inventory Spreadsheet as of Aug. 31, 2008 [LBEX-DOCID 1025119]. Thee Examiner's financial advisor has determined that the combined amount in this spreadsheet for the Commercial Mortgages and Real Estate Held for Sale asset classes ($32.6 billion) reconciles with Lehman's financial disclosures for the third quarter in its September 10, 2008 press release. Lehman, Press Release: Lehman Brothers Announces Preliminary Third Quarter Results and Strategic Restructuring (Sept. 10, 2008) [LBHI_SEC07940_028677]. Similar to the May 31, 2008 amounts, these amounts refer to Lehman's balance sheet at risk and do not include the value of the underlying assets held by entities in which Lehman had an investment interest because Lehman did not have direct economic exposure to such underlying assets.

[751] *Id.* GREG reported the following amounts: Level 1 - $15 million; Level 2 - $20.1 billion; Level 3 - $12.5 billion; and Real Estate Held for Sale - $8.7 billion. GREG's assets in the U.S. included $0.6 billion that was classified as "Other." The Examiner also reclassified $0.4 billion of SunCal positions from PTG into the "Other" category.

were classified as Level 2, while the PTG and Bridge Equity positions were generally classified as Level 3.[752]

(b) Overview of Valuation of CRE Portfolio

(i) GREG Leaders

Mark A. Walsh served as the Head of GREG and reported to the head of Lehman's Fixed Income Division ("FID").[753] Serving under Walsh were Kenneth Cohen, Head of U.S. Originations, and Paul A. Hughson, Head of Credit Distribution.[754] Walsh, Cohen and Hughson served on GREG's Global Credit Committee and were responsible for approving origination of CRE deals in the first instance.[755]

(ii) Participants in the Valuation Process

As with other business units, the applicable GREG business unit was responsible for valuing, or marking, its assets.[756] The values assigned to assets are commonly referred to as "marks," and determining the value of the assets as "marking the

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[752] *Id.*

[753] Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 4. Michael Gelband served as Lehman's Head of FID until May 2007, when he was replaced by Roger Nagioff. Lehman, Press Release Naming Roger B. Nagioff Global Head of Fixed Income (May 2, 2007) [LBEX-DOCID 1470086], attached to e-mail from Monique Wise, Lehman, to Jasjit Bhattal, Lehman, *et al.* (May 1, 2007) [LBEX-DOCID 1605828]. Nagioff himself departed Lehman in January 2008.

[754] Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 4.

[755] Lehman, GREG Approval Policies and Procedures Manual (June 2006), at p. 12 [LBEX-DOCID 624251]. *See* Section III.A.1.b.2.b.viii for information on the approval process for deal origination.

[756] The process for marking by the business desk is discussed in greater detail in the subsections dealing with valuations of each portfolio and the Archstone positions.

book."[757] For the PTG positions, asset managers valued these positions based on their knowledge of the development of the underlying real estate asset.[758] Anthony J. Barsanti, Senior Vice President in PTG, and Aristides Koutouvides, Vice President in PTG, were the two employees primarily responsible for determining the marks for the PTG assets during the period that is the subject of the Examiner's review. Their valuations were subject to review by Kenneth Cohen, Walsh and other members of Lehman's senior management.[759]

Commercial positions were valued by personnel who marked the book based on their understanding of how debt was trading in the applicable market.[760] Their valuations were subject to review by Hughson, who also supervised the marking of the Bridge Equity assets.[761]

A group of product controllers was assigned to conduct price verification for the CRE assets. This price verification, or price testing, process for each GREG business unit is discussed in more detail in the applicable subsection addressing Lehman's valuation of such assets. Jonathan Cohen, Senior Vice President, directly oversaw this

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[757] Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009, at p. 5; Examiner's Interview of Kenneth Cohen, Oct. 20, 2009, at p. 11; Examiner's Interview of Kenneth Cohen, Jan. 21, 2010, at pp. 2, 4; Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 6.
[758] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 11.
[759] *Id.* at pp. 10-11.
[760] Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 10.
[761] *Id.* at p. 10.

process.[762] Abebual Kebede, Vice President, served under Jonathan Cohen, and was responsible for price testing the Bridge Equity positions and supervised the three product controllers who price tested the Commercial Book and the PTG positions.[763] Jennifer Park price tested Commercial Book, Eli Rabin price tested PTG equity positions and Rebecca Platt price tested the PTG debt positions.[764]

As a general matter, the product controllers performed price testing on positions by inputting position-specific information into spreadsheet models that produced an "output" value based on calculations and formulas selected by Lehman as price testing tools.[765] The product controllers then compared the model output value to the business desk value to determine whether the difference between the two, referred to as the variance, exceeded a certain threshold.[766] The product controllers discussed variances with the appropriate business desk person who selected the mark in order to determine

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[762] Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification Presentation [Draft] (Feb. 2008), at p. 3 [LBEX-WGM 916015].

[763] *Id.*; Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009, at p. 5 (Kebede told the Examiner that his job was "to make sure the marks made sense.")

[764] Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification Presentation [Draft] (Feb. 2008), at p. 3 [LBEX-WGM 916015].

[765] *Id.* at pp. 6-10; Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009, at p. 5.

[766] Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification Presentation [Draft] (Feb. 2008), at pp. 6-10 [LBEX-WGM 916015]; Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009, at p. 6.

whether the business desk or valuation control value should be accepted for each position.[767]

When disagreement persisted as to the variance, Product Control elevated the issue to Kebede, and if Kebede was not satisfied with the business desk's basis for the marks, he would bring the dispute to Jonathan Cohen's attention.[768] Cohen could further elevate the dispute up through the Product Control chain of command, to Clement Bernard, the CFO for FID,[769] to Gerard Reilly, the Global Product Controller[770] and ultimately to Lehman's CFO.[771] The interaction between the GREG business desks and Product Control is discussed in the following subsection.

(c) Changes in the CRE Portfolio from 2006 through 2008

In order to understand the difficulties Lehman encountered in valuing its CRE positions in the second and third quarters of 2008, it is necessary to first briefly review the material changes in the GREG portfolio and the real estate markets beginning in

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[767] Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification Presentation [Draft] (Feb. 2008), at p. 21 [LBEX-WGM 916015]; Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009, at p. 3.

[768] Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009, at pp. 6-8 (noting that prior to 2008, the valuation control team, along with senior GREG employees, including Barsanti and Jonathan Cohen, determined the final marks for CRE assets).

[769] Lehman, Capital Markets and IBD Finance – Offsite Presentation on Valuation and Control Group (Jan. 16, 2008), at p. 12 [LBEX-WGM 756817].

[770] Examiner's Interview of Kenneth Cohen, Oct. 20, 2009, at p. 10. Gerard Reilly passed away in a skiing accident on December 29, 2008; Christopher M. O'Meara, Lehman's former CFO, described Reilly as the person ultimately responsible for valuations of Level 2 and Level 3 assets. Examiner's Interview of Christopher M. O'Meara, Aug. 14, 2009, at p. 26.

[771] Examiner's Interview of Christopher M. O'Meara, Aug. 14, 2009, at p. 26 (stating that the product controllers who took responsibility for valuation were under his direction as CFO); Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009 at p. 6.

2006. In 2006, Lehman decided to commit more of its balance sheet to historically profitable businesses and to put more of Lehman's capital at risk in order to remain competitive with other investment banks.[772] That strategy included substantially increasing its CRE investments.[773] Lehman executed upon this strategy, reporting that the aggregate value of its global CRE assets was $55.2 billion as of the end of its 2007 fiscal year, increasing from $28.9 billion as of the end of its 2006 fiscal year.[774]

Over July and August 2007 Lehman personnel recognized that the market for placing investments backed by commercial real estate was "virtually closed"[775] and the leveraged loans market had shut down.[776] In light of these events, Lehman decided to stop originating new loans in the leveraged loan and commercial real estate businesses until the end of the third quarter of 2007.[777] However, Lehman had already committed to finance several large CRE deals that closed in October and November of 2007, including Archstone.

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[772] Examiner's Interview of Kenneth Cohen, Oct. 20, 2009, at p. 7.

[773] *Id.*; e-mail from Paul A. Hughson, Lehman, to Kentaro Umezaki, Lehman, *et al.* (May 9, 2006) [LBEX-DOCID 1776281] (requesting a meeting with Umezaki to discuss "Global Real Estate Risk Appetite-and how the new limits coincide with our plan to expand our business in Asia, Europe and our bridge equity globally").

[774] Lehman, Presentation to Moody's Investors Service, Commercial Real Estate (Feb. 13, 2008), at p. 5 [LBHI_SEC_07940_ICP_008206].

[775] E-mail from William J. Hughes, Lehman, to Alex Kirk, Lehman, *et al.* (July 27, 2007) [LBEX-DOCID 174304].

[776] E-mail from Alex Kirk, Lehman, to Roger Nagioff, Lehman (Aug. 6, 2007) [LBEX-DOCID 173492]; Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 9.

[777] Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 9.

As 2007 progressed, Lehman increased its focus on the size of its balance sheet and its leverage.[778] On November 3, 2007, Walsh e-mailed Roger Nagioff, Lehman's Global Head of Fixed Income, regarding his plans to reduce the balance sheet at a steady rate, with a target of a $45 billion GREG balance sheet on a global basis.[779] GREG's November 6, 2007 presentation to the Executive Committee stated that "under any circumstance an estimated $15 billion reduction in global balance sheet is warranted," and recommended reducing the global GREG balance sheet to $43.7 billion by March 31, 2008.[780]

Despite this emphasis on deleveraging and the stated plan to reduce the GREG balance sheet by $15 billion, GREG's balance sheet of $55.0 billion at the end of February 2008 was only $200 million less than the GREG balance sheet at the end of November 2007.[781] In the first quarter of 2008, Lehman's plan to reduce its balance

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[778] *See* Section III.A.4.f on Repo 105/108. With respect to reducing the size of the GREG balance sheet, Hughson told the Examiner that he and Walsh recognized the need for such reduction in May 2007. Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at pp. 4-5; *see also* e-mail from Paul A. Hughson, Lehman, to Thomas Pearson, Lehman, *et al.* (May 23, 2006) [LBEX-DOCID 1776282]. Walsh pointed to the fall of 2007 as when he knew balance sheet reduction was a necessary step. Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 10. In September 2007, Kentaro Umezaki, Head of Fixed Income Strategy, told Hughson that a flat growth policy was being considered for GREG. *See* e-mail from Kentaro Umezaki, Lehman, to Paul A. Hughson, Lehman, *et al*. (Sept. 24, 2007) [LBEX-DOCID 1809381].

[779] Walsh broke down the target GREG balance sheet as follows: $25 billion in the United States, $10 billion in Europe and $10 billion in Asia. E-mail from Mark A. Walsh, Lehman, to Roger Nagioff, Lehman (Nov. 3, 2007) [LBEX-DOCID 175741].

[780] Lehman, GREG Global Real Estate Update Presentation (Nov. 6, 2007), at p. 1 [LBEX-DOCID 2072935]; e-mail from Abebual A. Kebede, Lehman, to Jonathan Cohen, Lehman, *et al.* (Nov. 4, 2007) [LBEX-DOCID 523669].

[781] Lehman, GREG Update (June 5, 2008), at p. 1 [LBEX-DOCID 1417258].

sheet resulted in the sale of less than $400 million of CRE assets.[782] According to former Lehman CFO Erin Callan, Lehman did not set balance sheet reduction targets for businesses until after Bear Stearns's near collapse in March 2008.[783]

During the second quarter of 2008, Lehman publicly disclosed that it sold approximately $8 billion of CRE positions.[784] Despite the second quarter sales, many of the largest CRE positions originated in 2007 were not sold or securitized, such that many of these transactions remained among the 10 largest exposures on GREG's balance sheet as of May 31, 2008.[785] Lehman reported that its global CRE positions as of

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[782] Lehman, GREG Second Quarter 2008 Sales Spreadsheet (May 29, 2008) [LBEX-DOCID 4352112]. The spreadsheet shows the GREG positions that were sold since November 30, 2007. According to the spreadsheet, during the first quarter of 2008, 13 positions were sold in the United States for $350.5 million, no positions were sold in Europe and one position was sold in Asia for $33.1 million.

[783] Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at pp. 11-12.

[784] Transcript of Lehman Brothers Holdings Inc. Second Quarter 2008 Earnings Call (June 16, 2008), at p. 12. Lehman also reported to its Audit Committee that it sold approximately $8 billion of CRE positions during the second quarter of 2008. Lehman, Presentation to the Audit Committee: Valuation Review - 2nd Quarter 2008 (July 2008), at pp. 21-23 [LBHI_SEC07940_2969525]. However, for purposes of benchmarking its sales during the quarter to the valuation of its remaining CRE positions, Lehman told E&Y that it sold $5.2 billion of CRE assets during the second quarter of 2008. E&Y Workpaper, Global Real Estate Q208 Sales Activity, Q2.J1 - GREG Sales 2nd Qtr 08 Lead.xls, at p. 30 [EY-SEC-LBHI-MC-GAMX-08-138412]. The Examiner's financial advisor has observed that the difference in these numbers reflects a different methodology for calculating "sales" for the purposes of benchmarking the remaining positions, and the lower number reflects the exclusion of approximately $1 billion of sales in Europe that were seller-financed without recourse, over $600 million of loan payments that were characterized as sales to the Audit Committee and over $250 million from the sale of two U.S. PTG positions that were deemed outside the scope of the benchmarking analysis due to the unique nature of the investments. There were $3.8 billion of Commercial sales in the United States during the second quarter of 2008 that Lehman deemed to be relevant for purposes of benchmarking to the valuation of its remaining positions; there were no such sales for PTG or Bridge Equity positions. *See* Lehman, GREG Second Quarter 2008 Sales Spreadsheet (May 29, 2008) [LBEX-DOCID 1139324]; Lehman, GREG Second Quarter and Third Quarter 2008 Sales Spreadsheet (Aug. 19, 2008) [LBEX-DOCID 4323975].

[785] Ronald S. Marcus, Office of Thrift Supervision, Report of Examination (July 7, 2008), at p. 6 [LBEX-OTS000004].

that date had a value of approximately $50 billion.[786] After accounting for total net write-downs, the Commercial Book was valued at $15.1 billion, the PTG positions at $8.5 billion and the Bridge Equity positions at $3.1 billion.[787]

(d) "Perfect Storm" Impact on CRE Valuation in 2008

The economic crisis in the 2007 and 2008 was referred to as a "perfect storm" in several Lehman presentations.[788] As the declining market persisted in the fourth quarter of 2007, Lehman considered taking write-downs on its CRE positions. On October 28, 2007, Walsh e-mailed Nagioff to let him know that "the last few days in the market have been ugly and cmbs is down big."[789] As a result, Walsh reported GREG "will be passing thru a significant write down on monday," and anticipated more write-downs to come.[790]

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[786] LBHI 10-Q (filed July 10, 2008), at p. 70. The amount of CRE often depends on the definition used by Lehman. Lehman's 10-Q for the second quarter of 2008 listed its CRE holdings at $40 billion, but that amount excluded certain real-estate related corporate debt or corporate equity positions. The $50 billion total includes those positions, which were determined by the Examiner's financial advisor pursuant to a review of Lehman's product control share drive. Unless noted otherwise, these figures represent Lehman's numbers as balance sheet at risk. Balance sheet at risk is the portion of an asset, adjusted to market value (which takes into account the write-downs), that Lehman considered as representative of its economic exposure. The balance sheet at risk is the best indicator for these purposes because it looks at Lehman's true exposure to an asset as it does not include any third party portion that is consolidated for accounting purposes.

[787] Lehman, Global Real Estate Inventory Spreadsheet as of May 31, 2008 (Aug. 8, 2008) [LBEX-DOCID 2077095]. GREG's assets in the U.S. also included $0.8 billion that was classified as "Other." The Examiner also reclassified $0.4 billion of SunCal positions from PTG into the "Other" category.

[788] *See* Lehman, GREG 2009 Strategy – Executive Update Draft Presentation (June 20, 2008), at p. 1 [LBHI_SEC07940_124425]; Lehman, Global Commercial Real Estate Presentation (Aug. 6, 2008), at p. 4 [LBHI_SEC07940_302586].

[789] E-mail from Mark A. Walsh, Lehman, to Roger Nagioff, Lehman, *et al.* (Oct. 27, 2008) [LBEX-DOCID 175724].

[790] *Id.* Also, on November 6, 2007, GREG produced for internal circulation a Global Real Estate Update stating that Lehman's global CRE assets were "maintaining strong profitability based on its conservative

Over the course of 2008, Lehman wrote down its CRE positions by more than $3 billion:

Net Write-downs by Business Unit[791]

	Q1	Q2	Q3	Total
PTG	271	302	504	1,077
Bridge Equity	72	349	265	686
Commercial	293	195	306	794
SunCal[792]	156	178	212	546
Total	792	1,025	1,286	3,103

The January 2008 GREG Product Control report on Global Real Estate Markdowns provides a useful summary of the market conditions at the time and their

policies and the cushion of imbedded profitability." Lehman, GREG Global Real Estate Update Presentation (Nov. 6, 2007), at p. 1 [LBEX-DOCID 2072935]. The update continued: "Notwithstanding strong real estate fundamentals, transactions have slowed to a trickle due to uncertainty around financing, valuation (stalemate), and weakening of economic forecasts." *Id.* The update stated that Lehman would make net write-downs of its U.S. CRE assets in the amount of $825 million for fiscal year 2007. *Id.*

[791] Lehman, Global Real Estate 2008 Net Mark Downs (Sept. 5, 2008) [LBEX-AM 346991].

[792] SunCal consisted of approximately 25 positions in California real estate that straddled both the PTG and Commercial portfolios. The Examiner's financial advisor has observed that the files containing the write-downs reported one number for SunCal and did not allocate it between PTG and Commercial. Therefore, the Examiner has presented SunCal separately and did not attempt to allocate the total SunCal write-down into its PTG and Commercial components. Further, given that SunCal was comprised of as many as 25 properties (depending on the date), the Examiner determined that it was not a prudent use of resources to investigate the valuation of each SunCal position.

impact on the value of the CRE portfolio.[793] This report's executive summary stated in full as follows:

- The capital markets meltdown continued into the first quarter. CMBS spreads have widened to all-time highs and investors have been staying on the sidelines.
- CMBS delinquencies are still at historic lows, but real estate is usually a lagging indicator.
- Many of our bank loans and PTG positions are directly related to the residential housing sector, which is extremely troubled.
- In general, the collateral performance of our whole loan positions has not been an issue, but the spread widening at all the debt tranches have led to lower values.
- The inability to hedge our floating rate book and the mezz classes of our fixed rate loans has continued to result in losses.
- The mark downs effected in January are the best estimates by the business and product control at this time.
- As part of its ongoing methodology, the Global Real Estate Group (GREG) performed a valuation review of their entire portfolio. The review took into consideration the continuing widening of credit spreads, continued sluggishness in the residential market, and lack of liquidity in the market place.
- The Real Estate Product Control group has reviewed the mark adjustments and agrees with these adjustments.
- The review resulted in a total mark-down of $665 mn (approx. $505mn in the US, and $160 mn in Europe.

For CMBS positions and loans originated with the intention that they would be transformed into CMBS, the January 2008 report further stated that "[w]rite-downs

[793] Lehman, Global Real Estate Product Control, Global Real Estate Markdowns Presentation (Jan. 2008), at pp. 1-2 [LBEX-WGM 771226].

were triggered by spread widening and lack of liquidity."[794] For both floating-rate and fixed-rate loans, the "[o]riginal exit plan was through syndication to institutional investors" and the "[s]yndication market is suffering from lack of liquidity" in part due to market-wide inability to create liquidity through securitization of loans for sale as CMBS positions.[795] The value of PTG investments, which were primarily "related to land or condominium development/conversion," were affected by "the softness of the residential market thereby extending the absorption period and reducing sales prices."[796] With respect to Bridge Equity, the report explains that the "[w]idening of credit spreads eats into the equity yield, making syndication at par difficult."[797]

In February 2008, the Product Control Group observed that the "[f]loating rate securitization market is inactive; no deal in the market since Dec-07."[798] As a result,

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[794] *Id.* at p. 4. The "spread" data referenced in this January 2008 report is CMBS spread data contained in publications such as Commercial Mortgage Alert. As with spreads produced for other types of assets, the CMBS spreads typically show the difference between the CMBS yield (or return on a CMBS investment divided by each month of ownership) and the yield of some benchmark asset (which is typically U.S. treasuries) assuming the same maturity date for each. Spreads are an indicator of an asset's risk, as they show the premium (or discount) an investor requires above and beyond the "risk free" benchmark asset. To form CMBS bonds, commercial loans are pooled and carved up into different risk baskets, or "tranches." The CMBS spread tracks the yield difference for investments in each tranche. The lower end of the CMBS spread range features tranches containing the pooled loans with the highest risk (*i.e.*, subprime loans) and the higher end of the spread range features tranches with the best credit risk or lowest risk (*i.e.*, conventional loans to borrowers with good credit). A wider credit spread indicates that the lower-rated portions of the pooled loans will result in lower yields, and as a result, the marketplace imposes a higher discount to the lower-rated tranche in any attempted sale. In other words, a wide credit spread indicates that investors will either demand a higher rate of return or a reduction in purchase price.

[795] *Id.* at pp. 6-8.

[796] *Id.* at p. 9.

[797] *Id.* at p. 5.

[798] Lehman, Valuation & Control Report – Fixed Income Division (Feb. 2008), at p. 27 [LBEX-WGM 002238]; Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009; Frank S. Aldridge, E&Y Walkthrough

Lehman's ability to verify the prices for floating rate loans had become "extremely challenging."[799] As the market for new issuances of CMBS deteriorated and then eventually shut down (a trend documented in contemporaneous industry publications),[800] Lehman lost the ability to execute its traditional exit strategy for a substantial part of its Commercial Book. Furthermore, Lehman recognized that the lack of securitizations made price testing particularly difficult.[801]

Template for Conduit, Large Loan, and CMBX Price Verification Process (Nov. 30, 2008), at p. 9 [EY-LE-LBHI-MC-GAMX-08-063735] (citing to E&Y Workpaper B32.4); E&Y Workpaper, B32.4 First Quarter Management Valuation & Control Report No. 137 (Nov. 30, 2008) [EY-LE-LBHI-MC-GAMX-08-063053] (containing Lehman's Feb. 2008 Pricing Report with E&Y's note that it "deems management review of pricing reasonable").

[799] Lehman, Valuation & Control Report – Fixed Income Division (Feb. 2008), at p. 27 [LBEX-WGM 002260].

[800] Prudential Real Estate Investors, U.S. Quarterly, Oct. 2007, at p. 1, *available at* http://www.irei.com/web/do/pub/research/view ("The credit market troubles that began with the collapse of the subprime mortgage market in February caught up with commercial real estate in the third quarter, upsetting the debt markets and slowing transaction activity.") The quarterly issuance of U.S. CMBS fell from approximate aggregate amounts of $75.83 billion in second quarter 2007, to $59.94 billion in third quarter 2007, $33.27 billion in fourth quarter 2007, $5.90 billion in first quarter 2008, $6.24 billion in second quarter 2008, and finally to zero throughout the remainder of the 2008 fiscal year. *See* Commercial Mortgage Alert, Summary of CMBS Issuance, Sept. 30, 2009, *available at* http://www.cmalert.com/ranks.php; Commercial Mortgage Alert, Summary of CMBS Issuance, June 30, 2009, *available at* http://www.cmalert.com/ranks.php; Commercial Mortgage Alert, Summary of CMBS Issuance, Mar. 31, 2009, *available at* http://www.cmalert.com/ranks.php; Commercial Mortgage Alert, Summary of CMBS and Real Estate CDO Issuance, Dec. 31, 2008, *available at* http://www.cmalert.com/ranks.php.

[801] The February 2008 Valuation & Control Report also states, with respect to the Commercial Book, that "[s]preads published in third party publications are stale." Lehman, Valuation & Control Report – Fixed Income Division (Feb. 2008), at p. 27 [LBEX-WGM 002260]. This meant that the reported spreads did not reflect the rapid deterioration in the market and were of questionable value for calculating the discount rate used to value Commercial positions. CMBS yields obtained directly from Bloomberg.com show that CMBS AAA Junior yields increased from 6.8% on November 30, 2007 to 9.6% on February 29, 2008. Over the same period, CMBS AAA Mezz yields increased from 6.3% to 8.0%, CMBS AA yields increased from 7.2% to 10.6%, CMBS A yields increased from 8.3% to 12.6% and CMBS BBB yields increased from 11.1% to 17.1%. The movement in yields during the fourth quarter 2007 and first quarter 2008 caused Lehman to be concerned that the lag time for reporting market data in third-party publications would undermine Lehman's ability to price test the marks. Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009, at pp. 2-3, 7-8. The lack of sales data in the marketplace also made it difficult for Lehman to determine the fair market value of its CRE assets. *Id.* To compensate for the lack of such data, the February 2008 Valuation

Lehman noted the effects of the perfect storm on its CRE business in a presentation to the Board of Directors on August 6, 2008 (appearing in earlier iterations throughout the summer),[802] which detailed an "[u]nprecedented [credit] spread widening across the capital structure [that] [d]ramatically reduced CMBS volumes since securitization markets are shut," causing a "[d]ichotomy between *Equity* buyers focused on fundamentals and *Credit* buyers impacted by spread contagion."[803] The spread widening caused Lehman to "hold [CRE] positions originally originated for securitization/syndication," meaning that assets that had been liquid were now illiquid.[804]

(2) Outside Review of Lehman's CRE Valuation Process

In reviewing the reasonableness of Lehman's valuation of its CRE portfolio, the Examiner has taken into consideration the separate reviews of Lehman's valuation process that were undertaken by the SEC and Ernst & Young in 2008.

& Control Report stated that "[p]roduct control is having continuous discussions with Front Office going through deals in more detail and trying to obtain market color using recent syndications, bids, offers and any other market information." Lehman, Valuation & Control Report – Fixed Income Division (Feb. 2008), at p. 27 [LBEX-WGM 002260].

[802] Lehman, GREG 2009 Strategy – Executive Update Draft Presentation [Draft] (June 20, 2008), at p. 1 [LBHI_SEC07940_124424]

[803] Lehman, Global Commercial Real Estate Presentation (Aug. 6, 2008), at p. 4 [LBHI_SEC07940_302580] (emphasis in original). CMBS AAA Junior spreads widened from 4.15% on May 30, 2008, to 6.95% on August 29, 2008. Over the same period, CMBS AAA Mezz spreads widened from 2.95% to 4.60%, CMBS AA spreads widened from 5.65% to 9.20%, CMBS A spreads widened from 7.15% to 13.70% and CMBS BBB spreads widened from 14.65% to 21.70%. The Examiner's financial advisor compiled this data from Bloomberg.

[804] Lehman, Global Commercial Real Estate Presentation (Aug. 6, 2008), at p. 4 [LBHI_SEC07940_302580].

(a) SEC

In February 2008 the SEC commenced a special project to review the CSE's price verification processes for their CRE portfolios.[805] Lehman cooperated with this process, as did the four other CSE firms.[806] The SEC did not produce a formal report for this project and declined to provide the Examiner any formal conclusions produced in connection with this project.[807] However, the SEC provided the Examiner with its informal analysis and comments during an interview.[808]

The SEC's inspection included a review of the materials Lehman used in its price verification process, and was initially focused on the marks reported as of January 31, 2008, and then as of February 29, 2008.[809] The SEC began meeting with Lehman in

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[805] Memorandum from Raymond Doherty, SEC, *et al.*, to Erik Sirri, SEC, *et al.*, re: Scope Memorandum for the Consolidated Supervised Entity ("CSE") Commercial Real Estate ("CRE") Price Verification Inspections (Feb. 27, 2008), at p. 1 [LBEX-WGM 001752]. An e-mail widely circulated within Lehman stated that "[t]he intent of the inspections program . . . is for the SEC to conduct meaningful and focused inspections of the five CSE firms." E-mail from Laura Vecchio, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Jan. 22, 2008) [LBHI_SEC07940_068584]. The SEC's letter to Lehman describing the scope of the review stated that it would:

> [F]ocus on (1) gaining a general understanding of the CRE products held in inventory by [Lehman], including the related hedging strategies, (2) reviewing the price verification policies and procedures to determine if appropriate valuation controls have been designed, and (3) testing the price verification process to ensure that the controls are operating as intended. Ultimately, the staff will compare and contrast the various CRE-related price verification policies and procedures across the five CSEs.

Memorandum from Raymond Doherty, SEC, *et al.*, to Erik Sirri, SEC, *et al.*, re: Scope Memorandum for the Consolidated Supervised Entity ("CSE") Commercial Real Estate ("CRE") Price Verification Inspections (Feb. 27, 2008), at p. 1 [LBEX-WGM 001752]

[806] Examiner's Interview of SEC staff, Aug. 24, 2009, at pp. 3-4, 13-14.

[807] *Id.* at p. 14 (noting that the SEC never released its findings formally). The SEC expressed its concerns informally throughout its inspection but no formal presentation was made .

[808] *Id.* at passim.

[809] *Id.*; Letter from Raymond Doherty, SEC, to Laura Vecchio, Lehman, re: Commercial Real Estate Price Verification Inspection – Initial Document Request (Feb. 27, 2008), at p. 1 [LBEX-WGM 001754]; e-mail from Thomas O'Dougherty, SEC, to Abebual A. Kebede, Lehman, *et al.* (Apr. 11, 2008)

February 2008 and continued these meetings throughout the spring and summer.[810] During the first meetings, the SEC conducted a general review of the CRE business, and the related audit and product control functions.[811] Lehman addressed various topics, including an overview of the CMBS business,[812] an overview of the real estate risk review process,[813] real estate product control process,[814] and the fixed income product control process. As the inspection continued, the SEC focused on Lehman's price verification procedures,[815] price verification models[816] and the valuation of particular positions.[817]

[LBHI_SEC07940_2229003]. The SEC held a series of meetings to review information and ask questions, and the SEC typically requested materials in advance of and subsequent to a meeting. Letter from Raymond Doherty, SEC, to Laura Vecchio, Lehman, re: Commercial Real Estate Price Verification Inspection – Initial Document Request (Feb. 27, 2008), at pp. 1-2 [LBEX-WGM 001754] (indicating SEC's intent to schedule meetings for an internal audit workpaper review, to walk through the price verification package and to walk through the Quest-GFS reconciliation); e-mail from Laura M. Vecchio, Lehman, to Abebual A. Kebede, Lehman, *et al.* (Feb. 29, 2008) [LBHI_SEC07940_5494331].

[810] In 2008, the SEC met with Lehman on February 7-8, March 5, March 31, May 21-22, June 20, July 3 and July 16.

[811] Lehman, Feb. 8, 2008 Meeting Agenda for SEC-CSE Inspections of Commercial Mortgage Valuations (Jan. 29, 2008) [LBHI_SEC07940_113571], attached to e-mail from Laura Vecchio, Lehman, to Kenneth Cohen, Lehman, *et al.* (Jan. 29, 2008) [LBHI_SEC07940_113570].

[812] Lehman, An Overview of the CMBS Business Presentation to the SEC (Feb. 8, 2008), at pp. 1-22 [LBEX-WGM 000574-95].

[813] Lehman, Holistic Trading Book Migration Presentation to the SEC (Feb. 7, 2008), at pp. 1-32 [LBEX-DOCID 3176398] (addressing risk allowance and model assumptions), attached to e-mail from Laura M. Vecchio, Lehman, to Erin Callan, Lehman, *et al.* (Feb. 8, 2008) [LBEX-DOCID 3186259].

[814] Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification Presentation [Draft] (Feb. 2008), at pp. 1-23 [LBEX-WGM 916015-37].

[815] Letter from Raymond Doherty, SEC, to Laura Vecchio, Lehman, re: Commercial Real Estate Price Verification Inspection – Initial Document Request (Feb. 27, 2008), at p. 1 [LBEX-WGM 001754]; e-mail from Laura M. Vecchio, Lehman, to Jonathan S. Cohen, Lehman, *et al.* (Feb. 13, 2008) [LBHI_SEC07940_972136] (noting that SEC has made its first follow-up request, asking for GREG price verification policies and procedures).

[816] E-mail from P.C. Venkatesh, SEC, to Michele Bourdeau, Lehman, *et al.* (Mar. 19, 2008) [LBEX-DOCID 271655]; Letter from Raymond Doherty, SEC, to Laura Vecchio, Lehman, re: Commercial Real Estate

The SEC asked Lehman to provide detailed information regarding the price verification process, including data relating to Lehman's use of a third-party, TriMont Real Estate Advisors ("TriMont"), the third-party servicer for PTG positions.[818] The SEC sought this information in order to sample CRE positions from all portions of Lehman's CRE book.[819] In particular, during May and June 2008 the SEC sought supporting documentation confirming the status of $5 billion in sales of CRE positions.[820] In late

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Price Verification Inspection – Initial Document Request (Feb. 27, 2008), at p. 1 [LBEX-WGM 001754]. Based upon the model inventory Lehman provided it, the SEC selected a sample of models designed to get "a broad cross-section---'core' models/frameworks likely to be heavily used; models likely to have some complexity, potential sensitivity to modeling assumptions, and so on."

[817] E-mail from Laura M. Vecchio, Lehman, to Raymond Doherty, SEC, *et al.* (Feb. 21, 2008) [LBHI_SEC07940_977936] (forwarding detailed inventory listing as of January 31, 2008 for CMBS, PTG, and related derivatives).

[818] E-mail from Thomas O'Dougherty, SEC, to Abebual A. Kebede, Lehman, *et al.* (Mar. 31, 2008) [LBHI_SEC07940_2872557]. The SEC requested a list of second quarter "sales and circles" from which it would select a sample for which Lehman would be asked to supply supporting documentation. E-mail from Thomas O'Dougherty, SEC, to Abebual A. Kebede, Lehman, *et al.* (May 27, 2008) [LBHI_SEC07940_2906636] (requesting additional documentation based on a spreadsheet of post first quarter sales and circles that Laura [Vecchio] provided to the SEC in the middle of April); e-mail from Thomas O'Dougherty, SEC, to Abebual A. Kebede, Lehman, *et al.* (June 18, 2008) [LBHI_SEC07940_2949734-35] (same). Lehman provided the SEC with a document summarizing its second quarter 2008 total sell-downs as proof that Lehman had minimal losses on sales and supporting the fact that Lehman sold assets at prices that equaled Lehman's marks. Lehman, Total Selldown Summary for Q2'08 (June 18, 2008) [LBHI_SEC07940_1141406], attached to e-mail from Jeffrey Goodman, Lehman, to Paul A. Hughson, Lehman, *et al.* (June 18, 2008) [LBHI_SEC07940_1141405]. In a June 18, 2008 e-mail forwarding the sell-down summary to the SEC, Jeffrey Goodman, Senior Risk Manager of Fixed Income Risk Management, stated that "[w]e would say that everything we sold was at the marks hence no gain/loss." E-mail from Jeffrey Goodman, Lehman, to Paul A. Hughson, Lehman, *et al.* (June 18, 2008) [LBHI_SEC07940_1141405]. The SEC apparently discussed the supporting documentation, which included securities trade confirmations, commitment documentation, and bids for select second quarter sales, at a June 20, 2008 meeting with Kebede. E-mail from Thomas O'Dougherty, SEC, to Abebual A. Kebede, Lehman, *et al.* (June 16, 2008) [LBHI_SEC07940_2946054]; e-mail from Thomas O'Dougherty, SEC, to Abebual A. Kebede, Lehman, *et al.* (May 27, 2008) [LBHI_SEC07940_2946054].

[819] E-mail from Thomas O'Dougherty, SEC, to Abebual A. Kebede, Lehman, *et al.* (May 14, 2008) [LBHI_SEC07940_2889284].

[820] *Id.*

June, the SEC requested the Archstone price flex agreement, materials related to certain February 2008 marks, and further support for second quarter sales.[821]

The SEC's requests for material in July included questions about Lehman's Internal Rate of Return ("IRR") models and information on credit spreads.[822] Follow-up e-mails continued until early August.[823] The SEC was unable to complete its inspection of Lehman's price valuation controls before LBHI's bankruptcy filing. The SEC did not provide Lehman with any formal feedback from the project or issue any formal conclusions related to Lehman.[824]

The SEC did, however, identify strengths and weaknesses in Lehman's price verification procedures from time to time during the inspection. The SEC believed that Lehman's price verification weaknesses were more pronounced than the other CSEs because of the size of Lehman's balance sheet and the nature of its CRE business.[825] Specifically, the SEC recognized that Lehman's product control staff was too small to be

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[821] E-mail from Abebual A. Kebede, Lehman, to Thomas O'Dougherty, SEC, *et al.* (June 20, 2008) [LBHI_SEC07940_7545309].

[822] E-mail from Thomas O'Dougherty, SEC, to Abebual A. Kebede, Lehman, *et al.* (July 7, 2008) [LBEX-DOCID 697796] ("I received the IRR calculations and the SunCal May 31st marks from Laura [Vecchio] on Thursday [July 3, 2008]."); e-mail from Laura M. Vecchio, Lehman, to Thomas O'Dougherty, SEC, *et al.* (July 21, 2008) [LBEX-WGM 011921] (providing a response to SEC's question regarding LehmanLive spreads).

[823] E-mail from Laura M. Vecchio, Lehman, to Thomas O'Dougherty, SEC, *et al.* (Aug. 1, 2008) [LBEX-WGM 011934].

[824] Examiner's Interview of SEC staff, Aug. 24, 2009, at p. 14 (noting that the SEC was unable to complete CSE inspection of Lehman's price valuation controls or give Lehman formal feedback before Lehman collapsed).

[825] *Id.* at pp. 13-14.

an effective independent check on the business desks' valuations given the size and number of assets in the CRE portfolio.[826]

(b) Ernst & Young

Although E&Y audited Lehman's valuation of the CRE portfolio as part of the 2007 audit,[827] E&Y's annual 2008 audit of Lehman's valuation of the CRE portfolio was only in its beginning stages when LBHI filed for bankruptcy.[828] While E&Y had performed quarterly reviews throughout 2008, these reviews consisted of "inquiry, observation, and analytical review" and did not include substantive testing as to the accuracy or reasonableness of Lehman's marks.[829] When LBHI filed for bankruptcy,

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[826] *Id.*

[827] E&Y's 2007 year-end audit included a comprehensive memo on CRE price testing, a memorandum specifically about PTG positions, a spreadsheet analyzing particular variances between the marks by the business desk and valuation control, and a review of 25 of TriMont's collateral valuations. *See* Wyatt de Silva, E&Y, Memorandum to Files: Commercial Real Estate Testing Approach (Jan. 25, 2008) [EY-LE-LBHI-MC-GAMX-07 067631] (comprehensive memo); Memorandum from Nicholas McClay, E&Y, to Files, re: U.S. PTG Analytics (Feb. 7, 2008) [EY-LE-LBHI-MC-GAMX-07 070778] (memorandum about PTG positions); E&Y, PTG Year End Substantive Analysis: Product Control Price Verification Variances (Nov. 11, 2007) [EY-LE-LBHI-MC-GAMX-07 074517-74) (spreadsheet analyzing variances); Memorandum from Robert Martinek, E&Y, to E&Y Audit Team for Lehman Brothers, *et al.*, re: Lehman Brothers Commercial Real Estate Portfolio (Dec. 17, 2006) [EY-LE-LBHI-KEYPERS 0 675302] (review of 25 Tri-Mont valuations).

[828] Examiner's Interview of Ernst & Young, Nov. 11, 2009, at pp. 4, 13-14. The audit process was: (1) a staff person or senior manager conducts detailed audit work; (2) the results from the audit work are reviewed by an audit team, which formulates an initial opinion and (3) the audit work is reviewed an additional two to four times (the exact number of reviews depends on the risk of the area being tested). Generally, for audit testing of the CRE portfolio, E&Y would design testing, pick two months of product control work papers to review and confirm that product control was performing the work as described in the walkthrough. E&Y would also designate two months to re-test select positions. *Id.*

[829] *Id.* at pp. 3-4. E&Y's 2008 quarterly reviews of product control and the valuation of Lehman's CRE portfolio focused on whether the process, as a whole, was functioning. *Id.* at p. 4. E&Y reviewed price testing files, examined variances between business desk prices and product control's prices, and confirmed that variances deemed to be significant were resolved in accordance with Lehman's internal procedures. *Id.* E&Y did not resolve these variances, but merely assured itself that discussions regarding

some underlying testing of the CRE portfolio had begun, but no review of that work had been performed and no initial opinions had been reached.[830] Regarding CRE specifically, E&Y had not yet selected all of the positions it planned to test.[831]

E&Y performed "walkthrough" analyses as part of the annual audit process to understand how Lehman's Product Control Group performed its independent price verification functions.[832] The purpose of the walkthroughs was to document the "significant classes of transactions," and "[v]erify that [E&Y had] identified the appropriate 'what could go wrongs' ('WCGWs') that have the potential to materially affect relevant financial statement assertions."[833] In addition, E&Y identified "the design and implementation of controls" that Lehman had in place to internally regulate its price verification process.[834]

An E&Y's Walkthrough Template memorandum reviewing the price verification process for large loans and CMBS stated that all components of the U.S. CRE portfolio met E&Y's criteria based on price verification data selected from the month of February

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significant variances were occurring and that product control was ultimately comfortable with the final mark. *Id.*

[830] Examiner's Interview of Ernst & Young, Nov. 11, 2009, at pp. 13-14.

[831] *Id.*

[832] *Id.* at p. 3.

[833] E&Y, Walkthrough Template (Nov. 30, 2008), at pp. 2, 13 [EY-LE-LBHI-MC-GAMX-08-063735]. The "Walkthrough Template" memoranda contain three sections: the walkthrough description of the valuation control process, an assessment of whether valuation control is segregated from other incompatible duties, such as management, and a conclusion.

[834] *Id.*

2008.[835] Other documents produced by E&Y personnel over the course of 2008 indicate that E&Y did not find any material flaws with Lehman's price verification process.[836] E&Y personnel told the Examiner that the conclusions stated in these documents were preliminary in nature and the product of work performed by lower-level auditors, and therefore were not reflective of the opinion of E&Y.[837]

Given the prominence of Archstone and SunCal positions in 2008, E&Y had already determined that it would be substantively testing both positions as part of its 2008 year-end audit. E&Y separately documented its walkthroughs of these positions as part of its preliminary planning for the 2008 year-end audit testing.[838]

An E&Y memorandum dated July 9, 2008 explained E&Y's quarterly review valuation procedures for Archstone in the second quarter 2008.[839] E&Y held multiple

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[835] *Id.* at p. 5.

[836] E&Y, Lehman Brothers Holdings Inc. Summary Review Memorandum, Consolidated Financial Statements Quarter-ended May 31, 2008 (Aug. 8, 2008), at p. 17 [EY-SEC-LBHI-WP-2Q08 000117] ("Based on our review of Company's unaudited interim consolidated financial statements as of and for the three and six-month periods ended May 31, 2008, nothing came to our attention that indicates that a material modification should be made to the unaudited interim financial statements in order for them to be in conformity with U.S. generally accepted accounting principles. Furthermore, we are not aware of any material modification that in our judgment should be made to the disclosures about changes in internal control over financial reporting in order for management certification to be accurate and to comply with the requirements of Section 302 of the Sarbanes-Oxley Act of 2002."); E&Y Workpaper, GREG Price Verification Summary, Q2 - J1 J2 J3 PTG-Coml Pricing Summary.xls, at p. 1 [EY-SEC-LBHI-MC-GAMX-08-138328] ("Based on the results of our review, we noted that significant positions appear to be valued within Product Control's threshold or were reasonably contemplated and explained."); E&Y Workpaper, Global Real Estate Q208 Sales Activity, Q2.J1 - GREG Sales 2nd Qtr 08 Lead.xls, at p. 1 [EY-SEC-LBHI-MC-GAMX-08-138412] ("Appears Reasonable.")

[837] Examiner's Interview of Ernst & Young, Nov. 11, 2009, at p. 6.

[838] *Id.*

[839] Memorandum from Nicholas McClay, E&Y, to Files, re: Quarterly Review Valuation Procedures for Archstone & SunCal Real Estate Investments (July 9, 2008), at p. 1-2 [EY-SEC-LBHI-DF-MFIN 000048].

meetings with Jonathan Cohen and Kebede "to understand the portfolios of positions, the underlying variables and value drivers of each position, and the summary of the methodology used to price each position in the portfolio."[840] The memorandum explains that E&Y "obtained and reviewed the Archstone valuation model for reasonableness and noted detailed data inputs and assumptions, specific calculation scenarios, and price sensitivity stress tests of IRR, growth rates, cap rates, development value and timing, loan terms, and other assumptions designed to provide reasonable ranges for position values."[841] The memorandum states that, based on E&Y's understanding of the Archstone position, Lehman's valuation assumptions and the results of discussions with Lehman management, "the process by which the Archstone … positions are valued as well as the related inputs, assumptions, and calculated values appear reasonable for the purpose of assessing reasonableness for our quarterly review."[842]

Jerry Gruner, a senior manager on the E&Y Lehman audit team, told the Examiner that E&Y had received Lehman's Archstone model but had not reviewed the model or its inputs as part of its quarterly review.[843] Gruner explained that he and other E&Y auditors had scanned through the Archstone model to confirm that it "looked on its surface to be a complex model. . . . There were a lot of tabs that we flipped through

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[840] *Id.* at p. 1.
[841] *Id.* at p. 2.
[842] *Id.*
[843] Examiner's Interview of Ernst & Young, Nov. 11, 2009, at p. 9.

as part of a high level review."[844] According to Gruner, E&Y intended to review the model and marks in greater detail during the 2008 audit, which never occurred.[845]

William Schlich, E&Y's lead audit partner, told the Examiner that E&Y was aware that Lehman had not sold any Archstone bridge equity and that Lehman was generally having difficulties selling Archstone bridge equity.[846] Both Schlich and Gruner stated that they never heard any concerns from product controllers that the unsold bridge equity was improperly marked.[847]

c) Senior Management's Involvement in Valuation

During the second and third quarters of 2008, Lehman's senior management intensified its focus on valuation of the GREG portfolio.[848] There had been high profile public criticism that Lehman had not properly marked down its asset values that year.[849]

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[844] *Id.*

[845] *Id.*

[846] *Id.* at p. 4.

[847] *Id.* at p. 15.

[848] Examiner's Interview of Clement Bernard, Oct. 23, 2009, at p. 13; Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009, at p. 8; Examiner's Interview of Eli Rabin, Oct. 21, 2009, at pp. 11-12; Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at p. 10.

[849] *See* Andrew Bary, *Apartment-House Blues*, Barron's, Jan. 21, 2008, *available at* http://online.barrons.com/article/SB120070919702802265.html#articleTabs_panel_article%3D1 (noting that "based on current REIT prices, the value of the Archstone equity could be zero."); *see also* David Einhorn, Greenlight Capital, Presentation to the Value Investing Congress, A Few Thoughts About Risk (Nov. 29, 2007) [LBEX_DOCID 2490444]; Transcript of Speech by David Einhorn, Presentation to Grant's Spring Investment Conference, Private Profits and Socialized Risk (Apr. 8, 2008), at p. 9, *available at* http://www.foolingsomepeople.com/main/mroom/Grants%20Conference%2004-08-2008.pdf.

On the other hand, certain senior Lehman managers were concerned that GREG might have been overly aggressive in taking write-downs.[850]

Beginning in 2008, Mark A. Walsh, Head of GREG, was required to submit proposed mark downs to Andrew J. Morton, Global Head of Capital Markets — FID or Alex Kirk, Co-COO for FID and later, Head of Global Principal Businesses, for approval.[851] It was Walsh's understanding that Morton and Kirk showed the proposed marks to another person, who he assumed to be Joseph M. Gregory, Lehman's President, prior to approving them.[852]

While the firm's senior management had legitimate reasons to be concerned with the valuation process, the potential for undue management involvement in valuation raises two serious issues. First, that involvement might have resulted in unreasonable valuations that must be taken into account when determining the solvency of LBHI and the LBHI Affiliates in the months prior to their bankruptcy cases. Second, if senior management intentionally caused Lehman to report materially inaccurate valuations,

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[850] Examiner's Interview of Alex Kirk, Jan. 12, 2010, at p. 14. It might seem counter-intuitive that a business unit whose performance was at least partially tied to the valuation of its investments would be incented to mark down those assets more than necessary. But Kenneth Cohen told the Examiner that GREG's senior managers had already been told that they would receive no bonuses in 2008 because of significant GREG losses already incurred; they had no incentive, therefore, to artificially prop up the values of GREG assets in 2008. Examiner's Interview of Kenneth Cohen, Oct. 20, 2009, at p. 11. Kirk and others were concerned that GREG might be incented to mark down assets more than indicated in 2008 to set the stage to show greater profits in 2009 when bonuses presumably would be reinstated. *Id.*, at p. 14.

[851] Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 14.

[852] *Id.* Walsh had no understanding as to whether the review was actually for approval of the marks or simply to give management notice. *Id.* There was no occasion when his proposed marks were changed by Morton, Kirk, Gregory or anyone else. *Id.*

such an action might constitute a breach of the fiduciary duty of care owed by those officers.[853]

The Examiner finds evidence that certain Lehman executives perceived pressure from above in the second quarter of 2008 to artificially limit write-downs, but there is no evidence that any caps were in fact imposed or that improper marks were knowingly taken. In the third quarter of 2008, there is similar evidence that certain executives felt pressure, and there is also some evidence that the pressure actually resulted in improper marks. But the evidence is in conflict, and because it relates to the third quarter it is not possible to conclude that improper marks were actually taken — Lehman, of course, had ceased operations before final third quarter financial statements were prepared. The Examiner therefore finds insufficient evidence to support the existence of a colorable claim that Lehman's senior management imposed arbitrary limits on write-downs of assets during that quarter.

(1) Senior Management's General Role With Respect to CRE Valuation

As with other asset classes, marks for Lehman's CRE portfolio were determined by its business desks, subject to price testing performed by the Product Control

[853] *See* Appendix 1, Legal Issues, Section II, for a discussion of corporate officers' fiduciary duties. Lehman did not file a quarterly report for the third quarter of 2008 before the commencement of the bankruptcy cases. However, during its third quarter earnings call, Lehman did report to its investors and the market that "[o]n a net basis, commercial write-downs for the quarter totaled $1.6 billion." Transcript of Lehman Brothers Holdings Inc. Third Quarter 2008 Earnings Call (Sept. 10, 2008), at p. 9.

Group.[854] Historically, GREG had full control of its marks and would simply give the head of the FID notice of the marks.[855] However, during 2008, the process changed and required Walsh to submit GREG's proposed marks to Morton for approval.[856] At some later point, approval responsibility shifted to Alex Kirk.[857]

Walsh understood that Morton and Kirk showed GREG marks to someone else before they approved them; Walsh assumed it was Joseph Gregory.[858] Walsh was not clear whether the senior officers reviewed the marks to actually approve them or simply to be informed before write-downs were taken.[859] Walsh stated that, in any event, there was no occasion on which a write-down GREG proposed to take was overruled or modified.[860] Likewise, Walsh told the Examiner that there was never a time when senior

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[854] Examiner's Interview of Kenneth Cohen, Oct. 20, 2009, at pp. 9-10; Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 13.

[855] Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 14.

[856] *Id.* Walsh was unable to specify the exact date on which this change occurred; however, Morton was appointed head of FID in February 2008, so it must have been after this date. Kenneth Cohen, head of U.S. Originations for GREG, confirmed the process by which valuations were approved, noting that after GREG came up with marks, Walsh would provide them to the head of FID and that GREG would be "given permission" to take write-downs or write-ups. Examiner's Interview of Kenneth Cohen, Oct. 20, 2009, at pp. 9-10.

[857] Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 14.

[858] *Id.*

[859] *Id.*

[860] *Id.* at p. 14. While Walsh was clear that senior management never changed marks he deemed to be appropriate, he did note that management played an active role in resolving disputes between Lehman's trading desks and the Product Control Group as to proper valuations. Walsh told the Examiner that in late 2007 and 2008 it became difficult for him to resolve disagreements as to a position's value, and Walsh was more inclined to "kick it upstairs" for resolution by McDade, Kirk or Lowitt. *Id.*

management predetermined the amount of write-downs that would be taken for a quarter or limited the amount of write-downs GREG was permitted to take.[861]

(2) Senior Management's Involvement in Valuation in the Second Quarter of 2008

During the second quarter of 2008, there was greater scrutiny of Lehman's U.S. CRE marks after an Executive Committee meeting in early 2008 regarding CRE valuations due to "communication problems" between Walsh and Morton.[862] Gregory stated that Morton thought that the CRE marks were being written down without anyone informing him, and Gregory set up this meeting to discuss the need for clearer and more consistent communication.[863]

Jonathan Cohen, a Senior Vice President and Head of the GREG Product Control Group, recalled an incident in the second quarter of 2008 that made him uncomfortable with the degree to which senior management was involved in the valuation process. Jonathan Cohen proposed to Kenneth Cohen, Head of U.S. Originations for GREG, that certain positions for which Kenneth Cohen was responsible be written down.[864] These included one PTG position and two or three Commercial positions. Jonathan Cohen

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[861] *Id.* Other members of Lehman's senior management confirmed that Lehman did not place limits on write-downs or predetermine marks for GREG assets. Examiner's Interview of Christopher M. O'Meara, Aug. 14, 2009, at p. 26; Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at pp. 21-22.

[862] Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009, at p. 8; Examiner's Interview of Joseph Gregory, Nov. 13, 2009, at p. 9; Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 6.

[863] Examiner's Interview of Joseph Gregory, Nov. 13, 2009, at p. 9.

[864] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 7.

recalled that Kenneth Cohen replied that "I can't take it right now."[865] It was Jonathan Cohen's impression that Kenneth Cohen did not have the authority to take the write-down.[866]

Jonathan Cohen explained that he was surprised by Kenneth Cohen's reaction and that he raised the issue with the CFO for FID, Clement Bernard, who in turn went to Morton.[867] Jonathan Cohen was uncomfortable that he was forced to go high up the chain to get approval to take the write-down, but approval was eventually given.[868] Jonathan Cohen told the Examiner that "in the end, all I can do is price test – the front office owns the mark" and "all I can do is start the conversation."[869]

A similar incident was related by Anthony Barsanti, the PTG Senior Vice President responsible for marking the PTG positions.[870] Barsanti recounted that during the second quarter valuation process, he met with Kenneth Cohen to inform him of a list of PTG assets he wanted to write down.[871] Barsanti wanted to take write-downs on three positions, but Kenneth Cohen told him that he was only allowed to write down positions to a certain dollar value, which would not allow Barsanti to take the three

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[865] *Id.*
[866] *Id.*
[867] *Id.*
[868] *Id.*
[869] *Id.*
[870] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at pp. 3, 11.
[871] *Id.*, at p. 15. As noted above, "PTG" refers only to U.S. PTG, and "PTG assets" refers only to assets held or managed by U.S. PTG.

write-downs identified.[872] The next day, Kenneth Cohen called Barsanti and stated that he could take the write-downs on the three positions.[873]

Kenneth Cohen did not recall the events described by Jonathan Cohen or Barsanti in his interview with the Examiner.[874]

While the incidents described by Jonathan Cohen and Barsanti establish that they perceived pressure to cap write-downs, there is no evidence that any caps were actually imposed; rather, the write-downs Jonathan Cohen and Barsanti determined should have been taken were actually taken. The Examiner finds insufficient evidence to support the existence of a colorable claim that senior management involvement led to unreasonable valuations in the second quarter of 2008.

(3) Senior Management's Involvement in Valuation in the Third Quarter of 2008

Similarly, the Examiner finds insufficient evidence to support the existence of a colorable claim that Lehman predetermined a net loss for GREG in the third quarter of 2008.[875]

The Examiner was given three somewhat different — but not entirely conflicting — accounts of the role that senior management played in the valuation process for the

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[872] *Id.*

[873] *Id.*

[874] Examiner's Interview of Kenneth Cohen, Oct. 20, 2009, at p. 11; Examiner's Interview of Kenneth Cohen, Jan. 21, 2010, at pp. 4-5.

[875] Because of Lehman's bankruptcy, Lehman's third quarter financial statements were never formally finalized. The tentative GREG gross write-down for the quarter was $1.732 billion and the gross write-up was $0.147 billion, for a net write-down of $1.585 billion. *See* Lehman, Global Real Estate 2008 Net Mark Downs (Sept. 5, 2008) [LBEX-AM 346991].

quarter: (1) Senior managers told the Examiner, without reservation or qualification, that there was never a predetermined limit on write-downs for any business unit;[876] (2) Paul Hughson, Head of Credit Distribution, told the Examiner that senior managers initially attempted to impose a limit on write-downs, but GREG eventually prevailed and was allowed to take the marks it had determined were appropriate[877] and (3) Barsanti and Jonathan Cohen told the Examiner that an arbitrary limit prevented GREG from taking write-downs they determined were appropriate.[878]

(a) Senior Management's Account

During the pressure-filled third quarter of 2008, senior management became concerned with "late breaking news" about proposed CRE write-downs.[879]

Christopher M. O'Meara, Global Head of Risk Management, was asked by Herbert H. "Bart" McDade, III, President and COO, and Ian Lowitt, CFO, during the weekend of August 23, 2008, to help with the third quarter P&L close.[880] Things were chaotic and Lowitt was being pulled away for due diligence on a potential Korea Development Bank transaction; there was a likelihood of an accelerated close and

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[876] This position is consistent with findings by the SEC, which informed the Examiner that it did not uncover any evidence during the SEC's 2008 review of Lehman's CRE price testing process that Lehman priced its positions to hit predetermined balance sheet or earnings targets. However, it should be noted that the SEC did not examine Lehman's price testing process for the third quarter of 2008. Examiner's Interview of SEC staff, Aug. 24, 2009, at p. 14.

[877] Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 8.

[878] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at pp. 7-8.

[879] Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 14.

[880] Examiner's Interview of Christopher M. O'Meara, Jan. 21, 2010, at p. 2.

preliminary earnings call to address the market's concerns.[881] As a former CFO, O'Meara had the stature to move the process along and get information to the appropriate finance group more quickly.[882]

O'Meara told the Examiner that he had no direct conversations with McDade or Lowitt about write-downs or how numbers were calculated.[883] He was simply told by Gerard Reilly, Lehman's Global Product Controller, that there was already an estimate of the GREG quarterly write-down. He recalled that the write-down was estimated to be $1.5 billion, but he was not sure whether this included hedges or not. Reilly told O'Meara that the $1.5 billion figure was presented to senior management and had been discussed between the Walsh team and senior management, including McDade and others.[884]

However, on Monday, August 25th, O'Meara heard that the third quarter real estate write-down might be larger.[885] Subsequent to hearing about the additional write-downs, O'Meara received a fax, the "Q3 Writedown Summary," prepared by Kenneth Cohen and forwarded to him by Reilly, showing position-level estimated PTG write-downs and including two pages of handwritten notes and calculations providing an

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[881] *Id.*

[882] *Id.* O'Meara also stated that he was not doing anything in regard to financial reporting and was not involved in planning for the earnings call. *Id.*

[883] *Id.*

[884] *Id.*

[885] *Id.* at p. 3.

estimated total write-down of $1.561 billion.[886] O'Meara told the Examiner that he asked Jonathan Cohen whether the numbers had changed since the presentation to senior management, but Jonathan Cohen was not able to provide him specific information. O'Meara stated that Jonathan Cohen told him that he should contact Walsh's team for more information and O'Meara explained that he was disappointed that Cohen did not know more about the valuation process at this point.[887]

In addition to this conversation with Jonathan Cohen, O'Meara stated that he had conversations with Kenneth Cohen, and possibly Walsh, about the Q3 Writedown Summary. He was told that nothing substantive had changed, and that Kenneth Cohen had advised that the $1.5 billion figure previously provided was the result of rounding.[888] O'Meara noted that "there was definitely some confusion there," and asked them to go back and take a harder look at the projected write-down.[889] O'Meara emphasized that he "didn't have a view on any particular number."[890] O'Meara thought it was fair to characterize this as "pushback" on the higher write-downs GREG wanted to take, but that he did not have a view on what was the appropriate number.[891] He stated that he just wanted to understand why the number was higher than what had

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[886] *See* e-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Aug. 25, 2008) [LBHI_SEC07940_2278241]; Lehman, Q3 Writedown Summary [LBHI_SEC07940_2278242].
[887] Examiner's Interview of Christopher O'Meara, Jan. 21, 2010, at p. 3.
[888] *Id.*
[889] *Id.*
[890] *Id.*
[891] *Id.*

previously been presented to senior management. He noted that his response to higher write-downs could be characterized as "resistance" and that he thought the higher write-downs were overly conservative based on the fact that a lower figure had already been provided by GREG to senior management.[892]

O'Meara stated that he thought it was possible that someone may have interpreted something he said as imposing an inflexible limit on write-downs. He noted that when presented with the higher write-down number he told Jonathan Cohen, Kenneth Cohen and possibly others that "this has to be 1.5," meaning that if nothing had changed the number should be same as what had already been presented to senior management.[893] O'Meara emphasized that he thought GREG managers were being excessively conservative and he was simply pushing back.[894] O'Meara told the Examiner that GREG may have felt pressured to change the number as a result of this questioning but insisted that he was merely trying to understand the reasoning for the additional write-down.[895] The final write-down number, according to O'Meara, was exactly what the business units proposed.[896]

O'Meara's account is consistent with the recollection of Kirk. Kirk stated that Lowitt was frustrated in late August 2008 because write-downs, particularly on

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[892] *Id.* at p. 4.
[893] *Id.*
[894] *Id.*
[895] Examiner's Interview of Christopher M. O'Meara, Aug. 14, 2009, at p. 27.
[896] *Id.*

Archstone, were a moving target.[897] Kirk noted that Kenneth Cohen told the Finance group late in August that GREG write-downs were going to be $1.5 billion and then told them the next day that they were actually $1.6 billion.[898] Kirk also stated that Lowitt was concerned that GREG wanted lower valuations to set itself up for better bonuses in 2009.[899] Ultimately, Lowitt sent Reilly to discuss his concerns with managers in GREG.[900]

The specific position at issue was Archstone, where Hughson thought an additional $90 to $100 million in write-downs were appropriate.[901] Kirk did not think that this amount was material in the context of a $50 billion portfolio, but Hughson was concerned about the mark given Archstone's visibility.[902] Kirk instructed Kenneth Cohen to discuss the issue with Steven Berkenfeld, Head of the Legal Compliance and Audit Division, Thomas A. Russo, Chief Legal Officer, and Bart McDade and believes that the issue was finally resolved to everyone's satisfaction.[903] Kirk was clear that he never heard of a cap being set on the amount of write-downs taken.[904]

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[897] Examiner's Interview of Alex Kirk, Jan. 12, 2010, at p. 14.

[898] *Id.* In his interview with the Examiner, Kirk stated that the Archstone write-down for the third quarter was originally $1.5 billion and then changed to $1.6 billion. It is the Examiner's view that this was an accidental misstatement and that Kirk was actually speaking of the total GREG net loss for the quarter. The Archstone valuation write-down for the quarter was much smaller, $125 million. *See* Lehman, Q3 Writedown Summary, at p. 36 [LBHI_SEC07940_2258765].

[899] Examiner's Interview of Alex Kirk, Jan. 12, 2010, at p. 14.

[900] *Id.*

[901] *Id.*

[902] *Id.*

[903] *Id.*

[904] *Id.*

Lowitt told the Examiner that he had no role in approving write-downs and that senior management had never imposed arbitrary limits on the level of write-downs.[905] Lowitt explained that Lehman had a process of forecasting likely write-downs within asset classes but frequently the final write-downs differed from the forecasts.[906] He was clear that the forecasts were not static but would change when new information was obtained.[907]

(b) Paul Hughson's Account

Hughson told the Examiner that Kirk communicated to Walsh, who then relayed to Hughson that "you got 1.5 of marks," meaning that GREG could not take write-downs beyond $1.5 billion in the third quarter.[908] Hughson stated that some members of Lehman's senior management, such as Lowitt, had challenged GREG to explain why the write-downs should be greater than $1.0 billion.[909] Hughson stated that he believed

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[905] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 39.

[906] *Id.*

[907] *Id.*

[908] Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 8. Hughson's description of having conversations with senior management regarding the contentious third quarter marks is partially corroborated by Abebual A. Kebede in the Product Control Group. Kebede stated that Hughson told him that he was unable to write down certain commercial real estate assets as much as he would like during the third quarter of 2008. Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009, at p. 8-9. Kebede could not recall which assets were discussed, but that Hughson referred to a "bunch of assets." *Id.* at p. 9. Kebede stated that Hughson's statement gave him "suspicion" that there had been an order regarding acceptable levels of write-downs for the quarter. *Id.*

[909] Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 8.

that the appropriate write-downs were approximately $1.7 billion and that he argued for write-downs he and his team determined were appropriate.[910]

David O'Reilly, a Senior Vice President in Real Estate Investment Banking, told the Examiner that he overheard Hughson tell Walsh: "you can tell Alex [] Kirk that if that's the way he wants to mark it, he can talk to the SEC."[911]

Hughson took pride in the fact that he had pushed for higher write-downs and thought that the $1.7 billion figure was the appropriate write-down in light of then-current market conditions. Hughson, who was directly involved in discussions with senior management as to the third quarter write-down, took the fact that the gross write-down ultimately taken was $1.7 billion as evidence that there was no limit on write-downs in the third quarter.[912]

(c) Other Accounts

While Hughson, who was responsible for distribution of bridge equity and debt positions held in Lehman's Commercial Book and was ultimately content with the level of write-downs taken in the third quarter of 2008, those responsible for marking and price testing Lehman's PTG book were not.

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[910] *Id.*

[911] Examiner's Interview of David O'Reilly, Oct. 26, 2009, at p. 2 (expletive deleted). Hughson confirmed that this exchange occurred. Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 8.

[912] Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 8.

Historically, Lehman had used a method it referred to as "Cap * 105" to value the collateral underlying PTG debt and equity positions.[913] This method simply multiplied the capitalization of the development by 105% to determine the collateral value.[914] While this method was deemed a conservative approach when real estate values were increasing, Lehman recognized that in the down-market of late 2007 and 2008 it could produce overstated collateral values.[915] Accordingly, Lehman had worked with its primary asset manager, TriMont, to implement a new valuation model, known as an internal rate of return ("IRR") model, to value PTG collateral.[916] The process was managed by Anthony Barsanti and Aristides Koutouvides, Asset Managers in Lehman's PTG group.[917] The IRR model was introduced on a rolling basis and by the third quarter of 2008 a substantial part of Lehman's PTG book was valued using an IRR model.[918] The switch to the IRR model resulted in lower estimates of collateral values than the old Cap * 105 method, and, as a consequence, indicated that material write-downs were appropriate for a significant number of PTG assets.

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[913] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at pp. 12-13; Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 4.

[914] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 4.

[915] *Id.*; Lehman, Valuation & Control Report - Fixed Income Division (Feb. 2008), at p. 27 [LBEX-BARFID 0000058] ("Current valuation methodology for land and development projects is based on cap * 105%, which was a conservative or prudent approach is an up-market. Given current market conditions, this approach may not be appropriate.").

[916] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 13.

[917] *Id.*

[918] *Id.*

According to Barsanti, during the third quarter of 2008, he wanted to take $700 million in write-downs on PTG positions.[919] However, Barsanti stated that Kenneth Cohen directed that no more than $500 million of write-downs could be taken on the PTG portfolio during that quarter.[920] Kenneth Cohen, during his interview with the Examiner, did not recall any such exchange.[921]

The same $500 million limit on PTG write-downs was also recalled by Jonathan Cohen, who remembered it as one part of a $1.585 billion limit on GREG write-downs generally. Jonathan Cohen stated that during a meeting with Kenneth Cohen in Kenneth Cohen's office a few days before the end of the third quarter, Kenneth Cohen told him that there was a limit of $1.585 billion for GREG's third quarter loss.[922] Jonathan Cohen stated that Kenneth Cohen explained that this would result in a limit of $500 million in write-downs on PTG assets.[923] During the meeting, Jonathan Cohen pointed out to Kenneth Cohen that certain write-downs had not been considered in Kenneth Cohen's analysis. These additional write-downs included $28 million in Asia, "run rate" GREG P&L of $20 million, and Coeur Defense and IMD Archstone

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[919] *Id.*

[920] *Id.*

[921] Examiner's Interview of Kenneth Cohen, Oct. 20, 2009, at p. 11. The incident described by Barsanti is somewhat corroborated by Walsh. Barsanti's proposed write-down was one part of the "late breaking news" during the third quarter that Walsh described. Walsh stated that when Barsanti informed him that GREG's initial estimate of $1 billion in write-downs should have been increased by $700 million, this caused McDade and Lowitt to become upset about getting information so late in the quarter. Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 14.

[922] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 7.

[923] *Id.*

write-downs of $19 million.[924] Jonathan Cohen also stated that during this meeting, Jim Blakemore, a Managing Director in the London office, called and wanted to take an additional $10 to $15 million of write-downs on certain assets and was told by Kenneth Cohen that he could not do so.[925]

Additionally, Jonathan Cohen told the Examiner that at one point during this meeting O'Meara joined by phone. According to Jonathan Cohen, the three discussed additional write-downs and Jonathan Cohen was told that "the number is the number."[926]

Jonathan Cohen stated that during this meeting he and Kenneth Cohen performed calculations and he took notes on the Q3 Writedown Summary.[927] In the top right-hand corner of the Q3 Writedown Summary (as sent by Kenneth Cohen), the document shows a column of figures summed to 1,585, the same number Jonathan Cohen stated was the limit imposed on GREG's third quarter write-downs.[928] The net

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[924] *Id.*

[925] *Id.*

[926] *Id.* at p. 8.

[927] *See* Lehman, Q3 Writedown Summary [LBHI_SEC07940_2258765]. During their meeting, Jonathan Cohen added additional handwritten notations to this document. Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 7.

[928] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 7. The document also shows that the addition of two write-ups to the 1,585 figure, one of "15" related to Europe and another of "9" attributed to "Santa Monica," brought the total net write-down on the document to $1.561 billion. Lehman, Q3 Writedown Summary, at p. 23 [LBHI_SEC07940_2258765].

loss actually determined by GREG for the quarter was $1.585 billion.[929] In addition, the bottom of the first page of the document also shows "500" as the number assigned to PTG for third quarter write-downs, consistent with the $500 million limit on write-downs that both Jonathan Cohen and Barsanti described on PTG assets. The net write-down taken on PTG assets for the third quarter was $504 million.[930]

The Examiner has found no evidence suggesting that the Q3 Writedown Summary, which was circulated on August 25, 2008, was drafted in bad faith. Kenneth Cohen, who drafted this document, was likely unaware at the time of the significantly larger than expected write-down of PTG assets suggested by the recent switch to IRR models.[931] Jonathan Cohen told the Examiner that he did not discuss the additional $200 million PTG write-down he thought was appropriate with anyone more senior than

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[929] Lehman, Global Real Estate 2008 Net Mark Downs, at p. 1 [LBEX-AM 346991]. However, as noted above, Lehman did not finalize its financial statements for the third quarter of 2008 and did not file a Form 10-Q prior to the bankruptcy.

[930] The calculation of this net write-down includes net write-downs of $8 million on a category Lehman labeled "CA Land & Condos - Troxler," $145 million on "CA Land & Condos - Other," and $350 million on "Land and Condos (US excluding CA)." Lehman, Global Real Estate 2008 Mark Downs, at p. 1 [LBEX-AM 346991]. The PTG gross write-down for the quarter was $555 million, with a write-up of $51 million, for a net write-down of $504 million. *Id.* at pp. 2-4. The Examiner's financial advisor has observed that a summary of write-downs in E&Y's workpapers suggests $503 million for PTG positions, but attributes this difference to rounding. See Lehman, 3Q Real Estate Gross and Net MTM Cash Bonds Spreadsheet (Aug. 29, 2008) [EY-SEC-LBHI-MC-GAMX-08-045830].

[931] It should be noted that Kenneth Cohen stated that he heard sometime early in August that some within GREG thought that $700 million in PTG write-downs were appropriate, but that by the end of the quarter, when the conversation with Jonathan Cohen and O'Meara occurred, he thought that only $500 million in write-downs were being suggested. Examiner's Interview of Kenneth Cohen, January 21, 2010, at p. 4.

himself other than Reilly.[932] Accordingly, it is the Examiner's view that this document represented a good faith effort to estimate write-downs as of August 25, 2008.

Jonathan Cohen stated that he had never before heard of a predetermined limit on write-downs.[933] However, even though he knew that such a limit would mean that there were appropriate write-downs that would not be taken, Jonathan Cohen stated that he did not question it with Kenneth Cohen or O'Meara.[934] He thought that he likely just said "OK" in return.[935] When asked why he did not raise the issue during this discussion with Kenneth Cohen and O'Meara, Jonathan Cohen explained that "when someone like Chris is telling me 'that is the number,' I'm not going to bring up something else."[936]

When asked whether he was surprised at the limit he understood to be set, Jonathan Cohen stated that he was not because of an analysis he had done for Reilly in late July.[937] He explained that Reilly told him that he was trying to get a sense of what positions they had to take a write-down on and where they still had options. Jonathan Cohen stated that Reilly asked him to determine how GREG write-downs would be allocated under different scenarios for global GREG write-downs.[938] Cohen said that at

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[932] Examiner's Interview of Jonathan Cohen, Jan. 22, 2010, at p. 3.
[933] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 7.
[934] *Id.*
[935] *Id.*
[936] Examiner's Interview of Jonathan Cohen, Jan. 22, 2010, at p. 3.
[937] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 8.
[938] *Id.*

that time he understood that he was being asked "if we could only take $X amount in writedowns, what would it be?"[939] Jonathan Cohen stated that this task prepared him for the idea of predetermined levels of write-downs. Cohen also stated that during the conversation in which Reilly asked him to do this, he voiced his opinion that they should take more write-downs, but did not ask why the limit was being set or where it was coming from.[940] Cohen explained that his impression was that the directive was coming from above Reilly.[941]

The document that Cohen prepared is titled "GREG Potential Markdowns - Q308" and sets forth four different scenarios for total GREG write-downs in the third quarter of 2008 and the applicable asset-level write-downs under each scenario.[942] The total GREG write-downs under each scenario are $2.194 billion, $1.531 billion, $1.0 billion, and $750 million. Jonathan Cohen told the Examiner that that the target write-down numbers for the last two scenarios were provided by Reilly.[943]

Jonathan Cohen also stated that the write-down numbers for specific assets on this document were "made up numbers," as he did this analysis very quickly and had to

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[939] *Id.*

[940] *Id.*

[941] *Id.*

[942] Lehman, GREG Potential Markdowns as of July 23, 2008 (July 2008) [LBEX-JC 000001]. The additional handwritten notes on the document were made by Jonathan Cohen. Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 8.

[943] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 8.

meet the scenarios' targets.[944] For instance, he stated that the write-down number for Archstone on this document was a "completely made up number."[945] Jonathan Cohen explained that there was a lot of juggling to get the numbers to fit the total write-down scenarios and that it was hard to get down to these numbers in the last two scenarios.[946] Jonathan Cohen told the Examiner that it was his opinion at the time that the proper write-downs in the third quarter would have been somewhere between $1.5 billion and $2.2 billion, which are the write-downs reflected by the first two scenarios in this document.[947] He also noted that he personally delivered the document to Reilly and that it was a "good question" whether Reilly asked him not to e-mail it.[948]

After his discussion with Kenneth Cohen and O'Meara, Jonathan Cohen worked to determine how to meet the $500 million write-down target for PTG assets. He and Kebede divided the write-downs into three tiers.[949] The first tier was composed of write-downs that Lehman would be unable to justify not taking.[950] The second and third tiers were composed of potential write-downs that Jonathan Cohen determined were appropriate, but for which Lehman would be able to offer support for a decision

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[944] *Id.*

[945] *Id.*

[946] *Id.* Jonathan Cohen stated that Kebede helped him put the document together and they had only an hour or two in which to produce the document. *Id.*

[947] *Id.*; Lehman, GREG Potential Markdowns as of July 23, 2008 [LBEX-JC 000001].

[948] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 8.

[949] *Id.* at p. 9.

[950] *Id.*

not to implement.[951] The third tier was composed of potential write-downs that Jonathan Cohen determined they had the strongest case for not taking.[952] However, Jonathan Cohen stated that he felt that all of the write-downs in each of the tiers should have been taken.[953] The total amount of the PTG write-downs Cohen calculated for all tiers was $714 million, or $214 million over the limit he understood was set for PTG.[954]

Ultimately, Jonathan Cohen could not identify any person he believed to be responsible for imposing a limit for GREG third quarter write-downs.[955] He stated that he did not think that Kenneth Cohen had the authority to impose such a limit on his own and that it also could not have been Walsh.[956] He speculated that Lowitt, O'Meara, Michael Gelband, Global Head of Capital Markets, or Kirk may have had such authority.[957]

Jonathan Cohen and Barsanti were the only witnesses who had direct contact with Lehman senior management on the subject of possible write-down caps. But other witnesses provided the Examiner with relevant evidence. Kebede stated that he found it difficult to explain why write-downs were not taken on many assets during the third

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[951] *Id.*
[952] *Id.*
[953] *Id.*
[954] *See* Lehman, untitled spreadsheet, at pp. 2-5 [LBHI_SEC07940_2258765]; Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 8.
[955] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 9.
[956] *Id.*
[957] *Id.*

quarter of 2008.[958] He also noted that, contrary to what had previously been customary, he was not involved in the final decision on write-downs in the second and third quarters of 2008.[959]

Rebecca Platt, a product controller responsible for PTG debt positions, also told the Examiner that she heard of a cap on total write-downs for the quarter, although she did not hear of this directly from senior managers and could not recall a specific number.[960] She also stated that, in her view, product controllers Jonathan Cohen and Kebede did not have sufficient authority to control valuations and that in many instances they were overruled by the business desk or senior management.[961] Platt also explained that part of her job was explaining the outcome of the price testing process — that is, why write-downs suggested by Product Control's models were not, in some cases, taken. She stated that as 2008 progressed, she had increasing difficulty coming up with justifications for not taking write-downs and that requests for write-downs were met with increasing resistance from the business desk and/or senior management.[962] When Platt could not create a rationale for why the write-down was not taken, she would consult with Kebede.[963] For the August 2008 pricing report, which set forth the results of the price verification process for the last month in the third

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[958] Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009, at p. 5.
[959] *Id.*
[960] Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at p. 10.
[961] *Id.*
[962] *Id.*
[963] *Id.*.

quarter, neither Kebede nor Platt could create cogent rationales to explain why certain positions were not written down.[964] Kebede suggested that Platt write "PCG [Product Control Group] is in discussion with desk regarding this variance" with respect to these positions.[965] Platt stated that, although she thought the PTG debt positions were not reasonably marked, there was "only so much [we] could do."[966] Referring to the Product Control Group, she stated that they were, "kind of sadly, the little people."[967]

Eli Rabin, the product controller responsible for PTG equity positions, also told the Examiner that he heard rumors that there was a limit on the amount of write-downs that could be taken on PTG positions in the third quarter of 2008.[968] He did not know whether the limit was imposed on just GREG or all of Lehman and did not specify who set the limit.[969]

Aristides Koutouvides, who worked on the PTG business desk, stated that the role played by senior management changed in the third quarter of 2008.[970] Specifically, he remembered that there was more pushback from senior management as to write-downs.[971] Koutouvides stated that the limit he understood to be in place was allocated

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[964] *Id.* at p. 11; Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009, at p. 6.
[965] Lehman, Pricing Report (Aug. 2008), at pp. 19-24 [LBEX-BARFID 0000248]; Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at pp. 10-11; Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009, at pp. 5-6.
[966] Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at p. 11.
[967] *Id.*
[968] Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 12.
[969] *Id.*
[970] Examiner's Interview of Aristedes Koutouvides, Nov. 20, 2009, at p. 16.
[971] *Id.*

across all positions, such that every position that he felt should be written down was, just not to the extent he deemed appropriate. He recalled one example in which he and Barsanti wanted $500 million in write-downs, but were only allowed $450 million.[972] He was also unable to specify where the supposed limit on write-downs originated. Koutouvides characterized the dialogue between the heads of the business units and senior managers as "expectations management" when it came to valuations.[973]

(4) Examiner's Findings and Conclusions With Respect to Senior Management's Involvement in CRE Valuation

The evidence is in great conflict as to whether senior management actually attempted to impose artificial limits on write-downs or whether more junior managers misperceived management pushback as management interference. The evidence is murky and based upon speculation as to exactly who among the senior managers would have engaged in such interference if in fact it occurred. The amount of the write-downs not taken because of the possible interference – approximately $200 million in a quarter in which Lehman would report $3.9 billion of losses – is of questionable materiality. Furthermore, the actual write-downs – right or wrong – were never formally reported. For all of these reasons, the Examiner concludes that the evidence does not support the existence of colorable claims arising out of write-downs in the third quarter of 2008.

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[972] *Id.*

[973] *Id.*

d) Examiner's Analysis of the Valuation of Lehman's Commercial Book

(1) Executive Summary

This section of the Report addresses Lehman's valuation of the commercial real estate assets commonly referred to as the Commercial Book. Lehman's Commercial Book was comprised of debt instruments, such as commercial mortgage loans and CMBS.[974] Within the Commercial Book, Lehman recognized, among others, the following asset categories: Large Loans (Fixed and Floating) and Conduit Loans, B-Notes / Mezzanine Notes, CMBS, and REIT Line of Credit ("LOC").[975] These assets were backed by real estate properties that were typically already constructed, operating and generating cash flow. Lehman's expectation at the time it originated or acquired these positions was that it would be able to syndicate, securitize and/or sell them within a few months. This expectation caused individuals within Lehman to refer to the Commercial Book as being in the "moving" business.[976]

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[974] Wyatt de Silva, E&Y, Memorandum to Files: Lehman Commercial Real Estate SFAS 157 Adoption (Jan. 28, 2008), at pp. 3-4 [EY-LE-LBHI-KEYPERS 2025663]. A significant portion of positions held in the Commercial Book related to Lehman's investments in Archstone and SunCal. However, Lehman did not price test these positions as part of the Commercial Book price testing process. Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 10. Accordingly, the valuation of these positions is not addressed in this Section, although Archstone is addressed in Section III.A.2.f of the Report.

[975] Lehman, Real Estate Monthly Price Verification Policy and Procedures (July 16, 2008), at p. 1 [LBHI_SEC07940_1184459].

[976] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at pp. 3, 6. Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 6. Examiner's Interview of Lisa Beeson, Oct. 23, 2009, at p. 9. Conversely, Lehman's PTG investments, which were intended to be held while the underlying real estate was being developed, was referred to as the "storage" business. Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 6.

As of May 31, 2008, Lehman determined that the value of its worldwide Commercial Book was approximately $29.5 billion, with $15.1 billion in the U.S., $10.3 billion in Europe, and $4.2 billion in Asia.[977] As of August 31, 2008, Lehman determined the value of its worldwide Commercial Book to be approximately $24.4 billion, with $11.9 billion in the U.S., $8.9 billion in Europe, and $3.6 billion in Asia.[978] As with other asset classes, the analysis in this section focuses on Lehman's U.S. assets, as the Examiner deemed the time and expense necessary to obtain information regarding non-U.S. assets to be an imprudent use of Estate resources.[979]

Historically, Lehman was able to sell certain positions within the Commercial Book shortly after origination.[980] However, beginning in the latter half of 2007 and continuing through the third quarter of 2008, the loss of liquidity due to the deterioration of the securitization and syndication markets forced Lehman to retain more of its Commercial Book assets on its balance sheet at a time when problems in the

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[977] Lehman, Global Real Estate Inventory Spreadsheet as of May 31, 2008 (August 8, 2008) [LBEX-DOCID 2077095]. The Examiner notes that there is an immaterial difference between the value of the U.S. Commercial Book based on this source ($15.1 billion) as compared to the value of the U.S. Commercial Book positions reviewed by E&Y ($14.9 billion) as discussed below. In addition, price testing models and internal and external Lehman presentations that have been located by the Examiner indicate slightly different values for the U.S. Commercial Book. The Examiner's financial advisor has concluded that the differences among these sources may be due to categorization or mark-to-market adjustments.

[978] Lehman, Global Real Estate Inventory Spreadsheet as of August 31, 2008 [LBEX-DOCID 1025119].

[979] As used in this Section, unless otherwise noted, the term "Commercial Book" refers only Lehman's U.S. assets.

[980] *See* E&Y, Memorandum re: Conduit, Large Loan, and CMBX Price Verification Process, at p. 5 [EY-SEC-LBHI-MC-GAMx-08-063735]. Fixed Rate Conduit Loans & Large Loans were historically syndicated every two to three months. *Id.* at p. 5. Fixed Rate Loans were typically held by Lehman for 180 days. *Id.* at p. 6. However, the average holding period for B-Notes / Mezzanine Notes was over 180 days. *Id.* at p. 8.

real estate market were putting downward pressure on valuations.[981] As evidenced by contemporaneous e-mails written by senior Lehman personnel, the markets for investments backed by commercial real estate were "virtually closed" at the time.[982] The reduction in CMBS securitizations after the third quarter of 2007 is demonstrated in the table below:

Lehman's Commercial Securitization Activities from the Second Quarter of 2006 to the Second Quarter of 2008[983]

In $Millions	2Q 06	3Q 06	4Q 06	1Q 07	2Q 07	3Q 07	4Q 07	1Q 08	2Q 08
Commercial mortgages securitized	3,412	6,700	7,149	2,829	5,083	10,480	1,507	-	1,500
Quarter-over-quarter change	*100.7%*	*96.4%*	*6.7%*	*-60.4%*	*79.7%*	*106.2%*	*-85.6%*	*n/a*	*n/a*

As the securitization market dried up, and Lehman's exit strategy for these assets became untenable, the value of Lehman's positions fell. In the second quarter of 2008, Lehman took approximately $195 million in write-downs on assets within its

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[981] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 3; Diane Hinton, S&P, Liquidity Management In Times Of Stress: How The Major U.S. Broker-Dealers Fare, Nov. 2007, S&P RatingsDirect, (Nov. 8, 2007), at pp. 2-3 [LBHI_SEC07940_439424] ("Recent disruptions in the subprime market and its contagion effects into the leveraged finance, asset-backed commercial paper (ABCP), and CDO spaces have substantially curtailed market liquidity."); FRBNY President Timothy Geithner, Transcript of Remarks to The Economic Club, New York City, New York, Reducing Systemic Risk In A Dynamic Financial System (June 9, 2008), *available at* http://www.newyorkfed.org/newsevents/speeches/2008/tfg080609.html ("The funding and balance sheet pressures on banks were intensified by the rapid breakdown of securitization and structured finance markets. Banks lost the capacity to move riskier assets off their balance sheets, at the same time they had to fund, or to prepare to fund, a range of contingent commitments over an uncertain time horizon.").

[982] E-mail from William J. Hughes, Lehman, to Alex Kirk, Lehman, *et al.* (Jul. 27, 2007) [LBEX-DOCID 174304].

[983] *See* Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2007 (Form 10-Q) (filed on July 10, 2007), at p. 27 ("LBHI 10-Q (filed July 10, 2007)"); Lehman Brothers Holdings Inc., Quarterly Report as of August 31, 2007 (Form 10-Q) (filed on Oct. 10, 2007), at p. 22 ("LBHI 10-Q (filed Oct. 10, 2007)"); LBHI 2007 10-K at p. 111 ("LBHI 2007 10-K"); LBHI 10-Q (filed July 10, 2008) at p. 35.

Commercial Book. Similarly, in the third quarter of 2008, Lehman took approximately $306 million in write-downs on its Commercial Book. Lehman's valuations of its Commercial Book resulted in cumulative net write-downs of $958 million during the period beginning in the fourth quarter of 2007 and ending in the third quarter of 2008, as set forth in the table below.[984]

Commercial Book Net Write-downs - First Quarter 2007 to Third Quarter 2008

	$ in millions					
	1Q thru 3Q 07	4Q 07	1Q 08	2Q 08	3Q 08	4Q 07 thru 3Q 08
Net Write-Downs	(38)	(164)	(293)	(195)	(306)	(958)

This section of the Report examines whether the value of Lehman's Commercial Book assets, as determined by Lehman in May and August of 2008, was reasonable. The Examiner's investigation has revealed that the sales data used by Lehman to verify the marks for many of its Commercial assets in the second and third quarters of 2008 may not have been sufficiently broad to be applicable to the entirety of the portfolio. However, while there is some uncertainty as to whether the sales data Lehman had for the second and third quarters of 2008 was representative of the assets remaining in its Commercial portfolio, the data shows that Lehman's valuations at this time assumed higher yields, and as a result lower values, than is reflected by actual sales during the quarter. Thus, Lehman's valuations appear reasonable in light of the available sales

[984] E&Y, Lehman Brothers Holdings Inc. CRE Sign P&L Q4 and YTD (November 11, 2007), at p. 2 [EY-SEC-LBHI-MC-GAMx-07 071061]; E&Y, Lehman Brothers Holdings Inc. 3Q.RE.8 Gross and Net MTM Cash Bonds 082908.xls [EY-SEC-LBHI-MC-GAMX-08-045833]. Lehman, Global Real Estate 2008 Net Mark Downs (Sept. 5, 2008) [LBEX-AM 346991]. The write-downs exclude SunCal related positions.

data. Furthermore, this sales data was the primary source of information available to Lehman, other than theoretical models that relied, in part, upon data from third parties, to conduct price verification of these assets at the time.[985] Most importantly, the asset values ultimately determined did not fall outside of a range of reasonableness. Accordingly, the Examiner does not find sufficient evidence to support a finding that Lehman's valuation of its U.S. Commercial Book in the second and third quarters of 2008 was unreasonable.

(2) Lehman's Valuation Process for its Commercial Book

As with other asset classes, the marks Lehman reported for its Commercial Book assets were those determined by its business desk, subject to a price verification process performed by its corresponding Product Control Group.[986] Product Control used a number of methodologies, depending on the asset category and available information, to verify the pricing information provided by Lehman's business desk.[987] For conduits

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[985] The Examiner notes that Lehman internally recognized that its theoretical models suffered from the use of stale data. *See* Lehman, Valuation & Control Report – Fixed Income Division (February 2008), at p. 27 [LBEX-BARFID 0000058]. This report listed the following "issue" for the "Floating Rate Large Loans & Junior Notes": "Floating rate securitization market is inactive; No deal in the market since Dec-07. Spreads published in third party publications are stale; Pricing becoming extremely challenging." *Id.* The proposed solution was for Product Control to work "with Front Office to obtain market color on deals that are currently in the market for syndication/sale." *Id.* This document also stated "Product control is having continuous discussions with Front Office going through deals in more detail and trying to obtain market color using recent syndications, bids, offers and any other market information." *Id.*

[986] Lehman, Price Verification Policy and Procedure 2008 [Draft] [LBHI_SEC07940_2965994]; Brian Sciacca, *et al.*, Lehman, HG, HY, & EMG Cash Price Testing Policy & Procedure (Jan. 24, 2007) [LBEX-BARVAL 0000001].

[987] Lehman, Price Verification Policy and Procedure 2008 [Draft] [LBHI_SEC07940_2965994]; Brian Sciacca, *et al.*, Lehman, HG, HY, & EMG Cash Price Testing Policy & Procedure (Jan. 24, 2007) [LBEX-BARVAL 0000001]. Testing files for non-U.S. positions were not available and the Examiner expresses no

and large fixed rate loans, prices were historically tested in aggregate using a mock securitization model, based on the most recent comparable Lehman securitization deal. Key model inputs included waterfall payment of the bonds, term to maturity, coupon rate and the Loan-to-Value ("LTV") ratio, which was generally derived from the value of the collateral at the time the loan was originated.[988] The present value of the subject loan was discounted based on a weighted average yield that was estimated from a mock securitization and/or yield spreads as published in the Commercial Mortgage Alert ("CMA").[989] However, the use of this methodology became ineffective as the securitization markets closed, causing Product Control to de-emphasize their use in the first quarter of 2008.[990]

For floating rate large loans and mezzanine loans, Lehman's marks were tested using a net present value ("NPV") methodology which considered the subject loan's riskiness and its collateral property value.[991] Key model inputs included the individual loan's LTV ratio, maturity date, spread, coupon rate, remaining payments, and discount

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view of the reasonableness of the valuation methodology or ultimate marks reported for Lehman's non-U.S commercial real estate assets.

[988] E&Y, Walkthrough Template re Conduits, Large Loan, and CMBX Price Verification Process, at p. 5 [EY-SEC-LBHI-MC-GAMX-08-063735].

[989] *Id.* at p. 8; Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification (Feb. 2008), at p. 10 [LBEX-WGM 000762].

[990] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 4.

[991] E&Y, Walkthrough Template re Conduits, Large Loan, and CMBX Price Verification Process, at pp. 7-8 [EY-SEC-LBHI-MC-GAMX-08-063735].

rate.[992] For the discount rate, Product Control based their calculation on the key model inputs mentioned above and yield spread data published by CMA.[993]

For CMBS, prices were tested using third party pricing data from IDC, and other market sources when available.[994] Product controllers then compared the average of all third-party pricing data for a position to the mark determined by the business desk.[995]

Finally, REIT LOC and term loans were typically price tested on an individual basis, using the NPV approach based on individual loan characteristics.[996]

During the fourth quarter of 2007 and the first quarter of 2008, the lack of sales of Lehman's Commercial Book assets, due to the slowing pace of securitizations and syndications noted above, meant that there was limited relevant market information to rely upon in performing price testing of these assets. This lack of information caused Lehman to be heavily reliant upon its theoretical pricing models for purposes of confirming asset valuations. However, in the second and third quarters of 2008, greater sales activity allowed Lehman's product controllers to use sales data in addition to models to perform price verification of the Commercial Book.[997] During the second

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[992] *Id.* at pp. 7-9.

[993] E&Y, B-Note, Discount Rate Recalculation.xls [EY-SEC-LBHI-MC-GAMX-08-063388].

[994] Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification (Feb. 2008), at p.16 [LBEX-WGM 000762].

[995] E&Y, Walkthrough Template re Liquid Products Price Verification Process, at p. 7 [EY-SEC-LBHI-MC-GAMX-08-067466].

[996] Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification (Feb. 2008), at p. 18 [LBEX-WGM 000762].

[997] The increased sales activity would have also benefited the business desk as they determined the correct mark for their positions.

quarter of 2008, Lehman was able to sell a range of Commercial Book positions for an aggregate price of $3.8 billion.[998] Similarly, during the third quarter of 2008, Lehman sold various Commercial Book positions for an aggregate price of $2.5 billion.[999]

The volume of actual sales transactions in the second and third quarters of 2008 gave Lehman's management a higher level of confidence in the valuation process compared to prior periods when the lack of any meaningful sales data forced them to rely mostly on theoretical pricing models.[1000]

After the product controllers determined their test marks for a position, variances, defined as the difference between the business desk's mark and the mark calculated by the product controller, were calculated. Lehman determined certain variance thresholds for each asset category.[1001] As with other asset classes, variances exceeding these thresholds were resolved through discussions between business desk and product controllers and unresolved variances were escalated to senior management.[1002]

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[998] Lehman, Q2 Q3 Greg Sales Scatter v2 [LBHI_SEC07940_1234185].

[999] *Id.*

[1000] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at pp. 5-6.

[1001] E&Y, Memorandum re: Conduit, Large Loan, and CMBX Price Verification Process, at p. 9 [EY-SEC-LBHI-MC-GAMX-08-063735]; E&Y, Lehman Brothers Holdings Inc., REIT Price Verification Process, at p. 7 [EY-SEC-LBHI-MC-GAMX-08-0641780]; E&Y, Lehman Brothers Holdings Inc., Liquid Products Price Verification, at p. 8 [EY-SEC-LBHI-MC-GAMX-08-067466]; Lehman, Price Verification Policy and Procedure 2008 [Draft], at p. 4 [LBHI_SEC07940_2965994].

[1002] E&Y, Lehman Brothers Holdings Inc. Price Verification P&P, Securitized Products and Valuation Controls (March 3, 2008), at p. 23 [EY-SEC-LBHI-MC-GMAX-08-067482]; E&Y, Lehman Brothers Holdings Inc. Price Verification Policy and Procedure 2008 [Draft], at p. 4 [LBHI_SEC07940_2965994].

(3) Examiner's Findings and Conclusions as to the Reasonableness of Lehman's Valuation of its Commercial Book

In assessing the reasonableness of Lehman's marks in the second and third quarters of 2008, the Examiner reviewed valuation analyses provided by Lehman to its auditors, models that Lehman's product controllers used to price test the business desk's asset valuations, and data from completed sales transactions.

(a) As of the Second Quarter of 2008

In a real estate price verification presentation, the Product Control Group summarized its price testing analysis for the second quarter of 2008.[1003] The presentation provided "Pricing Commentary" that explained how the Product Control Group arrived at its test prices and showed the aggregate variance calculated for the quarter. In the presentation, the Product Control Group identified a $70 million net negative variance, equal to approximately 0.5% of Lehman's $14.5 billion Commercial portfolio.[1004] A negative variance means that Lehman's marks for the assets tested were higher than the test prices, suggesting an overvaluation.

In addition to providing information regarding the test prices determined for the Commercial Book, the Product Control presentation also contained observations on factors impacting the pricing of each asset type.[1005] The presentation noted that some

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[1003] Lehman, Real Estate Price Verification [Draft] (July 17, 2008), at pp. 2, 3, 5 [LBHI_SEC07940_1169231].
[1004] *Id.* at p. 2. The Examiner notes that this presentation identified the value of the "US Commercial" portfolio to be approximately $17.5 billion, which included $3.0 billion of bridge equity positions. For the purpose of Commercial Book analysis, bridge equity positions were excluded from the analysis.
[1005] *Id.* at pp. 2, 3, and 5.

asset classes, specifically Archstone, benefited from price flex.[1006] Price flex shifted mark-to-market losses from debt positions to equity positions. A partially-reproduced summary of the Product Control Group's price testing analysis is shown in the table below.

[1006] *Id.* at pp. 2, 5. The Archstone debt positions were included in the Commercial Book and the valuation of these positions is addressed in Section III.A.4.e of the Report, which addresses Lehman's valuation of its Archstone B bridge equity investment.

Product Control's Draft Price Testing Summary for Q2 2008
U.S. Commercial[1007]

	Legal Balance	Mark	Market Value	Pricing Variance	Pricing Commentary
Fixed Rate:					
First Lien	419	90.60	379		Significant expsure is 61% LTV, $319mn senior loan on GM building marked at 95.7, or a yield of 6.7%. Sold all of $500mn placed into a Q208 securitization.
B-Notes/Mezz	1,021	88.50	904	(26)	Apporxiamtely 31% of portfolio has price flex; remainder of booked marked based on comparable spread levels from recent synidcation/sales activity. Sold $947mn during Q208.
Floating Rate:					
Archstone	526	99.00	521		Full Price flex on debt, i.e., any loss will be absorbed by bridge equity. 450 DM assumed on mezz in pricing bridge equity yield.
First Lien	3,434	94.90	3,260	(12)	Marked based on spreads derived or implied from recent syndication / sales activity on senior loans as well as b-notes / mezz notes. Sold $545 mn during Q208.
B-Notes/Mezz (excl. Archstone)	3,516	91.90	3,230	(32)	Price verified based on comparable spread levels on recent syndications / sales activity. Sold $742mn during Q208.
Term Loans / LOCs:					
Archstone	2,395	98.50	2,359		Full price flex. Pricing assumptions incorporated in bridge equity (i.e., term loan A to be repaid from asset sales and term loan B to be syndicated @ 90).
SunCal	1,944	75.60	1,470		Priced to target investor yield of 15% (except for Marblehead and Pacific Point, which are at 12% to account for their superior location & demographics compared to the rest of the portfolio). Cash flow and other projections (lot absorption, construction costs, and sale price) obtained either from third party vendors hired by LB or third party industry publications.
Others (excl. Archstone and SunCal)	876	96.00	841		Based on bank debt trading market of similar credits.
Corporate Debt	626	100.00	626		Seller financed trades originated in May 08 at market spreads.
Total (excluding Securities)	14,757		13,590	(70)	
Securities	29,966		908		Price verified using third party sources and recent trading activity. Sold $1bn of all tranches of securities during Q2 08. Floating rate IO's marked at zero due to the lack of prepayment protection and short duration.
Total (including Securities)	44,723		14,498	(70)	

[1007] *See* Lehman, Real Estate Price Verification [Draft] (July 17, 2008), at pp. 2-3 [LBHI_SEC07940_1169231]. This table excludes bridge equity positions and collapses the different types of securities into a single line item. The Examiner notes that the total value for U.S. Commercial assets in this draft price testing document ($14.5 billion) is different than the final values reviewed by E&Y ($14.9 billion) and other summaries of the Commercial Book located by the Examiner. The Examiner's financial advisor has concluded that these differences may be due to categorization or mark-to-market adjustments.

For the second quarter of 2008, Lehman provided E&Y an analysis that compared data from sales during the period to the carrying values of the assets that remained on Lehman's balance sheet.[1008] The analysis compared the selling yields that were implied by the prices at which assets were sold during the quarter to the carrying yields used for valuing the portfolio as of quarter-end.[1009] The analysis concluded that the average selling yield was lower than the average carrying yield of the remaining assets; and therefore, the prices that Lehman was achieving on actual sales were, on average, higher than the prices at which Lehman was carrying assets in these categories on its balance sheet.[1010] However, the Examiner notes that there is great variation among positions even within a single asset category and the applicability of a sale price to positions still held by Lehman can only be determined by a position-specific analysis. Assuming that the assets sold were comparable to the remaining assets, the Commercial Book as of May 31, 2008, was undervalued in light of the second quarter sales data available. Lehman relied on the sales data to support the valuation of Commercial assets at quarter end.[1011]

[1008] *See* E&Y, Global Real Estate Q2 '08 Sales Activity [EY-SEC-LBHI-MC-GAMX-08-138412].

[1009] *Id.*

[1010] *Id.*

[1011] Lehman, Real Estate Price Verification [Draft] (July 17, 2008), at p. 1 [LBHI_SEC07940_1169231]. Kebede affirmed the emphasis of sales data during his interview with the Examiner. Examiner's Interview of Abebual A. Kebede on Oct. 6, 2009, at p. 8. E&Y's workpapers stated: "For purposes of the Q2 review, the comparisons between inventory values and yields and sold values and yields appears reasonable to support Product Control's assertions of reasonable, observable, applicable sales activity to support its fair value marks as of 5/30/08 in addition to its other price verification procedures. Appears Reasonable." E&Y, Global Real Estate - Q208 Sales Activity, at p. 1 [EY-SEC-LBHI-MC-GAMX-08-

To evaluate the applicability of the sales data to the value of Lehman's remaining assets, the Examiner reviewed the distribution of sales across the asset categories within the Commercial portfolio.[1012] This analysis is summarized in the table below.

138412]. William Schlich told the Examiner that E&Y's quarterly reviews are not the same as the annual audit and that E&Y was still in the planning stages for its 2008 audit when Lehman filed for bankruptcy. Examiner's Interview of Ernst & Young, Nov. 11, 2009, at pp. 13-14.

[1012] *See* E&Y, Global Real Estate Q208 Sales Activity [EY-SEC-LBHI-MC-GAMX-08-138412]; Lehman, Q2 Q3 Greg Sales Scatter.xls, [LBHI_SEC07940_1234185].

U.S. Commercial Asset Classes with Sales Data - Q2 2008

	Sales During Quarter	Remaining Exposure	Selling Yield	Carrying Yield on Remaining Portfolio
Mezzanine - Floating Rate	606	2,799	8.8%	9.3%
Mezzanine - Fixed Rate	947	479	8.7%	9.4%
Large Loans - Senior Floating Rate	545	3,575	5.9%	6.6%
B-Notes - Floating Rate	136	152	6.6%	9.7%
Subtotal #1	2,234	7,005	N/A	N/A
Small Fixed Rate Mezzanine	499	379	7.5%	N/A
Securities	1,018	589	N/A	N/A
Interest Only	25	319	0.0%	N/A
Subtotal #2	1,542	1,287	N/A	N/A
Loans to REITs (e.g., Archstone and SunCal)	-	4,869	N/A	N/A
Floating Rate Mezzanine - Archstone	-	485	N/A	N/A
B-Notes - Fixed Rate	-	363	N/A	N/A
Derivatives Mark to Market	-	893	N/A	N/A
Subtotal #3	-	6,610	N/A	N/A
Total	3,776	14,902	N/A	N/A

As this table shows, Lehman was able to sell a substantial portion of assets within certain asset classes, and was unable to sell any portion of assets for other asset

classes. The four categories for which the Examiner obtained both selling yield and carrying yield information together account for approximately 47% of Lehman's Commercial Book, as measured by value.[1013] Within these categories, the average carrying yield for the remaining portfolio was consistently higher than the average selling yield.[1014] The majority of asset classes without any sales data are related to Archstone debt positions, which benefited from price flex, and SunCal.[1015]

While the sales data provides a degree of price transparency, many of the transactions that were executed during the second quarter closed during the last few days of the quarter.[1016] Further, many of the transactions that closed on the last day of the quarter were seller financed (with recourse).[1017] Kebede believed the terms of the seller financing were consistent with market rates at the time.[1018] The Examiner is not aware of any contemporaneous evidence that contradicts Kebede's belief.

The Product Control Group used data from the sale of positions during the quarter to value the remaining positions by comparing positions: (1) within the same deal; (2) within the same sector (*i.e.*, office); (3) within the same geography; (4) with

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[1013] *See* Lehman, Q2 Q3 Greg Sales Scatter.xls [LBHI_SEC07940_1234185-1234225].

[1014] *See* E&Y, Global Real Estate Q208 Sales Activity [EY-SEC-LBHI-MC-GAMX-08-138412]; Lehman, Q2 Q3 Greg Sales Scatter.xls [LBHI_SEC07940_1234185-1234225].

[1015] *Id.* As noted, the impact of price flex on the valuation of Archstone bridge equity is discussed in Section III.A.4.e.

[1016] E&Y, Global Real Estate Q208 Sales Activity, at pp. 1-10 of 31 [EY-SEC-LBHI-MC-GAMX-08-138412].

[1017] *Id.* Lehman, Seller Financed Positions, at p. 2 [LBEX-WGM 763628]. Because the seller-financing was provided "with recourse," in the event of a default Lehman would be permitted to seek the full outstanding amount of the loan from the borrower, not just the collateral.

[1018] Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009, at p. 9

similar loan-to-value ratio; and (5) with similar term to maturity.[1019] For example, Lehman sold a tranche of the 301 Howard mezzanine loan portfolio with a lower LTV ratio than the remaining tranches, which is consistent with the fact that the remaining positions were marked to higher yields than the positions sold. This is also consistent with the relative riskiness of each tranche – the higher the LTV ratio, the riskier the tranche.

As an additional check of the price testing process, the Examiner investigated how Lehman's valuation models performed when compared to spreads reflected in actual sales data. A review of available pricing models showed that, when sales data providing spreads was available, these spreads were manually entered by product controllers in place of the spreads calculated by the models.[1020] Among the 25 Commercial Book positions that the Examiner reviewed, this practice was done for 22 positions.[1021] To assess the models' ability to predict reasonable carrying spreads, the Examiner replaced the spreads reflected by the sales data with Lehman's own model calculations. A comparison of the selling spreads to the predicted spreads of the positions examined indicates that Lehman's pricing models, on average, predicted a

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[1019] *Id.*

[1020] The Examiner's financial advisor reviewed the majority of sold large loans and mezzanine loans within the Large Loan and Junior Note price testing models. However, since Lehman reported limited information regarding the selling spreads for several of these sold positions, the Examiner's financial advisor only reviewed 63.7% of the positions as measured by market value.

[1021] Lehman, Large Loans Pricing Summary (Apr. 30, 2008) [LBEX-BARFID 0022055]; Lehman, Junior Loans Pricing Summary (Apr. 30, 2008) [LBEX-BARFID 0020702]; Lehman, Large Loans (PTG Model) Pricing Summary (Apr. 30, 2008) [LBEX-BARFID 0022055].

higher spread than the average selling spread.[1022] This suggests that the price testing process was generally conservative, producing lower marks than those reflected in the sales data.

Based on the aforementioned facts and analyses, Lehman's Product Control Group had sufficient sales data and other information to effectively price test Lehman's Commercial Book during the second quarter of 2008. Furthermore, the available sales data suggests that Lehman's marks for these assets were conservative during the quarter. Accordingly, the Examiner finds that there is insufficient evidence to support a finding that Lehman's valuations of its Commercial Book assets in the second quarter of 2008 were unreasonable.

(b) As of the Third Quarter of 2008

The Examiner obtained less information about Lehman's price testing process for the third quarter of 2008 than for the second quarter. This appears to be due to LBHI's bankruptcy filing, which occurred just 15 days after the third quarter ended. As a result, the Examiner's financial advisor could not identify a document summarizing Lehman's price testing process similar to the one obtained for the second quarter. However, the process that Lehman used was generally similar to that for the second quarter - reliance on sales data where available and models in the absence of such data.

[1022] The predicted spreads were on average 262 basis points higher than the selling spreads.

Therefore, the Examiner's analysis for the third quarter followed a similar approach as was used for the second quarter.

Lehman sold approximately $2.5 billion of Commercial positions during the third quarter of 2008.[1023] These sales occurred across a variety of asset classes, as shown in the table below. Similar to the second quarter, there were no sales of Archstone or SunCal positions.[1024]

Third Quarter U.S. Commercial Book Asset Sales (Excluding REO/Equity)

Asset Type	**Value (in Millions)**
Large Loans - Floating Rate	725
Large Loans - Fixed Rate	305
Mezzanine - Floating Rate	846
Mezzanine - Fixed Rate	195
B-Note	144
Securities	253
Total	**2,468**

The majority of U.S. Commercial positions that were reviewed by the product controllers during this quarter were price tested in two pricing models: the Large Loan price testing model and the Junior Note price testing model.[1025] Therefore, the Examiner's analysis focused on these two price testing models.

[1023] Lehman, Q2 Q3 Greg Sales Scatter.xls [LBHI_SEC07940_1234185]. The $2.5 billion figure excludes REO/Equity sales.

[1024] *Id.*

[1025] *See* Lehman, US Real Estate Inventory vs. Pricing Reconciliation (Aug. 2008), at p. 1 [LBHI_SEC07940_3103034]. Fixed rate and floating rate large loans of an aggregate value of $6.3 billion were price tested in the August Large Loan pricing model. *See* Lehman, Large Loans Pricing Summary (Aug. 29, 2008), at p. 7 [LBEX-BARFID 0021979]. B-Notes, Fixed rate and floating rate mezzanine loans of an aggregate value of $2.5 billion were price tested in the August Junior Loan pricing model. *See*

A review of the Large Loan Floating Rate model shows that Product Control's review of the desk's valuations for the third quarter suggested a $45 million positive variance, or a 0.7% potential undervaluation of $6.3 billion worth of positions.[1026] The largest group of positions (excluding Archstone and SunCal) price tested in this model was a group of $412 million of senior Hilton positions, which were benchmarked against the yields received from the sale of relatively junior Hilton positions sold during the quarter.

A review of the Junior Note price testing model shows that Product Control's review of the desk's valuations for the third quarter showed an $87 million net negative variance, or a potential 3.5% overvaluation of $2.5 billion worth of positions.[1027]

Similar to the second quarter review, the Examiner followed the same procedure to examine how Lehman's valuation models performed in the third quarter when compared to the actual selling price/spread. The examination shows that Lehman's pricing models,[1028] on average, predicted a higher spread than the average selling

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Lehman, Junior Loans Pricing Summary (Aug. 29, 2008), at p. 14 [LBEX-BARFID 0021642]. These two models included $8.8 billion of the $10.4 billion in Commercial Book positions that were price tested as in the third quarter of 2008. Lehman, Real Estate Americas Price Testing Summary (Aug. 29, 2008) [LBEX-DOCID 1971828].

[1026] *See* Lehman, Large Loans Pricing Summary (Aug. 29, 2008) [LBEX-BARFID 0021979].

[1027] *See* Lehman, Junior Loans Pricing Summary (Aug. 29, 2008) [LBEX-BARFID 0021642].

[1028] The Examiner reviewed the majority of sold large loans and mezzanine loans within the Large Loan and Junior Note price testing models. However, since Lehman reported limited information regarding the selling spreads for several of these sold positions, the Examiner only reviewed 30.6% of the positions sold as measured by value.

spread, implying that positions were marked at lower prices than similar positions sold during the third quarter.[1029]

As with the second quarter, based on the aforementioned facts and analyses, the Examiner concludes that there is insufficient evidence to support a finding that the Commercial Book valuations as of the third quarter of 2008 were unreasonable.

e) Examiner's Analysis of the Valuation of Lehman's Principal Transactions Group

(1) Executive Summary

Lehman's Principal Transactions Group ("PTG") made debt and equity investments in real estate projects that were intended to be held for the period during which the underlying real estate was developed or improved.[1030] Unlike Lehman's Commercial Book positions, which were backed by already-developed, income-

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[1029] The predicted spreads were averaged 117 bps higher than the selling spreads.

[1030] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 4; Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 4. *See* Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification Presentation [Draft] (Feb. 1, 2008), at p. 4 [LBEX-WGM 916015]; Wyatt de Silva, E&Y, Memorandum to Files: Commercial Real Estate FAS 157 Adoption (Jan. 28, 2008), at p. 5 [EY-LE-LBHI-KEYPERS 2025661]. As noted above, this Report addresses the valuation of Lehman's U.S. assets. Accordingly, except as noted, the term "PTG" only refers to the GREG Principal Transactions Group in the U.S. and the investments that this group originated and managed. Additionally, the term PTG, as used herein, excludes the SunCal development, which was technically a part of the PTG portfolio. *See* Cushman & Wakefield, Appraisal of Pacifica San Juan Master Plan (289 Lots) (Oct. 1, 2007) [TR00031835]. Lehman's investment in SunCal amounted to, as of May 2008, approximately 4.4% of the balance sheet at risk for the PTG portfolio. Lehman, Global Real Estate Inventory Spreadsheet as of May 31, 2008 (Aug. 8, 2008) [LBEX-DOCID 2077095]. However, Barsanti stated that PTG had limited involvement in valuing SunCal, as that position migrated over to Hughson's group. Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 17. Jonathan Cohen also stated that Product Control had no involvement in valuing SunCal. Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 5. Because PTG and Product Control generally excluded SunCal from the valuation process, the Examiner has likewise excluded that asset from consideration of the reasonableness of the PTG marks, except as a basis of comparison in one instance below.

producing real estate and were intended to be sold to investors shortly after origination, PTG positions were not intended for near-term sale. Instead, PTG investments were premised on execution of a business plan, typically of two to five year duration, which often included sale of the underlying property after development.[1031]

Given this business strategy, Lehman generally did not market PTG positions for sale, as it did Commercial Book assets. As a result, PTG positions were relatively illiquid, even when commercial real estate values were increasing and capital was readily available. Anthony J. Barsanti, the PTG Senior Vice President responsible for marking the PTG positions, told the Examiner that Lehman valued these investments through a combination of financial projections and "gut feeling," due to the unique nature of each asset and the lack of sales data regarding comparable debt and equity positions.[1032] Lehman employed valuation models incorporating asset-specific information and projecting expected performance over time. However, while PTG asset managers on the business desk used the models as a guide, they did not regard them as "gospel."[1033] Barsanti and Aristides Koutouvides, the PTG Vice President who reported to Barsanti and also valued PTG positions, made judgment calls as to whether to modify or give weight to the model values.[1034] Barsanti and Koutouvides based these judgment calls on their experience, the collateral's performance with respect to the

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[1031] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 4.
[1032] *Id.* at p. 11.
[1033] *Id.*
[1034] *Id.* at pp. 9, 11-12; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 11-12.

development's business plan, and other market data related to the collateral's geographic region or property type that was not always accounted for in their models.[1035]

Lehman engaged a third party, TriMont, to produce the asset-specific data used by the business desk.[1036] This TriMont data was also used by the product controllers who separately price tested the asset values determined by the business desk.

Pursuant to GAAP, and specifically SFAS 157, the PTG portfolio's value was supposed to represent Lehman's judgment as to the price at which each position could be sold to a third party as of a particular measurement date, assuming that Lehman had sufficient opportunity to market such investment prior to that date.[1037] However, there was disagreement between Lehman personnel about whether the PTG portfolio reflected this price. Koutouvides and Jonathan Cohen, Senior Vice President, Head of Product Control Group in GREG, told the Examiner that PTG assets were not valued at the price they could be sold to a third-party investor in 2008.[1038] With respect to the values determined by Lehman for PTG assets during 2008, Koutouvides stated, "no one

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[1035] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at. pp. 9, 11-12; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 11-12.

[1036] Lehman & TriMont, Amended and Restated Loan Servicing and Asset Management Agreement (Sept. 1, 2004), pp. 11-12 [TR00044479].

[1037] For a more detailed discussion of the legal standards governing this Report's valuation analysis, see Appendix 1, Legal Issues, Section VII.

[1038] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 12; Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 5.

would pay you that."[1039] In fact, Koutouvides and Jonathan Cohen stated that Lehman was not required to mark the PTG assets at the price at which an investor would purchase such assets as of the particular measurement date.[1040] In contrast, another witness, Kenneth Cohen, a Managing Director in GREG and Head of U.S. Originations, told the Examiner that the PTG assets were marked at the price that an investor would pay to purchase the asset.[1041] Barsanti, who Kenneth Cohen identified as the person principally responsible for determining PTG marks, stated that he did not know whether PTG assets could be sold for the price at which they were marked and stated he had not thought about it.[1042]

The Examiner's analysis of the data provided by TriMont, as well as Lehman's use of this information to produce valuations, supports a finding that Lehman's process for valuing its PTG portfolio was systemically flawed because Lehman primarily valued these assets based on whether the development was proceeding according to the project's business plan and not the price a buyer would pay for the asset. This methodology did result, in the first three quarters of 2008, in approximately $1.1 billion in aggregate write-downs of the PTG portfolio, which was valued at approximately

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[1039] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 12.
[1040] *Id.* at pp. 11-12; Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at pp. 4-5.
[1041] Examiner's Interview of Kenneth Cohen, Jan. 21, 2010, at p. 4.
[1042] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 11.

$9.6 billion at the end of fiscal year 2007.[1043] However, there are sufficient facts to demonstrate that Lehman did not generally value PTG assets in light of the rates of return (or yields) that investors would require to purchase them. In other words, the facts support a finding that Lehman generally did not value PTG assets during these quarters at the prices at which they could be sold to a third-party investor.

This failure to appropriately consider an investor's required rate of return was initially due to the fact that TriMont calculated the value of the underlying real estate simply by reference to the project's capitalization.[1044] This calculation was called Cap * 105, because the collateral value — the most important input in the valuation exercise[1045] — was calculated by multiplying the development's capitalization (*i.e.*, outstanding debt plus equity raised) by 105%.[1046]

As the real estate markets deteriorated in 2007, Lehman recognized that Cap * 105 was flawed, and instructed TriMont to produce internal rate of return ("IRR") models for each development.[1047] The IRR models were typically designed to determine

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[1043] *See* Lehman, Global Real Estate 2008 Net Mark Downs (Sept. 5, 2008) [LBEX-AM 346991]. Lehman, GREG (PTG) Balance Sheet Position as of Nov. 30, 2007 (Dec. 6, 2007) [LBEX-DOCID 1374315] (Nov. 2007 data).

[1044] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 4.

[1045] Examiner's Interview of Jennifer Park, Sept. 10, 2009, at p. 8, Examiner's Interview of Abebual A. Kebede, Oct. 13, 2009, at p. 6; Examiner's Interview of Eli Rabin, Oct. 21, 2009, at pp. 6-7.

[1046] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 4.

[1047] The Examiner notes that the IRR models referenced here are not the same IRR models referenced elsewhere in this Report in the valuation analysis of Archstone. *See* Section III.A.2.f of this Report. The IRR models used in Archstone assumed a value, and the model derived a discount rate. While TriMont's models could perform the same calculation, Lehman relied on TriMont's models for PTG positions to produce a value based on an assumed discount rate for the collateral.

the value of the real estate by discounting the projected cash flows of the completed project to a present value. This was a cumbersome and time consuming process, but by July 2008 TriMont was able to provide early versions of the IRR models for substantially all of the PTG assets.[1048] Lehman recognized that the IRR models required continued development, and this process was projected to take many more months.[1049] The Examiner has analyzed a subset of the IRR models and determined that the models generally attributed a discount rate for the equity portion of the capital structure based on Lehman's expected rate of return (*i.e.*, 20% for land developments) and, for the debt portion, a discount rate based on the interest rate associated with the underlying loans at origination.[1050] The IRR models took a weighted average between these two rates to arrive at the weighted average discount rate for the property.[1051] In this manner, the IRR models used a yield that did not necessarily correspond to investors' required rate of return (*i.e.* market-based interest rates) as of the particular measurement date.

Barsanti and Jonathan Cohen, in part by using the TriMont IRR models, determined that it would be appropriate to write down the PTG assets by approximately $714 million for the third quarter of 2008.[1052] Jonathan Cohen understood

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[1048] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 15.

[1049] *Id.*

[1050] TriMont, TriMont Valuation Methodologies – Lehman PTG and LLG CMBS Hold Assets (Apr. 28, 2008) [LBEX-DOCID 2089942].

[1051] The weighted average was based on the equity invested to date and outstanding debt.

[1052] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 15; Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 9.

that there was a $500 million limit on such write-downs for the third quarter,[1053] but he did not inform Kenneth Cohen, Christopher M. O'Meara, Global Head of Risk Management, or anyone senior to him (other than Gerard Reilly, Global Product Controller) that he and Barsanti had calculated proposed write-downs beyond the perceived $500 million limit.[1054] In this manner, approximately $214 million of the write-downs were not taken.

The Examiner finds there is sufficient evidence to support a finding, for purposes of a solvency analysis, that certain of Lehman's PTG valuations as of May 31, 2008 and August 31, 2008 were unreasonable. Given that there were approximately 700 PTG positions as of LBHI's bankruptcy filing,[1055] the Examiner determined that it was not a prudent use of resources to determine the range of overvaluation for each investment. For purposes of illustration, the Examiner did analyze select positions, and describes below how Lehman's failure to properly consider the investors' required rate of return affected the valuation. Due to time constraints and lack of information that fully captures the nuances of PTG positions (or Lehman's internal process for valuing many of them), the Examiner's analysis of these assets does not present an opinion as to the

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[1053] The Examiner concludes that there is insufficient evidence to support a finding that Lehman's senior managers intended to impose such a limit, but Jonathan Cohen was unambiguous in asserting that it was his understanding that such a limit was in place. Examiner's Interview of Jonathan Cohen, Jan. 22, 2010, at pp. 2-3. See Section III.A.2.c of this Report, which discusses senior management's process for deciding write-downs for CRE assets, which included PTG assets, in the second and third quarters of 2008.

[1054] Examiner's Interview of Jonathan Cohen, Jan. 22, 2010, at pp. 2-3.

[1055] Lehman, GREG Inventory Spreadsheet as of Aug. 31, 2008 (Sept. 13, 2008) [LBEX-DOCID 1025119].

fair value of these assets as of May or August 2008, but simply investigates the assumptions and practices Lehman used in valuing the selected PTG assets and reaches a conclusion as to the reasonableness of those assumptions and practices.

In addition, the evidence does not support the existence of a colorable claim for a breach of fiduciary duty related to Lehman's valuation errors, as there is insufficient evidence to establish that any Lehman officer acted with the necessary scienter to support such a claim.

(2) Overview of Lehman's PTG Portfolio

Lehman's PTG positions took the form of investments in both the debt and equity of the development or improvement projects. PTG invested in real estate that required development or improvement in order to produce the desired return on capital.[1056] Prior to the development or improvement, the underlying PTG real estate had either no cash flow (*i.e.*, land to be developed), or materially less cash flow than was projected to be generated upon development (*i.e.*, conversion of rental apartment buildings to condominiums).[1057] Lehman generally planned to exit its PTG positions when the underlying real estate project was completed, at which point the real estate would be stabilized and could produce a cash flow through leasing or sales.[1058] While Lehman actively marketed Commercial Book assets for sale soon after origination,

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[1056] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 7-8.
[1057] *Id.* at p. 4.
[1058] *Id.*

Lehman usually did not market PTG assets. Development projects were typically completed two to five years after Lehman provided the funding (with the average being three years), at which time the underlying property was typically sold.[1059]

PTG invested in "[p]roperties in markets with lack of competition for the property type or having significant barriers to entry due to complexity of the situation or market issues."[1060] PTG typically invested in the construction of offices or hotels, the leasing of rental units in existing apartments or office buildings, the conversion of rental units into condominium units, and the acquisition and development of land for creation of residential, commercial, or resort properties.[1061]

Lehman partnered with developers on PTG investments. Each Lehman banker within PTG who originated investments had relationships with certain developers with a proven track record in a particular real estate market.[1062] It was not uncommon for Lehman to do multiple deals with a developer who had demonstrated the ability to

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[1059] *Id.* *See* Memorandum from Sunny Galynsky, Lehman, to Kenneth Cohen, Lehman, re: Corporate Audit Report for Real Estate: Principal Transactions – Americas (Dec. 19, 2007), at p. 2 [LBEX-DOCID 3570967] ("The Principal Transaction Group provides equity and debt funds for real estate investment in non-stabilized assets which were scheduled to be repaid over a three to five year period. The group engages in originating and restructuring short term mezzanine loans (average duration of 2.5 years) . . . ."); Mark A. Walsh & Kenneth Cohen, Lehman, An Overview of the Global Real Estate Business (June 6, 2005), at p. 18 [LBEX-DOCID 271653].

[1060] Mark A. Walsh & Kenneth Cohen, Lehman, An Overview of the Global Real Estate Business (June 6, 2005), at p. 18 [LBEX-DOCID 271653].

[1061] Lehman, GREG University: START Training Analysts & Associates Deep Dive Training Presentation (Sept. 2007), at p. 79 [LBHI_SEC_07940_ICP_007982].

[1062] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 7; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 8.

successfully complete a project.[1063] While certain PTG positions included sale or transfer restrictions, Lehman recognized that a third-party investor evaluating a PTG investment prior to the completion of a development would need to conduct significant due diligence on the developer responsible for the project, as the profitability of the investment largely depended on the developer's ability to complete the project on time and on budget.[1064] Koutouvides explained that Lehman relied on the developer to successfully complete the project, and that the relationship between Lehman and a developer could be described as a "marriage."[1065]

Lehman recognized that PTG investments were "higher-risk, higher-return" than Commercial Book investments,[1066] due to the lack of stabilized cash flows and the risk that development or improvement of the asset might not be accomplished according to the business plan.[1067] For example, a project could be delayed or derailed due to the developer's failure to timely obtain necessary zoning variances or to successfully

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[1063] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 7.

[1064] *Id.* at pp. 4, 5, 17.

[1065] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 8.

[1066] *E.g.*, Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 4.

[1067] *E.g.*, Lehman, GREG Global Real Estate Update (Nov. 6, 2007), at p. 12 [LBEX-WGM 771145] (identifying key risks to include "refinancing risk," "residential sales," "execution," and "credit risk"); Lehman, GREG University: START Training Analysts & Associates Deep Dive Training Presentation (Sept. 2007), at p. 96 [LBHI_SEC_07940_ICP_007982] (identifying CRE risks generally); Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 8.

manage a project.[1068] The developer's failure to perform in accordance with the business plan could have a material effect on the value of the PTG investment.[1069]

Given that the entity owning the underlying real estate was often highly leveraged, and a PTG asset generated insufficient cash flow until the completion of development, Lehman's expectation was that the entity would have substantial difficulty repaying the debt at maturity unless the development was successfully completed.[1070] Similarly, execution of the business plan was crucial to obtaining Lehman's targeted annual rate of return (or yield), for example, 20% for a PTG equity

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[1068] E-mail from Aristides Koutouvides, Lehman, to Anthony J. Barsanti, Lehman (May 16, 2008) [LBHI_SEC07940_2229897]; Zev Klasewitz, Lehman, Single Asset Debt Model May 2008 Spreadsheet (June 14, 2008), at tab "Pricing," cell BK98 [LBEX-LL 1985749]; Dennis Grzeskowiak, TriMont, Knickerbocker Hotel IRR Model (July 1, 2008), at cell F2 [TR00021056]; Lehman, Single Asset Debt Model Aug. 2008 Spreadsheet (Aug. 31, 2008), at cell BK95 [LBEX-BARFID 0023236]; Lehman, Valuation & Control Report – Fixed Income Division (Dec. 1, 2007), at p. 22 [LBEX-WGM 755798] ("Project is still in the entitlement process"; "[o]verall financing package is being restructured"); Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 8.

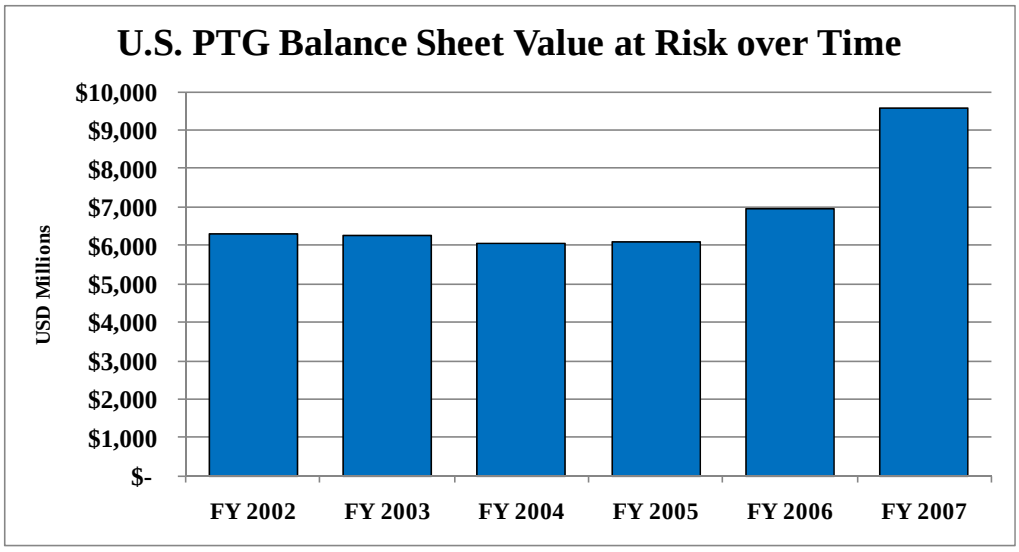
[1069] Lehman, GREG Global Real Estate Update (Nov. 6, 2007), at p. 12 [LBEX-WGM 771145] (identifying key risks to include "refinancing risk," "residential sales," "execution," and "credit risk"); Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 8.

[1070] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at pp. 5, 12. Additionally, if the development failed, Lehman could foreclose on the real estate and attempt to salvage value from the asset by revising the business plan, which could include partnering with a new developer or selling the property. When Lehman foreclosed and took ownership, the asset became "Real Estate Owned" or "REO." Lehman, Corporate Audit Dept. Entity Control Evaluation for Commercial Real Estate – Mezzanine & Equity (Jan. 4, 2006), at p. 2 [LBHI_SEC_07940_ICP_010891]; Memorandum from Robert Martinek, E&Y, to E&Y Audit Team for Lehman Brothers, re: Lehman Brothers Commercial Real Estate Portfolio (Dec. 17, 2006), at p. 5 [EY-LE-LBHI-KEYPERS 0675302] (noting that Lehman foreclosed on a borrower and categorized the note as an REO).

investment in land developments.[1071] Either way, as Barsanti told the Examiner, "[i]f you could not execute your plan – you're dead."[1072]

(3) Evolution of Lehman's PTG Portfolio From 2005 Through 2008

As Lehman executed its growth strategy during 2006 and 2007, the PTG portfolio grew larger in size and the average position became riskier. Beginning in November 2006, the PTG book balance sheet increased substantially, as illustrated by the following graph.[1073]



[1071] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at pp. 5, 12. According to Koutouvides, this 20% rate for equity approximated Lehman's expected rate of return for underwriting a deal. Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 7.

[1072] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 5.

[1073] *See* Lehman, Balance Sheet Trend and Profit & Loss Spreadsheet (Sept. 14, 2007) [LBEX-DOCID 2504119] (2002-2006 data); Lehman, GREG (PTG) Balance Sheet Position as of Nov. 30, 2007 (Dec. 6, 2007) [LBEX-DOCID 1374315] (Nov. 2007 data); Lehman, Global Real Estate Group (PTG) Balance Sheet Position as of Aug. 31, 2007 (Sept. 7, 2007) [LBEX-DOCID 1639856] (Aug. 2007 data); Lehman, GREG (PTG) Balance Sheet Position as of Feb. 29, 2008 (Mar. 5, 2008) [LBEX-DOCID 1374362] (Feb. 2008); Lehman, GREG (PTG) Balance Sheet Position as of May 31, 2008 (June 4, 2008) [LBEX-DOCID 1639939] (May 2008 data); GREG (PTG) Balance Sheet Position as of Aug. 31, 2008 (Sept. 4, 2008) [LBEX-DOCID 4418520] (Aug. 2008 data).

After remaining relatively constant from 2002 to 2005, the PTG balance sheet grew 57% between fiscal year 2005 and fiscal year 2007, or from $6.1 billion in fiscal year 2005, to $6.9 billion in fiscal year 2006, and to $9.6 billion in fiscal year 2007.

During this period, the composition of the PTG portfolio also changed in ways that made the portfolio more risky.[1074] The increasing level of risk associated with Lehman's PTG investments was largely the result of three factors: (1) an increased focus on land development projects; (2) a focus on California and other boom markets; and (3) a greater proportion of equity investments. Each of these factors is discussed below.

In regard to the first factor, land developments, Lehman determined that certain types of PTG investments, such as office building upgrades, no longer provided the returns the business required due to competition from other investors who were willing to accept lower returns.[1075] In order to obtain the targeted return on investment, PTG redirected its focus to developing land, particularly for residential development.[1076]

[1074] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 5; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 8.

[1075] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 5; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 8.

[1076] Lehman, GREG, America's Portfolio as of June 30, 2008 (July 19, 2008), at p. 4 [LBHI_SEC07940_241063] (stating that "PTG's largest exposure is in land"); Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 5; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 8. As noted, Lehman's SunCal positions are not included in this analysis and would inflate the total value of the PTG portfolio if included. However, the Examiner notes that SunCal is another example of this trend. *See, e.g.*, Cushman & Wakefield, Appraisal of Pacifica San Juan Master Plan (289 Lots) (Oct. 1, 2007) [TR00031835].

For example, Lehman's investment in Heritage Fields, PTG's largest position, representing approximately 6% of the PTG portfolio as of May 2008, involved the creation of a new residential community on the site of a decommissioned Marine Corps base near Irvine, California.[1077] The Heritage Fields developer proposed the preparation of parcels to be subdivided between builders of a planned community that included 4,895 residential units, along with parks, a golf course, educational facilities, a medical office, and commercial space.[1078] Lehman provided $500 million in first lien financing for Heritage Fields in December 2005 and provided an additional $275 million of financing in June 2007.[1079]

The PTG portfolio's increasing concentration of land developments, such as Heritage Fields, increased the overall risk profile of the portfolio. Land carries more risk than all other property types and is the most volatile in terms of value.[1080] As a

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[1077] *See* TriMont, Heritage Fields El Toro LLC IRR Model (May 1, 2008) [LBEX-BARFID 0026891]; Zev Klasewitz, Lehman, Single Asset Debt Model May 2008 Spreadsheet (June 14, 2008) [LBEX-LL 1985749]. Lehman did not invest directly in the homebuilding for Heritage Fields. Instead, Lehman invested in the sponsor, LNR Property Corp., that was to prepare the infrastructure and provide environmental clean-up in order to deliver the land parcels that would be subdivided between builders. Memorandum from Brent Bossung, *et al.*, Lehman, to LBHI Investment Committee, re: Loan Proposal for Heritage Fields, LLC (July 1, 2005), at pp. 3, 6-9 [LBEX-AM 193357].

[1078] Cushman & Wakefield, Heritage Fields Master-Plan Self-Contained Appraisal Report Vol. I (July 1, 2007), at p. 8 [LBEX-DOCID 2501688]; Lehman, Real Estate Deal Summaries: Top 50 Asset Reviews (Sept. 13, 2008), at tab 8 [CS-SEC-00003929].

[1079] Lehman, Real Estate Deal Summaries: Top 50 Asset Reviews (Sept. 13, 2008), at tab 8 [CS-SEC-00003929]; TriMont, Heritage Fields El Toro LLC IRR Model (May 1, 2008) [LBEX-BARFID 0026891].

[1080] *See* Stuart M. Saft, 7 Comm. Real Estate Forms 3d § 22.2 (Nov. 2009) ("The biggest risk of an investment in undeveloped and developing land is the virtual impossibility of predicting the direction of growth and the ever increasing cost of holding the land for future development. . . . Another problem is determining the sales price of raw land due to the fact that, unlike securities, there is no established market, which makes determining comparable sales impossible."); John D. Hastie, Real Estate

general matter, land is only projected to appreciate if it is "entitled," meaning that the developer has obtained the various zoning and environmental approvals to construct the development.[1081] The risk associated with investments in land is that approvals to construct the development might not be obtained, or might be obtained only after significant delay.[1082] Furthermore, given the time required to obtain such approvals and to then build the physical structures, there is the possibility of significant changes in the real estate market during the development period. For example, when Lehman first provided financing to Heritage Fields in December 2005, the expectation was that the land entitlements would be obtained in December 2006, construction of improvements would follow over the course of several years, and sales would continue through 2013.[1083]

In addition, the PTG portfolio was particularly concentrated in California land development. The rising value of all types of California property throughout the 2000s (particularly in 2005 and 2006),[1084] combined with low interest rates, perceived consumer

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Acquisition, Development and Disposition from the Developer's Perspective, SR001 ALI-ABA 1, 3 (2009) ("That cost [of land acquisition] customarily includes raw land cost, the cost of providing utility and other governmental services to the land, the costs of obtaining zoning, use and environmental approvals, the cost of creating access to and within the development, the cost of curing title defects and the interest expense or return on investment charged to the carrying period prior to development.").

[1081] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 8.

[1082] *Id.*

[1083] Memorandum from Brent Bossung, Lehman, *et al.*, to LBHI Investment Committee, re: Loan Proposal for Heritage Fields, LLC (July 1, 2005) at pp. 3, 6-9 [LBEX-AM 193357].

[1084] *See* Moody's/REAL Commercial Property Price Index, http://mit.edu/cre/research/credl/rca.html; Fed. Housing Fin. Agency, House Price Index for California (CASTHPI), http://research.stlouisfed.org/fred2/series/CASTHPI (showing a peak in house prices in 2005 and 2006).

demand for housing, available liquidity, and Lehman's recent track record of success, made raw California land an attractive PTG investment to Lehman during this period.[1085] As of the end of the second quarter of 2007, California land development represented 17.6% of the balance sheet at risk in the PTG portfolio.[1086]

Finally, Lehman's risk exposure also increased as it took equity stakes in developments.[1087] For fiscal year 2004, PTG equity made up approximately 26% of the PTG portfolio, increasing to 34% in 2005 and 2006.[1088] During 2007, Lehman took note of the softening market and realized that the PTG portfolio was too concentrated in land development and in equity positions.[1089] Koutouvides noted that the market was "dropping like a stone."[1090] Kenneth Cohen stopped approving, and originators stopped submitting, deals where Lehman was not sufficiently senior in the capital structure (*i.e.*, first lien debt instead of equity), thereby reducing the risk profile.[1091]

[1085] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 5. A presentation given by Paul A. Hughson outlines several advantageous aspects of the California market. Paul A. Hughson, Lehman, The Search for Yield – Alternative Real Estate Investment Opportunities (June 20, 2006) [LBEX-DOCID 1745526].

[1086] Lehman, Portfolio Characteristics – Americas (Principal Investments and CMBS Retained Positions) Spreadsheet as of May 31, 2007 (Oct. 23, 2007) [LBEX-DOCID 2501412]. SunCal is not included in this percentage.

[1087] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 5, 8.

[1088] Ketaki Chakrabarti, Lehman, Real Estate Balance Sheet Trends Spreadsheet (Apr. 18, 2007) [LBEX-DOCID 1419729]; Melissa Sullivan, Lehman, Bridge Equity Spreadsheet (July 5, 2007) [LBEX-DOCID 3604474].

[1089] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 6; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 9. *See* E-mail from Jeffrey Goodman, Lehman, to Anthony J. Barsanti, Lehman (Jan. 3, 2007) [LBEX-DOCID 249993] (discussing deteriorating home-building market in California and forwarding article with a "pretty negative view of CA land").

[1090] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 9.

[1091] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 6.

At the end of fiscal year 2007, despite further growth in the PTG portfolio, the proportion of equity investments had decreased slightly to 30% of the PTG portfolio.[1092] Lehman originated fewer PTG positions during the last quarter of 2007, a trend that continued into 2008.[1093] In addition, Lehman wrote down the value of PTG investments by $137 million in the fourth quarter of 2007 and by $271 million in the first quarter of 2008.[1094] Lehman wrote down PTG assets by $302 million in the second quarter of 2008.[1095]

As of the end of the second quarter of 2008, Lehman held 741 positions in the PTG portfolio. Lehman valued these positions at $8.5 billion with an average position

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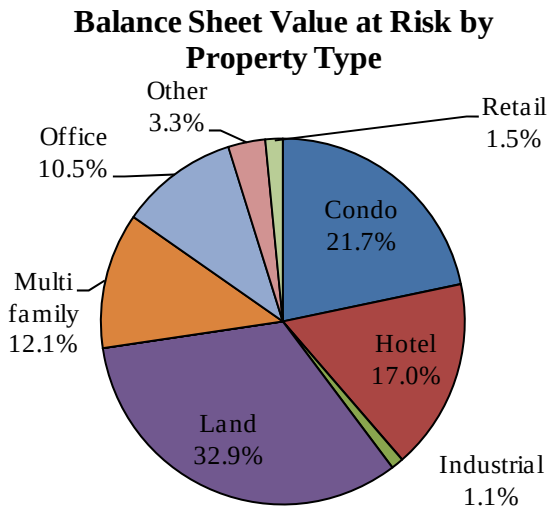
[1092] Lehman, GREG (PTG) Balance Sheet Position as of Nov. 30, 2007 (Dec. 6, 2007) [LBEX-DOCID 1374315].

[1093] Laura M. Vecchio, Lehman, FAS 144 Face_Basis Spreadsheet (July 14, 2008) [LBEX-DOCID 587401]. Lehman originated 52 positions in the fourth quarter of 2007, 40 in the first quarter of 2008, and 19 in the second quarter of 2008. *Id.*

[1094] Lehman, Global Real Estate 2008 Net Mark Downs (Sept. 5, 2008) [LBEX-AM 346991]. The net figures subtract Lehman's write-ups on PTG assets from the write-downs. Although net write-downs typically include the offset from hedging, the Examiner's financial advisor has observed that Lehman did not effectively hedge PTG positions during this period. Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 9. The gross write-down figures are $137 million in fourth quarter 2007 and $318 million in first quarter 2008. Lehman did not write up PTG assets in fourth quarter 2007, but did write up certain PTG assets by $47 million in first quarter 2008 (principally, Troxler – Spring Mountain Ranch). Lehman, Global Real Estate 2008 Net Mark Downs (Sept. 5, 2008) [LBEX-AM 346991].

[1095] Lehman's gross write-down for second quarter 2008 was $316 million, with a $13 million write-up. Lehman, Global Real Estate 2008 Net Mark Downs (Sept. 5, 2008) [LBEX-AM 346991].

size of $11 million.[1096] At that time, the PTG portfolio featured the following property types:[1097]



Property Type	# of Positions
Condo	146
Hotel	46
Industrial	27
Land	210
Multifamily	103
Office	128
Other	64
Retail	17
Total	**741**

Approximately 33% of the overall portfolio, or 210 positions, was land for development, with condominium developments and conversions comprising the second largest category.

The size of the PTG portfolio decreased slightly between the second and third quarters of 2008, from 741 positions valued at $8.5 billion to 690 positions valued at $7.8

[1096] Lehman, Real Estate Price Verification Presentation [Draft] (July 17, 2008), at p. 3 [LBHI_SEC07940_1169231]. The U.S. PTG portfolio accounted for 60.3% of the total PTG portfolio in terms of balance sheet at risk. The remaining PTG positions were held in the Asia and Europe portfolios. *Id.*

[1097] Lehman, Global Real Estate Inventory Spreadsheet as of May 31, 2008 (Aug. 8, 2008) [LBEX-DOCID 2077095]. The category "Land" was labeled "Land/Single Family" by Lehman in internal presentations. Based on a limited review of underlying positions, the Examiner's financial advisor has observed that this category only contains land development assets.

billion.[1098] This decrease was primarily driven by a $504 million net write-down in the third quarter.[1099]

By 2008, Lehman had slowed the pace of new originations, but still held many relatively risky positions originated during the up-market of 2004-2007. These positions, especially equity positions in land development projects, proved difficult to accurately value throughout 2008, as is discussed below.

(4) Lehman's Valuation Process for Its PTG Portfolio

Determining the fair value of any asset, especially illiquid assets such as PTG debt and equity positions, requires the party performing the valuation to exercise judgment as to a variety of criteria that a potential purchaser would consider.[1100] These criteria include, among others, the amount of future expected cash flows expected from the asset and an investor's willingness to accept the risk that the asset will not produce these cash flows.[1101] These criteria are reflected in the two components of the "mark-to-market" valuation process: "marking to credit" and "marking to yield."[1102]

[1098] *Id.*; Lehman, GREG Inventory Spreadsheet as of Aug. 31, 2008 (Sept. 13, 2008) [LBEX-DOCID 1025119]. The SunCal positions are excluded from this calculation. The Examiner's financial advisor observed that the data in Lehman's PTG files do not include the basis for a position being removed from the PTG portfolio (other than sales to third parties).

[1099] Lehman, Global Real Estate 2008 Net Mark Downs (Sept. 5, 2008) [LBEX-AM 346991]. The Examiner notes that a summary of write-downs in E&Y's workpapers suggests $503 million for PTG positions. The difference is due to rounding. See Lehman, 3Q Real Estate Gross and Net MTM Cash Bonds Spreadsheet (Aug. 29, 2008) [EY-SEC-LBHI-MC-GAMX-08-045830].

[1100] *See* Appendix 1, Legal Issues, Section VII.A, for a more detailed discussion of the legal standard for determining fair value pursuant to SFAS 157.

[1101] Future expected cash flows refer to the weighted average of projected cash flow projections adjusted for the probability that the cash flow will materialize. For example, if there were two cash flow projections, (1) a 50% chance that cash flow will be $10 and (2) a 50% chance that cash flow will be $20 in

In the context of Lehman's PTG portfolio, marking to credit refers to recognition of changes in the amount and/or timing of the future expected cash flows from the properties underlying the PTG positions (the "collateral").[1103] In terms of marking a PTG asset, marking to credit includes the recognition of a changed collateral value due to any change in the business plan that changed the amount of cash flows the collateral was expected to generate and/or the time period in which the expected cash flows would be received.[1104] Thus, marking to credit takes into account the changed circumstances of the particular asset in question.

In contrast, marking to yield takes into account changes in broader market conditions affecting the value of an asset even if the circumstances of the asset itself have not changed. Yield — sometimes referred to as a rate of return or discount rate — is the discount rate used to determine the present value of the future expected cash flows, accounting for the risk that the asset will not perform as expected. As an

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Year 1, the expected cash flow for Year 1 is $15, which is computed as follows: (50% * $10) + (50% * $20) = $15.

[1102] The terms "marking to credit" and "marking to yield" were used by various Lehman personnel who were responsible for the valuation of PTG assets. *E.g.*, Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009, at p. 6; Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 7; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 18. For example, in reviewing the proposed PTG write-downs for the third quarter of 2008, Kenneth Cohen made notes on a document stating whether the reason for the write-down was "Credit" or "Yield." Kenneth Cohen, Lehman, Q3 Writedown Fax (Aug. 25, 2008) [LBHI_SEC07940_2278242].

[1103] Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 7.

[1104] Marking to credit would result in an increase in value if the change in the business plan resulted in an increase in expected cash flows and/or accelerated the time period in which the expected cash flows would be received.

investor's willingness to accept the risk associated with an asset decreases, the yield demanded to purchase the asset increases and the purchase price goes down.

For the valuation of equity positions in the PTG portfolio, yield is relevant for the determination of the value of the underlying collateral. For the loans and debt instruments in the PTG portfolio, yield is relevant for the same purpose, but also for determining the discount rate required for valuing the debt investments that are backed by the collateral.[1105] Both discount rates adjust value to account for the risk that the expected cash flows will not materialize, but one is in relation to the cash flows produced by the underlying collateral and the other to the cash flows produced by the debt instrument.

In short, marking to market is integral to the concept of fair value. Marking to credit involves adjusting the value for deterioration (or appreciation) of future cash flows expected from the investment. Marking to market-based yield involves discounting the cash flows expected based on a rate of return that is required by investors as of the valuation date.

[1105] For an example of a discount rate used in valuing the underlying real estate collateral, see TriMont, Asset Status Report for Heritage Fields El Toro LLC (July 1, 2008), at tab "NPV" [LBEX-BARFID 0027112]. For an example of a discount rate used in valuing the debt investments that were backed by the collateral, see Zev Klasewitz, Lehman, Single Asset Debt Model May 2008 Spreadsheet (June 14, 2008), at tab "matrix(new)" [LBEX-LL 1985749].

(a) The Role of TriMont in the Valuation Process for Lehman's PTG Portfolio

Lehman's valuation process for its PTG Portfolio began with TriMont providing asset-specific information to the PTG business desk and Product Control. On the business desk, Barsanti and Koutouvides used that information, supplemented by their knowledge of the status of the development and local market conditions, to value the PTG positions.[1106] Product Control entered the TriMont data and other data into their models to price test the valuations determined by the business desk.[1107]

PTG outsourced a substantial part of the loan servicing and asset management functions to TriMont, its primary asset servicer.[1108] Given the substantial number and geographic diversity of PTG positions, it was more cost-effective for TriMont to provide these services than to use Lehman personnel.[1109] As of May 2008, TriMont serviced over 90% of Lehman's PTG assets.[1110]

[1106] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at pp. 9, 11-12; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 11-12.

[1107] Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification Presentation to the SEC (Feb. 1, 2008), at p. 5 [LBEX-WGM 916015]; Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 8; Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at p. 5.

[1108] Lehman & TriMont, Amended and Restated Loan Servicing and Asset Management Agreement (Sept. 1, 2004), at pp. 11-12 [TR00044479].

[1109] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 9; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 8, 9-10.

[1110] *See* Zev Klasewitz, Lehman, Single Asset Debt Model May 2008 Spreadsheet (June 14, 2008) [LBEX-LL 1985749]; Zev Klasewitz, Lehman, Single Family Debt Model May 2008 Spreadsheet (June 14, 2008) [LBEX-LL 1985605]; Lehman, Single Family Equity Model May 2008 Spreadsheet (May 31, 2008) [LBEX-LL 1985924]; Lehman, Strategic Equity Model May 2008 Spreadsheet (May 31, 2008) [LBEX-BARSOX 0000594]; Zev Klasewitz, Lehman, Single Family REO Model May 2008 Spreadsheet (June 13, 2008) [LBEX-LL 1985887]; Lehman, Strategic REO Model May 2008 Spreadsheet (May 31, 2008) [LBEX-LL 1985926].

TriMont serviced loans, handled insurance issues for the underlying real estate, dealt with the administrative aspects of funding borrowings for construction, and dealt with the local developer on a regular basis regarding operational issues.[1111] With respect to the valuation process, TriMont provided Lehman with property-level data, as well as data regarding overall value of the development and the status of the project.[1112] Barsanti and Koutouvides relied on this information to value the PTG positions.[1113] Koutouvides had day-to-day responsibility for working with TriMont.[1114] Lehman's policy was to not disclose its marks to TriMont, thus ensuring that TriMont provided data free from the influence of Lehman's valuation of its investments.[1115]

[1111] Lehman & TriMont, Amended and Restated Loan Servicing and Asset Management Agreement (Sept. 1, 2004), at pp. 11-12 [TR00044479]; Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 9. PCCP, LLC, serviced a smaller number of assets that are irrelevant to this analysis. Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification Presentation to the SEC (Feb. 1, 2008), at p. 5 [LBEX-WGM 916015]; Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 10.

[1112] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 10, 14. As part of the 2007 audit, E&Y internally circulated a review of 25 positions. Memorandum from Robert Martinek, E&Y, to E&Y Audit Team for Lehman Brothers, *et al.*, re: Lehman Brothers Commercial Real Estate Portfolio (Jan. 24, 2007), at p. 1 [EY-LE-LBHI-WP-HC 000397]. TriMont provided valuation data for all of these positions, and the review concludes for all of them that TriMont provided a valuation estimate "within the expected range of probable values supported by the market." *Id.* at pp. 3, 5, 7-9, 11, 13, 15, 17-18, 20, 22, 24-25, 27, 29, 30, 32, 34-35, 37.

[1113] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 9; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 10, 14.

[1114] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 9; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 10, 14; Lehman, GREG, Introduction to Asset Management (Sept. 11, 2007), at p. 3 [LBEX-LL 2746736] (describing TriMont as "[i]dentify[ing] deals, property types, sponsors and/or markets to focus asset manager efforts" and "[d]evelop[ing] and deliver[ing] efficient reporting to [Lehman] at the deal and portfolio level (projected deal P&L, IRR returns, annual valuations, expected payoffs, etc.").

[1115] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 9; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 12.

The value of the underlying real estate — the collateral value — was the most important piece of information for purposes of valuation.[1116] For each asset, TriMont provided a collateral value eight months after Lehman made its investment, and annually thereafter.[1117] Lehman typically did not change a PTG valuation from par (*i.e.*, 100% of the investment or the funded amount) unless there was a "triggering event," such as a failure of the business plan that reduced the collateral value provided to PTG by TriMont[1118]

The data files produced by TriMont for the second quarter of 2008 categorize the collateral valuation methods in a variety of ways, but as the data was incomplete, the Examiner's financial advisor identified the method used to value collateral for 473 of the 741 positions (or 64% of the PTG portfolio).[1119] Among these 473 positions, the valuation

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[1116] Examiner's Interview of Jennifer Park, Sept. 10, 2009, at p. 8, Examiner's Interview of Abebual A. Kebede, Oct. 13, 2009, at p. 6; Examiner's Interview of Eli Rabin, Oct. 21, 2009, at pp. 6-7.

[1117] Lehman & TriMont, Amended and Restated Loan Servicing and Asset Management Agreement (Sept. 1, 2004), at p. 23. [TR00044479]. In July 2008, TriMont agreed to reduce this to three months after closing. TriMont, TriMont Valuation Methodologies for Lehman Brothers PTG and LLG Assets: General Guidelines (July 1, 2008) [LBHI_SEC07940_1201683]. TriMont listed both the "current value," which was the present value of the asset, and the "stabilized value," which was the anticipated value of the asset after the development project was completed and the asset was generating sufficient operating revenue. Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at pp. 10, 12.

[1118] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 10. Koutouvides confirmed Barsanti's statement, saying "there had to be a catalyst for the value to change." Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 10-11.

[1119] TriMont, TriMont Valuation Methodologies for Lehman Brothers PTG and LLG Assets: General Guidelines (July 1, 2008) [LBHI_SEC07940_1201683]. For examples of the TriMont export spreadsheets, see the May 2008 TriMont export spreadsheet for debt positions, TriMont, Debt Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262026], and the May 2008 TriMont export spreadsheet for equity positions. TriMont, Equity Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262362].

method used by TriMont can be separated into two general categories: historical cost-based valuation methods and market-based methods.

The historical cost-based valuation methods were used for at least 228 positions, or about 30% of the positions in the PTG portfolio in the second quarter of 2008.[1120] These methods relied primarily on capitalization of the development, along with some multiplier, to calculate collateral values.[1121] Cap * 105 was the method used for the vast majority of these positions, although variations of the capitalization method were also used.[1122]

The market-based methods were used for at least 245 positions, or 33% of the positions in the PTG portfolio in the second quarter of 2008.[1123] These categories included IRR models (80 positions), as well as other methods that incorporated market-based assumptions.[1124] However, the TriMont spreadsheets contain little explanation for several of these methods. For some categories, such as "purchase offer" (17 positions), the method appears to be self-explanatory, but the TriMont files refer to facts that were

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[1120] Cap * 105 was used for 225 of these positions and Cap * 100 for 3 positions.

[1121] Due to limitations in the data, the Examiner has not determined why any of the variants of Cap * 105 were used instead of Cap * 105, but all of them appear to be equivalent in using historical cost-based approaches in valuing collateral and not including any market data.

[1122] TriMont, Debt Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262026]; TriMont, Equity Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262362].

[1123] TriMont, Debt Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262026]; TriMont, Equity Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262362].

[1124] The full list of categories includes: purchase offer, IRR, expected sale price, market prices, sell-out calculation, paid off, property sold, and cap rate. For examples of the TriMont export spreadsheets, see the May 2008 TriMont export spreadsheet for debt positions, TriMont, Debt Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262026], and the May 2008 TriMont export spreadsheet for equity positions. TriMont, Equity Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262362].

not documented in the files.[1125] For other categories, such as one for sell-out developments (95 positions),[1126] the TriMont files simply note a "sell-out calculation" was performed, but provide very little additional information.[1127] The Examiner's financial advisor has observed that most of these methods appear to rely on market-based assumptions, but there is insufficient information for the Examiner to evaluate the inputs TriMont used or the basis for the collateral value calculated.

However, one particular market-based method for calculating collateral value was the focus of PTG and TriMont during this time – the discounted cash flow method that served as the basis for IRR models. As described below, Lehman and TriMont were in the process of incorporating IRR models throughout 2007 and 2008. Because of the increased use of IRR models, and the effect that this switch had on Lehman's valuation of PTG assets, the Examiner has focused on this method in evaluating the reasonableness of Lehman's PTG valuations during the second and third quarters of 2008.

[1125] For example, for "purchase offer," the Examiner's financial advisor has observed no evidence showing the terms of any offer from an investor or how that was used to value the collateral.

[1126] A "sell-out" development is a real estate development in which the business plan is to sell off individual units of the property rather than the property as a whole.

[1127] TriMont, Debt Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262026]; TriMont, Equity Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262362].

(i) Lehman's Issues with TriMont's Data

According to several Lehman witnesses, it was commonplace for TriMont's data to include errors.[1128] Koutouvides told the Examiner that TriMont had "weak controls" for valuing land development assets.[1129] When the data indicated that a position might need to be remarked, it was sometimes caused by an error.[1130] The errors were substantial and extensive enough that Koutouvides spent much of his time fixing TriMont's errors.[1131] Koutouvides noted that, despite instructing TriMont to fix data as to an asset in one month, the same problem would often reappear the next month.[1132] During the period in which TriMont was providing IRR models, Koutouvides

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[1128] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at pp. 13-14; Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 8; Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at p. 5; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 13. *See* Lehman, Business Requirements Document (Full) for GREG – TriMont Export File [Draft] (Oct. 29, 2007), at p. 7 [LBEX-DOCID 3501542] ("In the current system, Trimont has not modeled the exit date as a function to factor the changes in market condition. The changes in market condition may result in repayment delays and hence the exit date may change."); e-mail from Anthony J. Barsanti, Lehman, to Britt Payne, TriMont (July 25, 2007) [LBEX-DOCID 2291650] (Barsanti responding "I thought so" to Payne's message that "the value for Annapolis Junction at 100% of capitalization is overstated" and "its a write-off"); e-mail from Eli Rabin, Lehman, to Aristides Koutouvides, Lehman (Dec. 12, 2007) [LBEX-DOCID 1639358] ("According to the [TriMont] export, this property has already been sold. I know this is still an active position on the BS, so I know something is incorrect."). Because of the errors, Koutouvides considered the stabilized value reported by TriMont to be useless. Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 15.

[1129] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 13.

[1130] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 13; Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at p. 5. Platt stated that, on occasion, a position would have a value that made absolutely no sense. For example, the position should have been making money but was not. Platt stated that she would assume that TriMont's data was flawed, such as that there was a wrong maturity date that threw off the cash flows, rather than conclude that the position needed to be remarked. *Id.*

[1131] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 13.

[1132] *Id.* According to Koutouvides, PTG hired him in late 2006 in part to improve TriMont's data reporting. Koutouvides stated that, even though he had no prior real estate experience, PTG hired him from Lehman's corporate division because of his experience overhauling Lehman's IT system and infrastructure. *Id.* at p. 6.

characterized several meetings with TriMont as "screaming matches," where he and Barsanti expressed frustration at TriMont's inability to provide accurate data.[1133]

In Koutouvides' view, TriMont asset managers varied widely in ability, and some had become too close to the developers, such that the asset managers were not reporting on deteriorating local market conditions, preferring instead to rely on the developer's assurances that the project would be a success.[1134] Koutouvides recalled that, on at least one occasion, his concern that the TriMont asset managers were not obtaining credible data as to the status of the project and local market conditions resulted in his telling TriMont's asset managers to "stop feeding me bullshit. I don't believe you."[1135]

Barsanti disagreed with Koutouvides' opinion that TriMont provided high valuations, but he confirmed that there were many instances where PTG had to instruct TriMont to correct the data.[1136]

(ii) Lehman Changed Its Valuation Methodology for Its PTG Portfolio in Late 2007

As noted, until 2007 Lehman's primary method for valuing the collateral underlying its PTG positions was the Cap * 105 method. Cap * 105 calculated the

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[1133] *Id.* at p. 14.

[1134] *Id.*

[1135] *Id.*

[1136] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at pp. 13-14. Barsanti stated that, in his view, TriMont had a conservative view towards valuation. *Id.* Barsanti also stressed throughout his interview with the Examiner the difficulty of valuing PTG assets without sales data to give an indication of value. *Id.* at p. 11.

current capitalization of the underlying property (*i.e.*, outstanding debt plus equity invested to date), and then multiplied this number by 105% to estimate the value of the collateral as of the specific valuation date.[1137] The additional 5% represented the presumed appreciation of the collateral.

By late 2007, Lehman had determined that Cap * 105 was not an appropriate methodology for determining collateral value.[1138] In an upward trending market, Cap * 105 tends to undervalue collateral when appreciation occurs at a rate higher than 5%.[1139] Kebede, Vice President in Product Control, stated that Cap * 105 was a way to restrain value inflation "when the markets were going crazy."[1140] Despite pressure from auditors and other business units, PTG's policy was to not write up positions until the business plan was substantially executed and realization of gains was imminent.[1141]

When real estate values began to decline in 2007, Cap * 105 started to overvalue PTG collateral.[1142] Because Cap * 105 simply calculated current capitalization and added

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[1137] A deal's "total capitalization" includes all outstanding debt – such as loan principal – and equity as of the valuation date, including borrower's equity and/or invested capital.

[1138] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at pp. 12-13; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 15. *See* e-mail from Ed Dziadul, RealCom Financial Partners LLC, to Dennis Grzeskowiak, TriMont, *et al.* (Mar. 23, 2008) [LBEX-DOCID 2293586] (noting that TriMont's collateral valuation methodology made current value "worthless").

[1139] *See, e.g.*, Lehman, Valuation & Control Report – Fixed Income Division (Dec. 1, 2008), at p. 27 [LBEX-WGM 755798] ("Current valuation methodology for land development projects is based on cap * 105%, which was a conservative or prudent approach [in] an up-market.").

[1140] Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009, at p. 4; Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 10.

[1141] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 10; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 11. Barsanti stated that this policy came directly from Kenneth Cohen and Mark A. Walsh. Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 10.

[1142] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at pp. 12-13.

a 5% premium, it could never capture deterioration of collateral value that could happen through, for example, market-wide declines in property values. Product Control determined by the end of 2007 that although Cap * 105 "was a conservative or prudent approach [in] an up-market . . . [g]iven current market conditions, this approach may not be appropriate."[1143]

In early 2007, PTG began to enact a plan to change TriMont's provision of asset-level data.[1144] This overhaul in the reporting system was intended to require TriMont to provide support for assumptions about assets and to be more responsive to marketplace changes.[1145] As part of that overhaul, PTG decided that Cap * 105 was "not going to cut it," and planned to have TriMont's calculation of collateral value move to a more market-based methodology.[1146] PTG and TriMont referred to the new models based on this methodology as IRR models.

Barsanti and Koutouvides preferred IRR models to Cap * 105 because the models had the ability to value collateral under a discounted cash flow method, which Barsanti and Koutouvides considered to be the best method for valuing collateral for PTG

[1143] *See, e.g.*, Lehman, Valuation & Control Report – Fixed Income Division (Dec. 1, 2007), at p. 27 [LBEX-WGM 755798].

[1144] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at pp. 12-13; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 15.

[1145] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 4, 15.

[1146] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 13.

positions.[1147] Under the discounted cash flow method, an IRR model calculated the current value of collateral by determining the Net Present Value ("NPV") of all monthly discounted Net Cash Flows ("NCF").[1148] As a first step, the IRR model calculated the NCF produced by the asset by taking monthly expected revenue and subtracting monthly expected expenses.[1149] To this result, the IRR model applied a discount rate to produce the NPV of the NCF. In order to reflect fair value, the discount rate should reflect, for both equity and debt investments, the yield an investor would require to purchase the property. However, Lehman generally attributed a discount rate for the equity portion of the capital structure based on Lehman's expected rate of return (*i.e.* 20% for land developments) and, for debt, a discount rate based on the interest rate associated with the underlying loans at origination.[1150] The IRR models took a weighted

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[1147] *Id.*; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 4, 15. The Examiner's financial advisor has observed that IRR models are a flexible tool for valuing collateral and do not necessarily use the discounted cash flow method for every valuation. However, the primary reason PTG required TriMont to use IRR models was that they performed a discounted cash flow analysis. *Id.*

[1148] TriMont, TriMont Valuation Methodologies – Lehman PTG and LLG CMBS Hold Assets (Apr. 28, 2008) [LBEX-DOCID 2089942]. The cash flows in this calculation included the cash flows expected to be generated by the property that would be available for distribution to all investors.

[1149] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 14. Revenues consisted of all of the income that the investors in the property expected to generate from the time of investment through execution of the exit strategy. As of 2007, the revenues for PTG assets typically were the sales revenue once the project was completed (*i.e.*, sale of a hotel), but sometimes the asset generated revenue in the form of rent, portions of a development sold, or other payments before its sale. Expenses could include anything the investors expected to pay in development costs (*i.e.*, entitling land, construction), financing costs (*i.e.*, loan fees, interests), or other indirect costs (*i.e.*, administrative fees, marketing).

[1150] TriMont, TriMont Valuation Methodologies – Lehman PTG and LLG CMBS Hold Assets (Apr. 28, 2008) [LBEX-DOCID 2089942].

average between these two rates to arrive at the weighted average discount rate for the property.[1151]

Instead of referring just to what Lehman and the other investors paid for the position to reflect current value, IRR models had the advantage of incorporating future events (projected revenues and expenses) into the present value, and then discounting that value in recognition of the risk that the investment might not be successful. Cap * 105 incorporated no discount for risk, and therefore, generally produced higher collateral values than IRR models in a downward trending market.[1152]

The IRR models were implemented on a rolling basis and the models were calibrated after they were put into use.[1153] TriMont started implementing the IRR models in California in 2007, as valuation of California land developments was a primary source of concern for PTG.[1154] Koutouvides and Barsanti worked closely with TriMont in implementing the IRR models, and Koutouvides stated that in March 2007 he was "on a plane all the time" to visit TriMont.[1155]

[1151] The weighted average was based on the outstanding debt and the equity invested to date.

[1152] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 15; Examiner's Interview of Jonathan Cohen, Jan. 22, 2010, at p. 4.

[1153] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 15. Koutouvides managed the process of acquiring the models, reviewing them with Barsanti, and following up with TriMont to fix errors in the data. *Id.* at p. 10.

[1154] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 13; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 15.

[1155] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 14. *See* e-mail from Lori Giesler, TriMont, to Chris W. Warren, Lehman (Jan. 21, 2007) [LBEX-DOCID 3606437]. Barsanti occasionally joined Koutouvides on these trips. *See* e-mail from Dennis Grzeskowiak, TriMont, to Jim Hill, TriMont, *et al.* (Mar. 7, 2008) [LBEX-DOCID 2293369].

The rollout of IRR models experienced many delays, and TriMont missed several deadlines in 2007 and 2008, causing more frustration for PTG.[1156] For example, after one missed deadline, Barsanti stated in a March 2007 e-mail that "[a]s the market continues to soften, I can't tell you how much we depend on these IRRs to mark our position."[1157] Over a year later, on March 23, 2008, an e-mail sent to TriMont by a PTG consultant indicated that the Cap * 105 method, which was still widely in use, was "worthless."[1158] In Product Control's Valuation & Control Reports, the same comment appears unchanged over a series of months, stating that TriMont was developing IRR models "and walking away from cap * 105% methodology."[1159] Because of the delays,

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[1156] *See* e-mail from Dennis Grzeskowiak, TriMont, to Jim Hill, TriMont, *et al.* (Mar. 7, 2008) [LBEX-DOCID 2293367] ("They are refusing to fund the Monte Sereno draw request until the IRR model is updated to reflect the current scenario."); e-mail from Aristides Koutouvides, Lehman, to Anthony J. Barsanti, Lehman (Mar. 7, 2008) [LBEX-DOCID 2293369] ("[T]hey [TriMont] need to update the model accurately before the final number can be determined."); e-mail from Dennis Grzeskowiak, TriMont, to Ed Dziadul, RealCom Financial Partners LLC (Mar. 23, 2008) [LBEX-DOCID 2293586] (containing an e-mail exchange revealing Dziadul's concern as to why "Current Value . . . determined by discounting the 'Remaining Value' to the Exit Date" was not being applied universally and Grzeskowiak's response that "[t]hat ties to TriMont's current valuation methodology . . . we're working on revising that policy"). Barsanti stated that many times he was "laying the hammer down" on TriMont because of its delays, which made updating the collateral values "lumpy." Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 13.

[1157] E-mail from Anthony J. Barsanti, Lehman, to Lori Giesler, TriMont, *et al.* (Mar. 13, 2007) [LBEX-DOCID 2290789].

[1158] E-mail from Ed Dziadul, RealCom Financial Partners LLC, to Dennis Grzeskowiak, TriMont, *et al.* (Mar. 23, 2008) [LBEX-DOCID 2293586]. Dziadul was a former PTG employee located in California who, after leaving Lehman, assisted with TriMont's implementation of IRR models. Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 13.

[1159] Lehman, Valuation & Control Report – Fixed Income Division (June 2008), at p. 29 [LBEX-WGM 370046]; Lehman, Valuation & Control Report – Fixed Income Division (July 1, 2008), at p. 29 [LBEX-WGM 790236]; Lehman, Valuation & Control Report – Fixed Income Division (Aug. 2008), at p. 29 [LBEX-BARFID 0000260]. *See also* e-mail from Brian Barry, Lehman, to Jeffrey Goodman, Lehman, *et al.* (June 19, 2008) [LBHI_SEC07940_2234984] ("Within the last 6+/- months, a change to the methodology (for valuations) was implemented by Trimont (at the request of Prod Control & the business). Trimont has

Koutouvides stated that he often still relied on collateral values based on Cap * 105 in marking positions, as it was the only available information.[1160]

As noted, TriMont's data provided to Lehman did not contain the information necessary to identify the methods used to value the collateral for each PTG position.[1161] However, in May 2008, at least 228 PTG positions still relied on some variant of the capitalization method (such as Cap * 100 and Cap * 105) to value their collateral.[1162] This represented roughly a third of the PTG portfolio. The Examiner's financial advisor has identified IRR models for 80 PTG positions in the second quarter of 2008.[1163] By July 2008, that total for IRR models found increased to 292. Due to limitations in the data, the Examiner's financial advisor has identified only 105 positions that switched from Cap * 105 to IRR models between May and July of 2008.[1164] Barsanti and Koutouvides

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made tremendous progress in implementing these changes, it is just a question of how much has actually made it to the export we receive. With that said, Trimont is actively updating current values."); TriMont, TriMont Valuation Methodologies – Lehman PTG and LLG CMBS Hold Assets (Apr. 28, 2008) [LBEX-DOCID 2089942] (replacing 105% of cap methodology with "[l]esser of 100% of Total Cap or the NPV of all monthly NCF's").

[1160] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 15.

[1161] The Examiner determined that it would not be a prudent use of resources to interview numerous TriMont asset managers to determine if they could recall information that was not set forth in the reports provided to Lehman.

[1162] TriMont, Debt Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262026]; TriMont, Equity Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262362].

[1163] TriMont, Debt Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262026]; TriMont, Equity Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262362].

[1164] TriMont, Debt Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262026]; TriMont, Equity Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262362]; TriMont, Debt Export as of July 5, 2008 (Aug. 1, 2008) [LBEX-AM 267134]; TriMont, Equity Export as of July 5, 2008 (Aug. 4, 2008) [LBEX-AM 267510]. The Examiner's financial advisor has identified 153 positions that transitioned from Cap * 105 (or its variants) to a different valuation method, but has not identified what that new method was for 75 positions. There

asserted that, by July 2008, TriMont had implemented use of IRR models for all of the land deals managed by its California office (which had approximately 100 positions) and 80% of those managed by its larger Atlanta office.[1165]

(b) The Role of Lehman's PTG Business Desk in the Valuation Process for Lehman's PTG Portfolio

Since PTG assets were risky, illiquid, medium-to-long term investments, the business desk had a difficult time valuing them, particularly during a market downturn.[1166] Under the classification scheme established by SFAS 157, which categorizes assets based on the degree of certainty the valuation process can provide, almost all PTG assets were classified as Level 3, whose values are the most subjective because they depend on unobservable inputs.[1167]

Consistent with the unobservable nature of the valuation inputs, the Examiner's financial advisor has observed that Lehman's records do not indicate the direct relation between the collateral values provided by TriMont and the business desk's mark.

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is a high likelihood that there were more than 105 positions that transitioned from Cap * 105 to IRR models in July 2008.

[1165] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 13; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 15.

[1166] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at pp. 11-14; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 8-9, 13.

[1167] Fin. Accounting Standards Bd., Fair Value Measurements, SFAS No. 157, ¶¶ 21-22, 24 (2006); Lehman, Global Real Estate Inventory Spreadsheet as of May 31, 2008 (Aug. 8, 2008) [LBEX-DOCID 2077095]. As of May 31, 2008, PTG held no Level 1 assets, 6 Level 2 assets, and 380 Level 3 assets. Lehman, Global Real Estate Inventory Spreadsheet as of May 31, 2008 (Aug. 8, 2008) [LBEX-DOCID 2077095]. The remainder of PTG assets were "Consolidated" assets and not subject to SFAS 157. *See* Lehman Brothers Holdings Inc., Press Release: Lehman Brothers Reports First Quarter Results (Mar. 18, 2008), at p. 14 [CITI-LBHI-EXAM 00078274]; Consolidation of Variable Interest Entities, Interpretation of Fin. Accounting Standards No. 46 (Fin. Accounting Standards Bd. 2003).

Lehman's asset managers, Barsanti and Koutouvides, routinely had to look beyond TriMont's data and refer to the business plans and sub-market data for a particular property type, and then exercise independent judgment as to how much the collateral's current value, as determined by the information provided by TriMont, should inform the mark.[1168] Although PTG's records set forth the status of each project, including any problems that the development was experiencing, they do not describe how Lehman employed its judgment to translate such problems into a write-down of a particular amount for the corresponding PTG asset.[1169]

Koutouvides described his valuation process as casting a net with TriMont's data to identify "outliers" and closely observing those positions to determine which ones needed to be remarked.[1170] According to Koutouvides, Lehman's policy for re-valuing a position was that "there had to be a catalyst for the value to change," such as a failure of the business plan.[1171] Koutouvides focused on harder-to-value land and condominium positions.[1172] Notably, 99% of write-downs taken on the PTG portfolio during 2008 related to positions with land or condominiums as collateral.[1173] When the reliability of

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[1168] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at pp. 9, 11, 13-14.

[1169] For example, the Examiner's financial advisor has observed that TriMont's IRR models and Lehman's price testing files do not indicate how exactly the business desk used this information to mark the portfolio or write down assets. *See, e.g.,* TriMont, Asset Status Report for Heritage Fields El Toro LLC (July 1, 2008) [LBEX-BARFID 0027112]; Lehman, Valuation & Control Report – Fixed Income Division (May 2008), at p. 22 [LBHI_SEC07940_2554301].

[1170] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 13.

[1171] *Id.* at pp. 10-11.

[1172] *Id.* at p. 12.

[1173] Lehman, Global Real Estate 2008 Net Mark Downs (Sept. 5, 2008) [LBEX-AM 346991].

TriMont's method for calculating collateral values improved through the shift to IRR models, Barsanti and Koutouvides relied on those values more frequently, but nothing TriMont provided was taken as "gospel" by the business desk.[1174]

(c) The Role of Lehman's Product Control Group in Price Testing the Valuation of Lehman's PTG Portfolio

Separate from the marking process of the PTG business desk, the Product Control Group performed an independent price verification of the PTG marks. Jonathan Cohen oversaw Product Control's valuation and price testing, and Abebual A. Kebede worked under him and had day-to-day oversight of the Product Control staff.[1175] Directed by Kebede, two junior product controllers ran models to generate test prices for PTG positions.[1176] Eli Rabin performed price testing on all PTG positions until early 2008, when Lehman hired Rebecca Platt to price test the PTG debt positions.[1177]

Product Control performed the price testing process for a given month at the beginning of the following month and performed its most thorough price testing at quarter end.[1178] To price test, product controllers fed collateral values and other inputs

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[1174] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 14.

[1175] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at pp. 6-7.

[1176] Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification Presentation to the SEC (Feb. 1, 2008), at p. 3 [LBEX-WGM 916015].

[1177] *Id.*; Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 4; Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at p. 4. Included in the price testing for PTG equity were the positions on which Lehman foreclosed and re-categorized as real estate owned. Lehman, Real Estate Monthly Price Verification Policy and Procedures (July 16, 2008), at p. 12 [LBEX-DOCID 1454682].

[1178] Lehman, Real Estate Price Verification Presentation [Draft] (July 17, 2008), at p. 1 [LBHI_SEC07940_1169231] ("Price Verification is performed on a monthly basis"); Lehman, Real Estate Monthly Price Verification Policy and Procedures (July 16, 2008), at p. 11 [LBEX-DOCID 1454682] ("The

into their models to produce a model price for the debt or equity position, which was compared with the business desk's value. The difference between the two was termed a "variance."[1179]

Rabin and Platt used the same asset-specific data that TriMont provided to the business desk.[1180] They generally applied the collateral values provided by TriMont, whether they were based on Cap * 105 or IRR models.[1181] However, Rabin told the Examiner that both of his superiors in the Product Control Group and business desk personnel sometimes instructed him to disregard the current value provided by the models.[1182] Product Control knew that Cap * 105 caused inaccurate valuations of collateral, but those collateral values were still used in the absence of IRR models.[1183] Platt told the Examiner that she observed a sudden drop in collateral values across the PTG debt book when more IRR models were incorporated in July 2008.[1184] In addition,

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quarterly analysis is a much more detailed analysis of pricing variances resulting from the routine monthly process."); Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 5.

[1179] Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009, at p. 5.

[1180] Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification Presentation to the SEC (Feb. 1, 2008), at p. 5 [LBEX-WGM 916015]; Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 8; Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at p. 5. Rabin and Platt could contact TriMont on their own to discuss the data. *See, e.g.*, e-mail from Harding Brannon, TriMont, to Rebecca Platt, Lehman (Mar. 13, 2008) [LBEX-DOCID 1802324].

[1181] Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 8; Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at p. 5.

[1182] Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 8.

[1183] Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009, at p. 7; Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 7. Rabin stated that the Cap * 105 pricing methodology often caused his price verification models to suggest that the values of a PTG position should be written up, even when Rabin had specific knowledge that the underlying deal was not performing well. Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 7.

[1184] Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at p. 7.

the price testing results at this time showed that the marks overvalued the PTG debt book.[1185]

The price testing models for PTG debt used market data to apply a discount rate (or yield) to account for the market-based risk of an investment in the debt of that property type. The risk level was in part determined by the Loan-to-Value ratio ("LTV"), which is the ratio of the value of the outstanding debt divided by the value of the collateral. After determining the LTV of a debt position, Platt referred to the Real Estate Finance & Investments newsletter, which provided discount rates based on LTV and property type.[1186] Platt then applied the appropriate discount rate to determine the present value of the debt position.[1187]

To price test equity positions,[1188] Rabin's models performed a "waterfall" analysis to check the marks, which is a process that examines the distribution of proceeds from a hypothetical sale of the collateral.[1189] In the waterfall analysis any outstanding debt is

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[1185] *Id.* at pp. 7, 10-11.

[1186] E-mail from Rebecca Platt, Lehman, to Abebual A. Kebede, Lehman (June 16, 2008) [LBHI_SEC07940_2945503]; Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at p. 8. The property types were residential, apartments, retail, malls, strip and power centers, industrial, multi-tenant, office, CBD, suburban, and hotel. *See* Institutional Investors, Inc., Real Estate Fin. & Inv. Newsl., May 26, 2008, at p. 7 [LBHI_SEC07940_2945508]; Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification Presentation to the SEC (Feb. 1, 2008), at p. 6 [LBEX-WGM 916015].

[1187] Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at p. 8. There were additional, more technical steps in this process, where the present value calculated by the model was compared to other benchmark values, such as the value of proceeds from the collateral in a liquidation scenario, and the lowest number after these comparisons became the model output. Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification Presentation to the SEC (Feb. 1, 2008), at p. 6 [LBEX-WGM 916015].

[1188] PTG REO positions were tested with a similar process as that for PTG equity. Lehman, Real Estate Monthly Price Verification Policy and Procedures (July 16, 2008), at p. 12 [LBEX-DOCID 1454682].

[1189] Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 6.

assumed to be paid out first, with equity holders entitled to the remaining proceeds subject to the terms of any shareholder agreements.[1190]

As noted, after Product Control calculated the model price for a debt or equity position, this price was compared to the business desk's mark to determine the variance. Lehman's policy was that "[v]ariances outside thresholds are discussed with the business for potential mark adjustments."[1191] In the PTG debt and equity models, the threshold for an overvaluation variance was $2 million and the threshold for an undervaluation variance was $5 million.[1192] If Rabin and Platt were unable to resolve the variance with the business desk, the issue was escalated to Kebede and Jonathan Cohen, who could then, if necessary, direct these valuation issues to Lehman's senior managers.[1193]

[1190] *Id.* at p. 6. The models assumed distribution of cash flows in the following order: (1) pay off full amount of debt; (2) distribution to owners for accumulated preferred returns; (3) distribution to owners for return of capital; and (4) distribution to owners for split of any remaining profit according to their profit and loss sharing ratios. Lehman, Real Estate Monthly Price Verification Policy and Procedures (July 16, 2008), at p. 12 [LBEX-DOCID 1454682]; Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification Presentation to the SEC (Feb. 1, 2008), at p. 8 [LBEX-WGM 916015].

[1191] Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification Presentation to the SEC (Feb. 1, 2008), at pp. 6, 8 [LBEX-WGM 916015].

[1192] For an example of such thresholds in the PTG debt price testing models, see formula in cell BF4 on the "Pricing" tab of Lehman's Single Asset Debt Model from May 2008. Zev Klasewitz, Lehman, Single Asset Debt Model May 2008 Spreadsheet (June 14, 2008), at tab "Pricing," cell BF4 [LBEX-LL 1985749]. For an example of such thresholds in the PTG equity price testing models, see Excel's filter function applied to column BA on the "Valuation" tab of Single Family Equity Pricing Model from June 2008. Lehman, Single Family Equity Model June 2008 Spreadsheet (June 30, 2008), at tab "Valuation" [LBEX-BARFID 0023444].

[1193] *See, e.g.*, e-mail from Rebecca Platt, Lehman, to Abebual A. Kebede, Lehman (June 18, 2008) [LBHI_SEC07940_2949726] (stating that she "wanted to discuss the comment [for positions that had pricing variances] with [Kebede] because they [were] foreclosures"); Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 4; Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at pp. 5, 10-11.

As a result of this escalation and resolution process, the positions for which variances exceeded the given threshold were either remarked or resolved.[1194] If remarked, the business desk lowered or raised its mark in light of the Product Control test price.[1195] If resolved, the business desk's mark would remain the same and Product Control provided an explanation for why the position was not remarked.[1196] The goal of the explanation, noted in Product Control's monthly Valuation & Control Report, was to provide information not captured by the models that justified disregarding the model price and maintaining the desk mark.[1197]

Platt and Kebede told the Examiner that they often had difficulty explaining why positions were not remarked and that in these situations they came up with formulaic explanations.[1198] As a result, Platt stated that many of the explanations she provided for not changing the marks in the PTG debt pricing models were not meaningful and contained many "form" responses, such as "Based on discussions with the business,

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[1194] Lehman, Global Real Estate Product Control, Real Estate Americas, Price Verification Presentation to the SEC (Feb. 1, 2008), at p. 21 [LBEX-WGM 916015]; Lehman, Real Estate Price Verification Presentation [Draft] (July 17, 2008), at p. 1 [LBHI_SEC07940_1169231].

[1195] Lehman, Real Estate Price Verification Presentation [Draft] (July 17, 2008), at p. 1 [LBHI_SEC07940_1169231].

[1196] *Id.*

[1197] *Id.*; Lehman, Global Real Estate Product Control, Real Estate Americas Price Verification Presentation to the SEC (Feb. 1, 2008), at p. 21 [LBEX-WGM 916015]; Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009, at p. 5; Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at pp. 10-11.

[1198] Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009, at pp. 10-11 (noting that he wrote explanations for marks and that he agreed with "some of them"); Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at p. 4.

position is marked appropriately" and "continue to monitor."[1199] Kebede confirmed that no write-down was taken for many of the positions for which a significant price testing variance was determined in the third quarter of 2008.[1200] Kebede stated that, although there was a valid explanation for not writing down some of these positions, he wrote or oversaw the writing of several "form" responses he did not actually agree with that were only written to come up with something.[1201]

(d) The Influence of Lehman's PTG Business Desk upon the Price Testing Function of Lehman's Product Control Group

Several witnesses gave conflicting statements as to whether Product Control had the ability to effectively provide an independent check on the business desk marks. Walsh told the Examiner that Product Control existed on an independent track and could not be "frozen out" of the valuation process.[1202] Kenneth Cohen also stated that Product Control ran on a "parallel track," and came up with its own numbers running its own models.[1203] Kenneth Cohen stated that the business desk had no control over Product Control and that, if the business desk could not convince Product Control that

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[1199] *See e.g.*, Lehman, Valuation & Control Report – Fixed Income Division (May 2008), at p. 22 [LBHI_SEC07940_2554301] (noting, with respect to Calwest and the Nashville Portfolio, that "[b]ased on discussion with [the] desk . . . . No markdown suggested"); Lehman, Valuation & Control Report – Fixed Income Division (July 2008), at pp. 22-23 [LBEX-WGM 790236] (stating, with respect to several positions for which no write-down was taken, including Whitworth Estates Senior, "[i]n discussion with the business"); Lehman, Valuation & Control Report – Fixed Income Division (Aug. 2008), at pp. 22-23 [LBEX-BARFID 0000260] (stating, with respect to Whitworth Estates Senior Whole, "[b]ased on discussions with the business, position is marked appropriately"); Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at pp. 10-11.

[1200] Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009, at p. 5.

[1201] *Id.*; Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at pp. 10-11.

[1202] Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 13.

[1203] Examiner's Interview of Kenneth Cohen, Oct. 20, 2009, at p. 10.

a number was correct, Product Control could elevate the issue, all the way up to Reilly if necessary.[1204]

Koutouvides considered the Product Control process to be credible, but stated that if there was a difference of opinion between Product Control and the business desk regarding valuation of a PTG asset (which Koutouvides estimated as happening three times a month), the mark did not change.[1205] Koutouvides confirmed that he did not take a suggested write-down from Product Control unless he was convinced that the price testing model was correct.[1206] With the market fluctuation in 2008, Koutouvides stated he was reluctant to remark a position only based on price testing until he could see where the asset was trending after another quarter.[1207] The process resulted in staggered write-downs, where a lag existed between identification of a trend and the resulting write-down.[1208]

Jonathan Cohen described Product Control as compromised by a lack of information, and stated that Product Control often took the business desk's word on

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[1204] *Id.*

[1205] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 16-17.

[1206] *Id.*

[1207] Lehman, Valuation & Control Report – Fixed Income Division (Aug. 2008), at pp. 21-23 [LBEX-BARFID 0000260]; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 16-17.

[1208] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 16-17. As an illustrative example, if the model suggested a $20 million write-down and if Lehman believed that there was a 60% chance that a write-down was appropriate, Lehman would take a $12 million write-down ($20 million * 60% = $12 million). In some instances, Lehman would wait a quarter to see what happened before taking the $12 million write-down.

valuation issues.[1209] For example, Jonathan Cohen pointed out that Product Control used the same discount rate for collateral that the business desk used (*e.g.*, 20% for equity investments in land developments).[1210]

Kebede stated that the "form" comments he used to explain why a position was not remarked, such as "based on discussions with the business," indicated that he could not think of anything else to explain as the reason for keeping the current mark and that, in some cases, he may not have actually agreed with the comment.[1211] Certain e-mails confirm that Kebede's work was to some extent influenced by the PTG business desk. On August 30, 2008, Koutouvides e-mailed Kebede stating that "Anthony [Barsanti] and I have given you guidance on the senior deals that we feel were incorrect. Please make the changes and let us know how this changed the total."[1212]

Rabin also stated that, in most matters, he deferred to the judgment of Koutouvides on the business desk, given Koutouvides' familiarity with the valuation models and the underlying business fundamentals of each position.[1213]

Platt stated that despite the fact that her models produced large overvaluations in the third quarter of 2008 (which she stated was after the integration of a significant

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[1209] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 5.

[1210] Examiner's Interview of Jonathan Cohen, Jan. 22, 2010, at p. 4.

[1211] Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009, at p. 5.

[1212] E-mail from Aristides Koutouvides, Lehman, to Abebual A. Kebede, Lehman (Aug. 30, 2008) [LBHI_SEC07940_212040]. *See also* e-mail from Abebual A. Kebede, Lehman, to Anthony J. Barsanti, Lehman, *et al.* (Aug. 27, 2008) [LBEX-DOCID 4449124] (Kebede asking Barsanti "not a large number [$1.4 million], should we look to a write-off?").

[1213] Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 8.

number of IRR models), write-downs were not taken for many PTG assets.[1214] Platt stated that Lehman did not pay much attention to her third quarter 2008 price testing results, characterizing the Product Control Group as, "kind of sadly, the little people."[1215]

(5) The Examiner's Findings and Conclusions as to the Reasonableness of Lehman's Valuation of PTG Portfolio

The Examiner finds sufficient evidence to support a determination that Lehman did not appropriately consider market-based yield when valuing PTG assets in the second and third quarters of 2008. While the Examiner recognizes that the valuation of illiquid assets requires judgment and that there is a wide range of reasonable valuations for any particular asset, Lehman's systemic failure to incorporate a market-based yield generally resulted in an overvaluation of PTG assets. Accordingly, the Examiner finds that there is sufficient evidence to support a finding, for purposes of a solvency analysis, that the values Lehman determined for certain of these assets were unreasonable.

The evidence supports a finding that, as real estate markets deteriorated and investors increased their required rates of return, Lehman was unable to quickly replace Cap * 105 with a valuation methodology that employed market-based yields. Furthermore, even when Lehman did implement a valuation methodology that applied

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[1214] Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at pp. 7, 10-11.
[1215] *Id.* at p. 11.

a yield — IRR models — the yields reflected the weighted average of the contractual interest rate for debt at origination and Lehman's expected rate of return for equity (*i.e.* 20% for land developments), rather than market-based rates.

The Examiner does not find sufficient evidence that Lehman's failure to employ appropriate yields for PTG assets during the second and third quarter of 2008 supports a finding that any Lehman officers breached their fiduciary duties.[1216] Although there is sufficient evidence to demonstrate that the valuation methodology for PTG assets did not rely on market-based assumptions, there is insufficient evidence to demonstrate that any Lehman officer acted with an intent to produce incorrect values or conducted the valuation process in a reckless manner. While Lehman's staffing was inadequate to comprehensively value or test the significant number of positions in the PTG portfolio, and there was also questionable judgment in the selection of yields, the valuation determined by Lehman did not result from actions (or omissions) that would support a claim of a breach of fiduciary duty.

The Examiner has determined that it would not be a prudent use of resources to perform an independent valuation of every PTG asset by selecting the market-based yield that would have been applicable in the second and third quarters of 2008. The uniqueness and illiquidity of PTG assets, combined with the volatile 2008 market, create

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[1216] *See* Appendix 1, Legal Issues, Section II, for a more detailed discussion of the legal standard governing a claim of breach of fiduciary duty.

a high risk of error for any portfolio-wide estimate of market-based yield.[1217] Instead of attempting to cast a wide net, the Examiner has made observations about PTG's application of yield generally and has investigated select positions in greater detail, as discussed below.[1218]

(a) Lehman Did Not Mark PTG Assets to Market-Based Yield

Former Lehman personnel provided conflicting statements as to whether PTG assets were valued at the price at which the asset could be sold, and in particular, whether the valuation took into account the market-based yield that would be required by an investor in light of then-current market conditions. However, the statements of those most deeply involved in the process of valuing PTG assets, as well as the documentary evidence, provide sufficient evidence to support a finding that Lehman did not mark its PTG assets to market-based yield in the second and third quarters of 2008.

Mark Walsh, head of GREG, did not indicate to the Examiner whether PTG assets were marked at a price at which they could be sold, but stated that Lehman

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[1217] This is especially true in that the Examiner's financial advisor has had limited time to review Lehman's files on PTG assets and has had limited data made available during the discovery process. The Examiner's financial advisor did not find sufficiently detailed information to value many PTG assets. Several witnesses were also unable to remember anything related to the valuation of specific assets. *See, e.g.*, Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009, at p. 5; Examiner's Interview of Eli Rabin, Oct. 21, 2009, at pp. 9, 11-12; Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at pp. 7, 9, 10-11; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 18 (providing very few details on Heritage Fields).

[1218] The chief criteria for selecting the assets (or groups of assets) analyzed below is whether the Examiner's financial advisor received sufficient information to issue a conclusion as to the valuation process for these assets in the second and third quarters of 2008.

"always" marked CRE assets to both credit and yield, although he conceded that it became difficult to mark to market-based yield as market conditions deteriorated during 2008.[1219] Walsh also stated that he was not normally involved in valuation issues and that Barsanti and Kenneth Cohen were more knowledgeable about PTG valuation.[1220]

Kenneth Cohen told the Examiner that PTG assets were marked to the price at which the assets could be sold to an investor.[1221] He stated that marking to both credit and market-based yield were components of PTG's valuation process.[1222] Kenneth Cohen described the PTG approach as "marking-to-model" but was clear that the model price was intended to incorporate Lehman's best judgment as to the market-based yield and reflect the price at which the asset could be sold.[1223] He also stated that a write-down based on credit should also encapsulate the effect of changes to market-based yield as well.[1224] However, Kenneth Cohen also stated that determining the PTG marks was primarily Barsanti's job.[1225]

[1219] Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 13.

[1220] *Id.*

[1221] Examiner's Interview of Kenneth Cohen, Jan. 21, 2010, at p. 4.

[1222] *Id.*

[1223] *Id.* He maintained this position even as he described PTG's valuation process as based on "mark-to-model," which implies that Lehman valued positions by selecting its own assumptions and inputs for the model. *Id.*

[1224] *Id.* Jonathan Cohen also said that where a notation in a Lehman document indicated that a write-down was made due to credit, yield was also taken into account. Examiner's Interview of Jonathan Cohen, Jan. 22, 2010, at p. 4.

[1225] Examiner's Interview of Kenneth Cohen, Jan. 21, 2010, at p. 2. Kenneth Cohen could not recall the specifics of any particular discussion regarding PTG marks and, in particular, did not remember the

Barsanti told the Examiner that Lehman was "probably not marking to yield," and instead would mark PTG assets based more on a "gut feeling" about the position in relation to the market.[1226] Barsanti, who both Walsh and Kenneth Cohen identified as the person principally responsible for determining PTG marks, stated that he did not know whether PTG assets could be sold for the price at which they were marked and stated he had not thought about it.[1227] As discussed below, Barsanti's statement is consistent with the Examiner's finding that PTG assets were generally marked in light of whether the development was proceeding according to plan, and not according to the return that an investor would require to purchase the position.

Koutouvides, who reported to Barsanti, spent substantially all of his time working on valuing PTG assets.[1228] Koutouvides stated that the PTG business desk did not mark to market-based yield in the second and third quarters of 2008, explaining that the desk's asset valuations did not reflect what a buyer would pay for the assets on the open market at that time.[1229] Koutouvides stated that Lehman's values for assets did not equal the prices at which they could be sold on the market and noted, regarding

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valuation methodologies used by PTG. *Id.* As discussed herein, the use of IRR models in place of Cap * 105 to determine collateral values was a principal driver behind the approximately $214 million in write-downs that were proposed but not taken in the third quarter of 2008. Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 9.

[1226] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 11.

[1227] *Id.*

[1228] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 13.

[1229] *Id.* at pp. 11-12. He stated that only assets marked for credit impairment were taken. *Id.*

Lehman's marks, "no one would pay you that."[1230] He stated that any sale of illiquid PTG assets would be steeply discounted, due to the many unique factors related to the development of the underlying real estate.[1231] These factors included the uncertainty surrounding the process of entitling the property and the relationship with the developer who was responsible for the day-to-day management of the project.

Koutouvides also stated that Lehman did not originate positions at the carrying yields used in 2008, meaning Lehman would not enter into investments at the yields it used to value its positions.[1232] In effect, by 2008 Lehman required a higher rate of return when making a new investment than it would use when marking an equivalent position that was already included in the PTG portfolio.

However, Koutouvides stated that despite not marking to yield, the assets were marked at "fair market value."[1233] According to Koutouvides, the selection of yield was largely immaterial because it would not make much difference over the short duration of the loans associated with PTG debt positions.[1234] Koutouvides also pointed to the two to five years that Lehman typically held PTG assets, arguing that it was inappropriate to focus on the value of the investment in the current market environment when Lehman

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[1230] *Id.* at p. 12.

[1231] *Id.*

[1232] *Id.* at p. 3.

[1233] *Id.* at pp. 11-12; Lehman, Q3 Firmwide Q&A – Summary [Draft] (Sept. 2008), at p. 43 [LBHI_SEC07940_743659] (noting generally that the assets in the CRE portfolio were subject to "fair value (mark to market) accounting").

[1234] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 3.

had no intention to sell the position in the near future.[1235] Koutouvides explained that, although a sudden decline in values could have a huge effect on the value of the property, the value of a PTG asset did not strictly correlate with market trends.[1236] Koutouvides dismissed the argument that PTG assets should have been marked based only on macroeconomic trends observed in the 2008 market.[1237]

Jonathan Cohen told the Examiner that it was fair to say that, in the second and third quarters of 2008, the PTG portfolio was generally not marked at prices at which the assets could be sold.[1238] Jonathan Cohen stated that, due to the large pricing variances between sellers and buyers in the market at that time, many buyers were offering what he thought of as "fire sale" prices.[1239] He expressed the view that PTG was not required to mark its assets at these "fire sale" prices. Specifically, he pointed to a significant number of positions that were carried at 90% of par value and stated that "a willing buyer was not going to pay that."[1240]

With respect to the valuation of PTG assets in the second quarter of 2008, Jonathan Cohen noted that the Cap * 105 method provided no way to mark to credit or

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[1235] *Id.* at p. 11. *See* Lehman, Q3 Firmwide Q&A – Summary [Draft] (Sept. 2008), at p. 43 [LBHI_SEC07940_743659] (noting generally for assets in the CRE portfolio that a separate entity – "REI Global" – would be able to manage assets "with a longer time horizon than Lehman would have in the current market environment").

[1236] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 11.

[1237] *Id.*

[1238] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 5.

[1239] *Id.*

[1240] *Id.*

yield.[1241] He stated that during this time, PTG assets were generally marked to the yield that was incorporated into Lehman's plan for the investment, and that assets were only written down when PTG had specific information that a project was experiencing difficulties.[1242]

When TriMont provided more IRR models in the third quarter of 2008, Jonathan Cohen stated that PTG was then able to mark to market-based yield.[1243] Cohen stated that he never considered marking to market-based yield a concern until this time, when the IRR models were producing materially lower collateral valuations, and in turn indicating materially lower values for PTG assets.[1244] Cohen identified approximately $714 million of PTG write-downs for the quarter, and only approximately $504 million of such write-downs were taken.[1245]

The documentary evidence also supports Cohen's assertion that Lehman generally marked for credit and not yield. A document listing Lehman's third quarter 2008 write-downs shows that 93% of those write-downs were based on credit impairment, with only the remaining 7% related to yield.[1246] Although both Jonathan

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[1241] *Id.* at pp. 4-5.

[1242] Examiner's Interview of Jonathan Cohen, Jan. 22, 2010, at p. 4.

[1243] *Id.*; Examiner's Interview of Jonathan Cohen, Jan, 11, 2010, at pp. 4-5.

[1244] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 5; Examiner's Interview of Jonathan Cohen, Jan. 22, 2010, at p. 4.

[1245] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 9; Lehman, Global Real Estate 12008, Net Mark Downs (Sept. 5, 2008) [LBEX-AM 34699].

[1246] Jonathan Cohen, Lehman, Q3 Write-downs Spreadsheet (Aug. 2008) [LBHI_SEC07940_2258789]. The Examiner has not found any comparable analyses that allocated write-downs to credit or yield for the PTG write-downs in the second quarter of 2008.

Cohen and Kenneth Cohen stated that a mark for credit impairment would necessarily take into account yield impairment, Jonathan Cohen stated that the rationale given in the document was the primary reason for the write-down.[1247]

(b) The Effect of Not Marking to Market-Based Yield

(i) Effect of Cap * 105 Not Marking to Market-Based Yield

The Examiner has investigated the impact of the switch from the Cap * 105 method to IRR models between the second and third quarters of 2008 and concludes that the large drop in collateral values between those quarters provides sufficient evidence to support a finding that collateral values, and thus PTG asset values, were overvalued in the second quarter of 2008.

Jonathan Cohen acknowledged that Cap * 105 could not be used for marking to market-based yield.[1248] As described, Cap * 105 had no market-based inputs and was incapable of marking collateral to either credit or yield; it simply computed collateral value by multiplying the development's current capital structure (reflecting all outstanding debt plus equity invested to date) by 105%. Cap * 105 applied no discount and did not calculate cash flows. The Examiner's financial advisor has observed that, as of May 2008, historical-cost based approaches (such as Cap * 100 and Cap * 105) were still used for collateral valuation for at least 228 positions, which was a third of the PTG

[1247] Examiner's Interview of Jonathan Cohen, Jan. 22, 2010, at p. 4.

[1248] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at pp. 4-5; Examiner's Interview of Jonathan Cohen, Jan. 22, 2010, at p. 4.

portfolio in the second quarter of 2008.[1249] The Examiner's financial advisor has identified only 54 positions valued by the historical cost-based approach as of July 2008, or less than 10% of the PTG portfolio.[1250] This does not mean that Lehman carried these positions at the amount of its investment. Lehman did write down assets for credit based on asset-specific conclusions that, regardless of the Cap * 105 calculation, there was deterioration of the collateral value. However, the high proportion of PTG assets with collateral values determined by the Cap * 105 method in the second quarter of 2008 is an indication that Lehman did not rely on reasonable collateral values in marking the PTG portfolio.

The large effect of Cap * 105 on collateral values can be observed in Platt's description of her price testing practices during 2008. As noted above, Platt stated that when more IRR models were added to Lehman's system in July 2008, the current values for collateral in her models dropped significantly and her models produced an output suggesting the PTG debt portfolio was significantly overvalued.[1251] The Examiner

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[1249] TriMont, Debt Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262026]; TriMont, Equity Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262362].

[1250] TriMont, Debt Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262026]; TriMont, Equity Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262362]; TriMont, Debt Export as of July 5, 2008 (Aug. 1, 2008) [LBEX-AM 267134]; TriMont, Equity Export as of July 5, 2008 (Aug. 4, 2008) [LBEX-AM 267510].

[1251] Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at p. 7.

investigated and confirmed that Lehman's collateral values dropped substantially when PTG moved away from Cap * 105.[1252]

The Examiner's financial advisor identified 153 PTG positions that used a historical cost-based valuation method (Cap * 105 or Cap * 100) in the second quarter of 2008, and then transitioned to a different valuation method in July 2008.[1253] These 153 positions represented a $3.1 billion value in the second quarter of 2008, or approximately 36% of the PTG portfolio by value. After a significant number of IRR models were incorporated into the price testing process in July 2008, the collateral values for these 153 positions dropped by 20% when compared to the second quarter values.[1254]

Due to limitations in the data, the Examiner's financial advisor has confirmed that 105 of these positions transitioned from Cap * 105 to IRR models between May and July 2008, although it is possible that others did so as well. The May 2008 price testing models suggested that the marks for these 105 positions were undervalued by $192

[1252] TriMont, Debt Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262026]; TriMont, Equity Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262362]; TriMont, Debt Export as of July 5, 2008 (Aug. 1, 2008) [LBEX-AM 267134]; TriMont, Equity Export as of July 5, 2008 (Aug. 4, 2008) [LBEX-AM 267510].

[1253] TriMont, Debt Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262026]; TriMont, Equity Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262362]; TriMont, Debt Export as of July 5, 2008 (Aug. 1, 2008) [LBEX-AM 267134]; TriMont, Equity Export as of July 5, 2008 (Aug. 4, 2008) [LBEX-AM 267510].

[1254] TriMont, Debt Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262026]; TriMont, Equity Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262362]; TriMont, Debt Export as of July 5, 2008 (Aug. 1, 2008) [LBEX-AM 267134]; TriMont, Equity Export as of July 5, 2008 (Aug. 4, 2008) [LBEX-AM 267510]. The Examiner's financial advisor found that 228 positions were valued using Cap * 105, but due to limitations in the data, was not able to confirm how collateral for the other 75 positions were valued in third quarter 2008.

million.[1255] After the switch to calculating collateral values for these 105 positions with IRR models, the price testing result suggested that the marks for these same positions were overvalued by $298 million as of July 31, 2008, and $90 million as of August 31, 2008.[1256]

Both the PTG business desk and Product Control knew that Cap * 105 led to unreasonable valuations in a downward trending market if strictly applied.[1257] Although the Examiner has not found any direct evidence to explain exactly how the business desk used the collateral values based on Cap * 105 in marking the PTG Portfolio, Barsanti and Koutouvides each stated that they used independent judgment, including a judgment that positions with collateral values calculated by Cap * 105

[1255] For the full set of 153 positions with collateral values based on a historical cost valuation methodology, the Examiner's financial advisor observed that price testing model suggested a $271 million undervaluation of the marks as of May 2008. TriMont, Debt Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262026]; TriMont, Equity Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262362]; Zev Klasewitz, Lehman, Single Asset Debt Model May 2008 Spreadsheet (June 14, 2008) [LBEX-LL 1985749]; Zev Klasewitz, Lehman, Single Family Debt Model May 2008 Spreadsheet (June 14, 2008) [LBEX-LL 1985605]; Single Family Equity Model May 2008 Spreadsheet (May 31, 2008) [LBEX-LL 1985924]; Lehman, Strategic Equity Model May 2008 Spreadsheet (May 31, 2008) [LBEX-BARSOX 0000594]; Zev Klasewitz, Lehman, Single Family REO Model May 2008 Spreadsheet (June 13, 2008) [LBEX-LL 1985887]; Lehman, Strategic REO Model May 2008 Spreadsheet (May 31, 2008) [LBEX-LL 1985926].

[1256] TriMont, Debt Export as of July 5, 2008 (Aug. 1, 2008) [LBEX-AM 267134]; TriMont, Equity Export as of July 5, 2008 (Aug. 4, 2008) [LBEX-AM 267510]; TriMont, Debt Export as of Aug. 5, 2008 (Sept. 2, 2008) [LBEX-AM 273310]; TriMont, Equity Export as of Aug. 5, 2008 (Sept. 2, 2008) [LBEX-AM 273058]. The Examiner's financial advisor observed that the lower overvaluation figure in August 2008 is primarily due to Product Control's modifications of the current values based on IRR models, discussed below, that occurred when the principal collateral valuation methodology switched to IRR models.

[1257] *E.g.*, Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009, at p. 7; Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 13; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 15; e-mail from Ed Dziadul, RealCom Financial Partners LLC, to Dennis Grzeskowiak, TriMont, *et al.* (Mar. 23, 2008) [LBEX-DOCID 2293586] (describing Cap * 105 as "worthless").

needed to be written down.[1258] However, collateral value was the most important data point for valuing PTG positions, and there is no indication that Barsanti and Koutouvides used some other method for calculating collateral values when they did not use TriMont's value based on Cap * 105.[1259]

The evidence is sufficient to support a finding that collateral values calculated by Cap * 105 were inflated, and this method calculated collateral values for at least one-third of the PTG portfolio.[1260] The large drop in collateral values that occurred when PTG moved away from Cap * 105 provides sufficient evidence to support a finding, for purposes of a solvency analysis, that certain marks in the PTG portfolio were not reasonable assessments of fair value as of the second quarter of 2008.

[1258] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at pp. 11-12; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 12.

[1259] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 13; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 15.

[1260] The Examiner's financial advisor analyzed data from TriMont export files from May 2008 and July 2008. TriMont, Debt Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262026]; TriMont, Equity Export as of May 5, 2008 (June 2, 2008) [LBEX-AM 262362]; TriMont, Debt Export as of July 5, 2008 (Aug. 1, 2008) [LBEX-AM 267134]; TriMont, Equity Export as of July 5, 2008 (Aug. 4, 2008) [LBEX-AM 267510]. The Examiner's financial advisor also analyzed data from pricing files from May 2008 and July 2008. Zev Klasewitz, Lehman, Single Asset Debt Model May 2008 Spreadsheet (June 14, 2008) [LBEX-LL 1985749]; Zev Klasewitz, Lehman, Single Family Debt Model May 2008 Spreadsheet (June 14, 2008) [LBEX-LL 1985605]; Lehman, Single Family Equity Model May 2008 Spreadsheet (May 31, 2008) [LBEX-LL 1985924]; Lehman, Strategic Equity Model May 2008 Spreadsheet (May 31, 2008) [LBEX-BARSOX 0000594]; Zev Klasewitz, Lehman, Single Family REO Model May 2008 Spreadsheet (June 13, 2008) [LBEX-LL 1985887]; Lehman, Strategic REO Model May 2008 Spreadsheet (May 31, 2008) [LBEX-LL 1985926]; Lehman, Single Family Debt Model July 2008 Spreadsheet (July 31, 2008) [LBEX-BARFID 0022574]; Lehman, Strategic REO Model July 2008 Spreadsheet (July 31, 2008) [LBEX-BARFID 0024563]; Lehman, Strategic Equity Model July 2008 Spreadsheet (July 31, 2008) [LBEX-BARFID 0012795]; Lehman, Single Family REO Model July 2008 Spreadsheet (July 31, 2008) [LBEX-BARFID 0024208]; Lehman, Single Asset Debt Model July 2008 Spreadsheet (July 31, 2008) [LBEX-BARFID 0023120]; Lehman, Single Family Equity Model July 2008 Spreadsheet (July 31, 2008) [LBEX-BARFID 0023610].

(ii) Effect of IRR Models Not Marking to Market-Based Yield

IRR models, in discounting projected cash flows, offered a more reasonable method of valuing collateral than Cap * 105. However, even when Lehman did implement IRR models that applied a yield, these models did not base their yields on market-based interest rates.[1261] Both Koutouvides and Jonathan Cohen stated that the yields selected were based on Lehman's expected rate of return at origination, rather than the rate of return that a typical market investor would require.[1262]

The Examiner has investigated select positions to determine whether TriMont's IRR models used a yield comparable to that applied to other positions or provided by other market-data sources, such as an appraisal. This analysis has focused on the property type identified by witnesses as being of greatest concern to PTG asset managers – land developments.

The discount rate that TriMont used in the IRR models to determine the current collateral value of an asset was the weighted average of the discount rates of the equity and debt positions at origination, as discussed above.[1263]

[1261] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at pp. 4-5; Examiner's Interview of Jonathan Cohen, Jan. 22, 2010, at pp. 3-4. Although Jonathan Cohen also stated that he discussed the issue of marking to market-based yield with Reilly, the Examiner has found no evidence that any such discussion ended up affecting the marks. Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 5.

[1262] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 7, 11-12. Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 5.

[1263] *See, e.g.*, TriMont, Asset Status Report for Heritage Fields El Toro LLC (July 1, 2008), at tab "NPV" [LBEX-BARFID 0027112]. In this manner the discount was a weighted average cost of capital, weighted

Since the cost of debt and cost of equity were based on rates as of deal origination, they remained static regardless of how the market participants' risk assessment changed throughout the investment's lifetime.[1264] Therefore, the discount rates used in IRR models were not market-based, as the discount rate did not materially change if the market's changing assessment of risk resulted in demand for a higher yield.

Heritage Fields provides an example of a position that Lehman valued using IRR models that contained a discount rate for collateral that was materially lower than that produced by a third party, Cushman & Wakefield ("C&W"). In a July 2007 appraisal of Heritage Fields that was provided to Lehman, C&W noted 18% as the discount rate for the collateral,[1265] and in an April 2008 appraisal, that discount rate was 21%.[1266] Meanwhile, TriMont used an 8.23% discount rate in its May 2008 IRR model and 11.98% rate in its July 2008 IRR model.[1267] In the face of this discrepancy, TriMont did not increase the discount rate to be more in line with the April 2008 C&W appraisal, but

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in this case by the current outstanding debt and all paid-in equity (which may be different than the capital structure at origination).

[1264] Again, Cap * 105 did not apply a discount rate to collateral values. The Examiner also notes that the capital structure could change over time due to amortization of debt or equity raises, which would impact the weighted average discount rate.

[1265] Cushman & Wakefield, Heritage Fields Master-Plan Self-Contained Appraisal Report Vol. I (July 1, 2007), at pp. 340-41 [LBEX-DOCID 2501688]. This discount rate was characterized by C&W as an unleveraged cost of equity, and the Examiner's financial advisor observed that this is consistent with a weighted average cost of capital rate with only equity in the capital structure. *Id.*

[1266] Cushman & Wakefield, Heritage Fields Master Plan Summary Appraisal Report (Apr. 1, 2008), at p. 61 [LBEX-DOCID 2096020]. The discount rate selected by C&W assumed an unleveraged position.

[1267] TriMont, Heritage Fields El Toro LLC IRR Model (May 1, 2008), at tab "NPV" [LBEX-BARFID 0026891]; TriMont, Asset Status Report for Heritage Fields El Toro LLC (July 1, 2008), at tab "NPV" [LBEX-BARFID 0027112].

rather, in its July 2008 model, TriMont lowered the projected cash flows of the development.[1268] Through this change, the collateral value TriMont produced in July 2008 for Heritage Fields, $797 million, was close to C&W's collateral value for April 2008, $790 million.[1269] Even though TriMont adjusted the cash flow and came up with a similar collateral value, the large gap between the discount rates indicates that TriMont's IRR models included discount rates that were too low.

In order to investigate whether the discount rates used in the IRR models were consistently lower than those obtained from other sources, the Examiner compared the discount rate that C&W used for Heritage Fields as a benchmark to measure the discount rates used for other similar properties. Heritage Fields was a land development with a sell-out component, meaning it was a real estate development where the business plan was to sell off individual units of the property rather than the property as a whole.[1270] Sell-outs were typically the most risky form of land

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[1268] *See* TriMont, Asset Status Report for Heritage Fields El Toro LLC (July 1, 2008), at tab "NPV" [LBEX-BARFID 0027112]. For example, absorption – the amount of time it takes to sell-out all lots – was assumed by TriMont to be complete by 2013 in the May data and that was extended to 2015 in the July data. TriMont, Heritage Fields El Toro LLC IRR Model (May 1, 2008), at tab "CF-Deal," cell BO4 [LBEX-BARFID 0026891]; TriMont, Asset Status Report for Heritage Fields El Toro LLC (July 1, 2008) [LBEX-BARFID 0027112].

[1269] TriMont, Asset Status Report for Heritage Fields El Toro LLC (July 1, 2008) [LBEX-BARFID 0027112].

[1270] *Id.* For example, in a land development, the developer will first purchase a plot of land, then secure entitlement (approvals to build), put in infrastructure (such as grading, roads, utilities, etc.), and subdivide the plot into individual lots. The developer will then sell the individual lots to merchant builders who will construct homes on the lots. When all the lots have been sold, the project is "sold-out." Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 4.

development, because they involved overseeing a development to completion and holding onto the asset while it was sold piece-by-piece.[1271]

For the purpose of this comparison, the Examiner included only those positions for which IRR models were used to estimate the collateral values. The Examiner's financial advisor identified three applicable land development sell-out properties meeting these criteria.[1272] Below is a comparison of the collateral values calculated using TriMont's discount rates for these properties with the collateral values calculated by the Examiner's financial advisor using the C&W April 2008 discount rate for Heritage Fields.

	Property Name	TriMont Discount Rate	TriMont Collateral Value	C&W Heritage Fields Discount Rate	Collateral Value Using C&W Heritage Fields Discount Rate	% Difference in Collateral Values
			(A)		(B)	(B)/(A)-1
1	West Bay Club Development	10.9%	81,185,918	21.0%	74,636,592	-8.1%
2	PlazaCorp 1.Berkley	7.3%	72,699,971	21.0%	50,205,769	-30.9%
3	Laurel Cove	12.2%	53,917,607	21.0%	40,298,467	-25.3%
Average		10.1%	69,267,832	21.0%	55,046,943	-20.5%

[1271] *See* Tony Sevelka, *Subdivision Development: Risk, Profit, and Developer Surveys*, Appraisal J. 242, 242-52 (Summer 2004), *available at* http://www.entrepreneur.com/tradejournals/article/120353039_2.html (noting generally that "[l]and in a raw state . . . carries the highest level of overall development risk" and that land may be ripe for residential development . . . but the question remains as to whether the developer will be able to sell the proposed finished lots").

[1272] These were West Bay Club Development, PlazaCorp1.Berkley, and Laurel Cove. TriMont, Asset Status Report for West Bay Club Development (July 1, 2008), at tab "NPV" [LBEX-BARFID 0030164]; TriMont, Asset Status Report for PlazaCorp1.Berkley (Aug. 1, 2008), at tab "NPV" [LBEX-BARFID 0029074]; TriMont, Asset Status Report for Laurel Cove (July 1, 2008), at tab "NPV" [LBEX-BARFID 0028845].

The three properties feature discount rates that were materially lower than the discount rate used by C&W in its April 2008 appraisal of Heritage Fields.[1273] If the discount rate in the April 2008 C&W appraisal of Heritage Fields were applied to these positions, the collateral values of these properties would drop by an average of 20%.

An additional benchmark by which the Examiner's financial advisor measured the discount rates Lehman used to value the collateral of these three properties is the discount rates used to value its SunCal collateral. SunCal consisted of investments in California land development projects.[1274] Lehman used a 15% weighted average discount rate for the majority of the SunCal properties.[1275] As shown above, the discount rates for all three PTG land development properties were lower than 15%.

The C&W appraisals for Heritage Fields also illustrate how Lehman's discount rates did not respond to market changes. C&W's two appraisals for Heritage Fields were performed in two different years when, according to Koutouvides, the market

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[1273] The discount rates used by TriMont were different due to differences in the cost of debt and the weights of debt versus equity in the capital stack. TriMont used the same cost of equity for each position, though it would likely have been more appropriate to use a cost of equity commensurate with the leverage.

[1274] *See, e.g.*, Cushman & Wakefield, Appraisal of Pacifica San Juan Master Plan (289 Lots) (Oct. 1, 2007) [TR00031835].

[1275] Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 9. The SunCal positions were valued based on projections that were influenced by third parties and a discount rate determined by Lehman. Hughson stated that he was the person who determined the 15% unleveraged discount rate for the majority of the positions. *Id.* The 15% unleveraged discount was based on the assumption of a 2/3 debt, 1/3 equity capital structure post restructuring with a cost of debt of 10% and cost of equity of 25%. Hughson stated that this discount rate assumption was supported by asset sales in the region. *Id.*

"was dropping like a stone."[1276] Therefore, the increase in the discount rates between C&W's two appraisals – 3% – is likely to have been the result of market-based activity.[1277] This assumption is consistent with Lehman's own practices in valuing non-PTG positions. In valuing Lehman's bridge equity position in Archstone, Lehman increased its discount rate from approximately 12% in May 2007 to 15% by the second quarter of 2008.[1278] This approximately 3% increase in the Archstone discount rate reflects Lehman's recognition that market-based yields were increasing as the market conditions deteriorated for stabilized assets. In accordance with the "higher risk, higher return" nature of the PTG investments,[1279] the Examiner's financial advisor has observed that it is reasonable to expect that the market yield for higher risk, non-stabilized assets would increase at a similar or higher rate than for stabilized assets (e.g. Archstone) in a

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[1276] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 9.

[1277] The Examiner notes that it is also possible that the difference in discount rates may suggest specific problems with the Heritage Fields's underlying collateral.

[1278] Memorandum from Mark A. Walsh, Lehman, et al., to LBHI Bridge Loan Committee & Investment Committee, re: Debt and Equity Financing Commitment Proposal for the Potential Acquisition of Archstone-Smith (May 16, 2007), at p. 9 [LBEX-DOCID 1674960]. Lehman, $23.4 billion debt and equity financing commitment in connection with the potential acquisition of Archstone-Smith by Lehman Brothers and Tishman Speyer Properties, May 16, 2007 [LBEX-DOCID 1674960]. The commitment documents identify an IRR for Archstone bridge equity of 12.1%. This rate included the cost of capital as well as Lehman's expected return from the investment. Therefore, the Examiner's financial advisor observes that, strictly speaking, the cost of capital alone would be less than 12.1%. E-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman, *et al.* (June 14, 2008) [LBEX-DOCID 1865693]; e-mail from Paul A. Hughson, Lehman, to Webster Neighbor, Lehman, *et al.* (June 15, 2008) [LBEX-DOCID 1865693]; e-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman (Sept. 12, 2008) [LBEX DOCID 2903130].

[1279] *E.g.*, Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 4.

downward trending market.[1280] Instead, the IRR models for PTG assets incorporated debt and equity discount rates that were incapable of responding to market changes. These rates were equal to the applicable development's rates for debt and equity as of the origination of the investment.

Koutouvides told the Examiner that the choice of discount rate for both the collateral and debt positions did not matter as much for PTG positions because of the short-term maturity date of many of the loans.[1281] Koutouvides' statement was based on the observation that the difference in yield between what Lehman used in its valuation and what a market participant would require in a sale did not have much time to compound for a short-term debt position.

Koutouvides' argument that the particular yield used is insignificant must be evaluated on a position-by-position basis. If the position has less leverage (and consequently a lower LTV ratio) and a shorter term maturity for the debt, then it is possible that the changes caused by the discount rate might not have a material effect on value. However, a longer-term debt position, such as the Heritage Fields position, would have a much longer time for the difference in yield to compound, resulting in a

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[1280] For one of the three land developments, West Bay Club Development, Lehman did take a write-down of $24 million in August 2008, after the position was valued at $76.5 million in July. Lehman, Global Real Estate 2008 Net Mark Downs (Sept. 5, 2008), at tab "Position & Monthly Detail," cell M148 [LBEX-AM 346991] However, Lehman did not write down the other two positions, and the use of a possibly incorrect discount rate for all three properties is sufficient evidence to support a finding that TriMont's IRR models produced discount rates used in the valuation process that were lower than the market supported.

[1281] *Id.* at p. 3.

bigger difference in values. If the development has significant leverage and the debt has a longer maturity date for the debt, then the changes to the discount rate can have a significant effect on value.

The PTG portfolio featured many positions that were highly leveraged debt positions or equity positions that would be affected by a change in collateral values.[1282] Barsanti and Koutouvides would together mark the PTG portfolio, position-by-position, using TriMont's data as modified by their judgment.[1283] The decrease of 20% or 15% in collateral value, as in the examples above, is sufficient evidence to support a finding that the PTG business desk was, at least in part, basing valuations on data that included higher collateral values than the market then supported, even after the transition to IRR models.

(iii) Effect of Product Control Price Testing Not Marking to Market-Based Yield

According to Barsanti and Koutouvides, the PTG business desk lacked necessary resources.[1284] Barsanti and Koutouvides were primarily responsible for valuing 700 positions in the book, and Koutouvides spent much of his time addressing TriMont's errors.[1285] Although, in theory, Lehman intended Product Control to serve as an

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[1282] Lehman Brothers, Global Real Estate Product Control Real Estate Americas Price Verification Presentation [Draft] (Feb. 2008), at p. 4 [LBEX-WGM 916018] (describing PTG assets as "High Leveraged debt and equity investments in commercial real estate properties").

[1283] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at pp. 11, 13-14.

[1284] *Id.*; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 10, 13. Examiner's Interview of SEC staff, Aug. 24, 2009, at pp. 14-15.

[1285] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 10, 13.

independent check on the business desk marks, it suffered from a similar lack of resources.[1286] According to Jonathan Cohen, product controllers were not given sufficient information to properly test values.[1287] Without an effective Product Control process, the risk of misstating the value of PTG assets rises significantly.

Above all, Product Control had no effective method for using market-based yields to test the marks for PTG assets. This was largely due to the fact that the Product Control price testing process relied heavily on input from the business desk and, in this manner, was not truly independent. Product Control used the same collateral values as those provided by TriMont to the business desk.[1288] Cap * 105 inarguably failed to take market-based yields into account and thus caused overvaluation of collateral in the second quarter of 2008. As noted above, the IRR models that became more prevalent in the third quarter of 2008 also did not use a market-based yield for determining collateral value.[1289] Additionally, Product Control would defer to the business desk's

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[1286] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 5; Examiner's Interview of Rebecca Platt, Nov. 2, 2009, at pp. 4, 7. The SEC also reached an informal conclusion that Lehman's Product Control staff was too small to be an effective independent check on the business desks' valuations given the size and number of assets in the CRE portfolio. Examiner's Interview of SEC staff, Aug. 24, 2009, at pp. 3-4, 13-14

[1287] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 5. Additionally, Jonathan Cohen noted that, without certain necessary information, Product Control could not effectively employ the models available to it. *Id.*

[1288] Examiner's Interview of Anthony J. Barsanti, Oct. 15, 2009, at p. 9.

[1289] In testing certain PTG debt positions, Product Control applied a discount rate based on the rates published in the Real Estate Investment & Finance newsletter. Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009, at p. 8; Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009, at p. 8; Examiner's Interview of Abebual A. Kebede, Oct. 13, 2009, at p. 7. The Examiner's financial advisor conducted a review of the spreads used by Product Control to calculate the debt discount rate and determined that the spreads used in the second quarter of 2008 did not reflect current market data.

judgment as to when to replace or modify the collateral values provided by TriMont and use the business desk's collateral values instead. [1290]

(iv) Effect of Modifying TriMont's Data in the Third Quarter of 2008

According to Jonathan Cohen, the switch to IRR models in the third quarter of 2008 enabled PTG to mark positions to market-based yield.[1291] This suggests that TriMont's IRR models materially improved Lehman's valuations to account for market-based yields. However, in many instances in the third quarter of 2008, PTG modified the collateral values provided by TriMont, elected to not give weight to other information suggesting that a position should be remarked, or was not persuaded by price testing results showing a large overvaluation after lower collateral values were incorporated into the price testing models. These facts provide further evidence that Lehman did not make a concerted effort to mark to market-based yield and that it was not merely the lack of IRR models in the second quarter of 2008 that prevented Lehman from marking PTG assets to market-based yield.

There is sufficient evidence to support a finding that the PTG business desk used its judgment to conclude that it should not use many of the values produced by TriMont when it was replacing Cap * 105 with IRR models. Among the positions for

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[1290] *E.g.*, e-mail from Aristides Koutouvides, Lehman, to Abebual A. Kebede, Lehman (Aug. 30, 2008) [LBHI_SEC07940_212040]; Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 8; Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 7; Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 16-17; Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 5.

[1291] Examiner's Interview of Jonathan Cohen, Jan. 22, 2010, at pp. 3-4.

which the Examiner's financial advisor has observed that TriMont's collateral values were modified, Lehman substituted a higher collateral value for 14 of the 18 positions (or 78%) in May 2008,[1292] and 38 of the 40 positions (or 95%) in August 2008.[1293] The magnitude of the departure from TriMont's collateral values also materially increased from May to August. In May 2008, the collateral values used by Lehman for these positions were, in aggregate, $636 million higher than TriMont's collateral values.[1294] However, in August 2008, Lehman's collateral values were $1.7 billion higher than TriMont's collateral values.[1295] The Examiner's financial advisor calculated that, had

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[1292] *See* Zev Klasewitz, Lehman, Single Asset Debt Model May 2008 Spreadsheet (June 14, 2008) [LBEX-LL 1985749]; Zev Klasewitz, Lehman, Single Family Debt Model May 2008 Spreadsheet (June 14, 2008) [LBEX-LL 1985605]; Single Family Equity Model May 2008 Spreadsheet (May 31, 2008) [LBEX-LL 1985924]; Lehman, Strategic Equity Model May 2008 Spreadsheet (May 31, 2008) [LBEX-BARSOX 0000594]; Zev Klasewitz, Lehman, Single Family REO Model May 2008 Spreadsheet (June 13, 2008) [LBEX-LL 1985887]; Lehman, Strategic REO Model May 2008 Spreadsheet (May 31, 2008) [LBEX-LL 1985926].

[1293] *See* Lehman, Single Asset Debt Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0023236]; Lehman, Single Family Debt Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0022749]; Lehman, Single Family Equity Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0023801]; Lehman, Strategic Equity Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0012946]; Lehman, Single Family REO Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0024249]; Lehman, Strategic REO Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0024594]. The specific valuation methodology for many of these positions is unknown, although the data reflects that only one of these positions was valued in August 2008 using a capitalization method.

[1294] *See* Zev Klasewitz, Lehman, Single Asset Debt Model May 2008 Spreadsheet (June 14, 2008) [LBEX-LL 1985749]; Zev Klasewitz, Lehman, Single Family Debt Model May 2008 Spreadsheet (June 14, 2008) [LBEX-LL 1985605]; Single Family Equity Model May 2008 Spreadsheet (May 31, 2008) [LBEX-LL 1985924]; Lehman, Strategic Equity Model May 2008 Spreadsheet (May 31, 2008) [LBEX-BARSOX 0000594]; Zev Klasewitz, Lehman, Single Family REO Model May 2008 Spreadsheet (June 13, 2008) [LBEX-LL 1985887]; Lehman, Strategic REO Model May 2008 Spreadsheet (May 31, 2008) [LBEX-LL 1985926].

[1295] *See* Lehman, Single Asset Debt Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0023236]; Lehman, Single Family Debt Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0022749]; Lehman, Single Family Equity Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0023801]; Lehman, Strategic Equity Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID

Lehman employed TriMont's collateral values, the price testing in August 2008 would have indicated a $671 million overvaluation for these positions.[1296] Instead, after Lehman used its own collateral values, the price testing indicated only a $56 million overvaluation.[1297]

(c) Examiner's Findings and Conclusions as to the Effect of Not Marking Lehman's PTG Portfolio to Market-Based Yield

As a substantial part of the PTG portfolio was not valued based on market-based yield, the Examiner concludes that there is sufficient evidence to support a finding that certain PTG assets were unreasonably valued, for purposes of a solvency analysis, during the second and third quarters of 2008.

Koutouvides and Jonathan Cohen told the Examiner that the PTG marks represented fair value.[1298] According to these witnesses, PTG was not required to mark these illiquid assets, backed by non-stabilized real estate, at prices they could sell for

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0012946]; Lehman, Single Family REO Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0024249]; Lehman, Strategic REO Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0024594].

[1296] *See* Lehman, Single Asset Debt Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0023236]; Lehman, Single Family Debt Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0022749]; Lehman, Single Family Equity Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0023801]; Lehman, Strategic Equity Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0012946]; Lehman, Single Family REO Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0024249]; Lehman, Strategic REO Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0024594].

[1297] *See* Lehman, Single Asset Debt Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0023236]; Lehman, Single Family Debt Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0022749]; Lehman, Single Family Equity Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0023801]; Lehman, Strategic Equity Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0012946]; Lehman, Single Family REO Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0024249]; Lehman, Strategic REO Model Aug. 2008 Spreadsheet (Aug. 31, 2008) [LBEX-BARFID 0024594].

[1298] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at pp. 11-12; Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 5; Examiner's Interview of Jonathan Cohen, Jan. 22, 2010, at p. 4.

during a sharp market downturn. Koutouvides, who was closest to the technical details of the business desk's valuation of PTG assets, told the Examiner that Lehman made no attempt to mark PTG assets to market-based yield during the second and third quarters of 2008.[1299] Koutouvides and Jonathan Cohen asserted that Lehman's intention to hold these assets as long-term investments meant that the asset values should not be subject to short-term fluctuations in the market. Lehman's logic (as represented in these witness statements) was that selling PTG assets was very difficult, and Lehman did not want to sell PTG assets at steeply discounted prices. Jonathan Cohen asserted that any sale of PTG assets at this time was a "fire sale," and Lehman had a policy against valuing assets based on distressed sales.[1300]

Lehman did not originate PTG positions with the intention of selling half-developed properties, and the unique features of each project, as well as the "marriage" between Lehman and the developer, made it difficult for a third-party to assess the risks inherent in an unfinished project. However, marking assets at fair value (whether for purposes of solvency or SFAS 157) is not overridden by the fact that Lehman did not market the underlying property until the project was nearly complete.[1301]

[1299] Examiner's Interview of Aristides Koutouvides, Nov. 20, 2009, at p. 11.

[1300] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 5; Examiner's Interview of Jonathan Cohen, Jan. 22, 2010, at p. 4.

[1301] Fin. Accounting Standards Bd., Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, Staff Position No. 157-4, ¶ 2 (2009) ("Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between

The definition of fair value under SFAS 157 relies on a transaction with typical marketing periods.[1302] This is an objective definition, allowing for the marketing period to extend for an appropriate period of time.

The Examiner's conclusions that there is sufficient evidence to support a finding that certain PTG positions were unreasonably valued during the second and third quarters of 2008 does not extend to all of Lehman's PTG positions. As described, the process of valuing PTG positions requires asset-specific information and an investigation of the circumstances and current state of a development project. For the purpose of performing a solvency analysis, a court could discount the PTG asset values reported by Lehman on a case-by-case basis after a consideration of the specific assets in question.

As noted, although there is sufficient evidence to demonstrate that the valuation methodology for PTG assets did not rely on market-based assumptions, there is insufficient evidence to support a colorable claim that any Lehman officer acted with an intent to produce incorrect values or conducted the valuation process in a reckless manner. The errors in valuation did not result from actions (or omissions) that would support a claim of a breach of fiduciary duty.[1303]

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market participants at the measurement date under current market conditions"). For a more detailed discussion of the legal standard for fair value measurements, see Appendix 1, Legal Issues, Section VII.

[1302] *See* Appendix 1, Legal Issues, Section VII.A.

[1303] For a more detailed discussion of the standard governing a claim of breach of fiduciary duty, see Appendix 1, Legal Issues, Section II.

f) Examiner's Analysis of the Valuation of Lehman's Archstone Positions

(1) Executive Summary

This section of the Report addresses Lehman's valuations of its Archstone positions.

Lehman, together with Tishman Speyer, agreed to acquire Archstone, a publicly traded Real Estate Investment Trust ("REIT"), on May 29, 2007 (the "Commitment Date"). The transaction closed on October 5, 2007 (the "Closing Date"). Lehman funded approximately $5.4 billion of the $23.6 billion purchase price, making Archstone Lehman's largest commercial real estate investment.

After the acquisition was announced, analysts opined that Lehman and Tishman Speyer had negotiated a favorable price. However, as the stock prices of Archstone's publicly traded peers began to decline over the summer and early fall of 2007, a Citigroup analyst suggested that Archstone's enterprise value had declined to a level where the Archstone acquirers would be better off paying the $1.5 billion break-up fee instead of completing the transaction.[1304]

Lehman initially projected that its Archstone investments would generate in excess of $1.3 billion in profits over 10 years. This projection was based on the following assumptions: (1) Archstone would sell certain properties for $8.9 billion

[1304] Citigroup, Archstone–Smith Trust: Could the Buyer Cut Their Losses and Walk Away? (July 26, 2007), at p. 1 [LBEX-DOCID 1192001].

contemporaneously with the closing, thereby reducing Lehman's exposure and risk; (2) Archstone's projected debt-to-enterprise ratio of over 80% at closing would be reduced shortly thereafter to approximately 70% pursuant to a $1.9 billion equity offering; (3) the promote feature embedded in Lehman's general partner interest (which it referred to as "permanent equity") would result in that equity interest receiving enhanced returns; and (4) Lehman would syndicate one-half of its Archstone debt and limited partner interests (which it referred to as "bridge equity") within two weeks of closing and the remainder during the following six months.

The assumptions supporting Lehman's initial profit projection were not realized: (1) Archstone sold only $1.4 billion of properties contemporaneously with the closing; (2) Archstone did not execute a post-closing equity offering; (3) by March 2008, Lehman determined that the promote feature would not provide enhanced returns; and (4) Lehman did not syndicate a material part of either its $2.3 billion Archstone entity-level debt or its bridge equity before LBHI filed for bankruptcy. Also as of the Closing Date, the lenders, including Lehman, only syndicated $71 million of bridge equity, which represented 1.5% of the aggregate $4.6 billion bridge equity commitment.[1305]

[1305] The lending group received expressions of interests from D.E. Shaw and Abu Dhabi Investment Authority, but these investors ultimately chose not to participate in the Archstone transaction. E-mail from Mike Mazzei, Barclays, to Mark Walsh, Lehman (Nov. 19, 2007) [LBEX-DOCID 1787730]. The Abu Dhabi Investment Authority expressed an interest in acquiring $250 to $550 million of bridge equity. Memorandum from Coburn Packard, Lehman, and Arash Dilmanian, Lehman, to Brett Bossung, Lehman, and Mark Newman, Lehman, Archstone Acquisition Update (Sept. 17, 2007), at p. 4 [LBEX-DOCID 2073832]. Lehman sold $50 million to the Irvine Company, $20 million to Consolidated Investor Group, and $1 million to Larry Cohen, a high net worth individual associated with Tishman Speyer.

However, Lehman and its financing partners were able to reduce their aggregate exposure by over $8 billion through the placement of Archstone mortgage debt with Fannie Mae and Freddie Mac at the closing. After the closing, Lehman, BofA and Barclays did not syndicate any bridge equity and only syndicated $43 million of term loans.[1306]

Archstone was a highly leveraged company with 76% loan-to-enterprise value as of the Closing Date.[1307] Lehman's approximately $2.2 billion of entity-level debt was structurally subordinate to over $12.0 billion of Archstone asset-level debt, and its approximately $2.4 billion of equity was subordinate to approximately $17 billion of debt. Given Archstone's leverage, a small decline in Archstone's enterprise value would result in a materially larger decrease in the fair value of Lehman's equity interest. Conversely, a small increase in Archstone's enterprise value would result in a materially larger increase in the fair value of that investment.[1308]

Lehman, Archstone Smith Multifamily JV Debt and Equity Redemption Schedule (Jan. 3, 2008), at Redemptions tab [LBEX-DOCID 2502413], attached to e-mail from Keith Cyrus, Lehman, to Paul A. Hughson, Lehman, *et al.* (Jan. 3, 2008) [LBEX-DOCID 2646616].

[1306] Lehman, Pro Forma Capitalization Company Balance Sheet (May 30, 2008), at p. 2 [LBEX-DOCID 4329013] attached to e-mail from Rachel Hamilton, Lehman, to Paul A. Hughson, Lehman, *et. al.* (May 31, 2008) [LBEX-DOCID 4329012].

[1307] The 76% ratio assumes the purchase price was representative of fair value as of the Closing Date.

[1308] The Examiner's financial advisor calculated that Lehman's $2.4 billion Archstone equity investment would be reduced by $1 billion in value if Archstone's enterprise value declined by approximately 10%.

As of the Closing Date, Lehman wrote down the value of its Archstone positions by $230 million, the aggregate amount of underwriting, structuring and M&A advisory fees it received in connection with the acquisition.[1309]

A January 2008 Barron's article suggested Archstone had no equity value based on an analysis of the decline in the stock prices of Archstone's publicly traded peers since the Closing Date.[1310] The lenders, including Lehman, were unable to syndicate any of their Archstone positions during the first quarter of 2008, and Archstone faced a tightening liquidity situation due to, among other things, its inability to execute its plan to sell properties to reduce the acquisition debt. Lehman did not take any valuation-related write-downs during the first quarter of 2008.

During the second quarter of 2008, the lenders, including Lehman, were still unable to syndicate Archstone debt, and over $1 billion of potential Archstone property sales fell through after Bear Stearns's near collapse. Archstone continued to face a tight liquidity situation, and by this time Lehman recognized that apartment building values were generally declining. In late March 2008, based on an updated valuation analysis, Lehman wrote down $200 million on its bridge equity position and $50 million on its permanent equity position.[1311]

[1309] Lehman, Archstone Origination Fees Marked into Position, at p. 1 [LBEX-BARFID 0024639].

[1310] Andrew Bary, *Apartment-House Blues*, Barron's, Jan. 21, 2008, at p. 1, *available at* http://online.barrons.com/article/SB120070919702802265.html#articleTabs_panel_article%3D1.

[1311] Lehman, Global Real Estate 2008 Mark Downs, at p. 8 [LBEX-BARFID 0013162].

Lehman continued to conduct an analysis of the value of its Archstone positions, resulting in an additional $90 million write-down on its bridge equity and $10 million on its permanent equity in May 2008.[1312] At this time, Lehman realized it would not meet its syndication goals for Archstone and changed the estimated completion of the syndication program from October 2008 to fiscal year 2010. Lehman's May 2008 valuation determination was based on its judgment that Archstone debt and bridge equity positions would be more marketable in the future after Archstone deleveraged by using the proceeds of property sales to satisfy part of the acquisition debt, and restructured certain of its remaining debt. In August 2008, Lehman took its final Archstone write-down of $110 million on its bridge equity position and $15 million on its permanent equity position.[1313]

In assessing the reasonableness of Lehman's valuations of its Archstone equity, the Examiner recognizes that this investment was an illiquid asset, and Lehman's valuations necessarily relied on unobservable inputs. In light of the absence of directly applicable market data, a court could find that there are a wide range of valuations that would be reasonable. In conducting the analysis, the Examiner only considered contemporaneous information that was available to Lehman, and is cognizant of the

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[1312] *Id.*

[1313] Lehman, Global Real Estate 2008 Mark Downs, at p. 8 [LBEX-BARFID 0013162].

standard that courts apply in assessing the reasonableness of a debtor's valuation judgments for purposes of a solvency analysis.[1314]

The evidence does not support a finding that Lehman's valuations of its Archstone equity positions as of the fourth quarter of 2007 were unreasonable. However, there is sufficient evidence to support a finding that Lehman's valuations for its Archstone equity positions were unreasonable beginning as of the end of the first quarter of 2008, and continuing through the end of the third quarter of 2008.[1315]

The Examiner's determination as to Lehman's first quarter valuation is based on the deterioration in Archstone's projected fundamentals (*e.g.*, net operating income, rent growth rates and capitalization rates) that occurred between the Commitment Date and the end of first quarter of 2008. The evidence supports a finding that Lehman's models employed unreasonably optimistic assumptions that were generally based on Lehman's assumptions when it committed to participate in the Archstone acquisition in May 2007. Notwithstanding the substantial data available to Lehman regarding the deterioration of such fundamentals, Lehman did not revise the assumptions that supported its valuation. The evidence supports a finding that Lehman's valuation of its Archstone equity was overstated, for purposes of a solvency analysis, by $200 million to $450

[1314] See Appendix 1, Legal Issues, Section VII, for a full discussion of relevant legal issues pertaining to valuation.

[1315] The Examiner's financial advisor quantified the amount of the indicative overvaluation of Lehman's bridge and permanent equity positions assuming the promote feature was turned off, which is consistent with Lehman's valuation analysis as of March 2008, and therefore the bridge and permanent equity would have the same marks.

million as of the end of the first quarter of 2008. Given that the valuation of an illiquid asset requires judgment, the Examiner determined that it is appropriate to express a range as to which there is sufficient evidence to support a finding that Lehman's Archstone equity valuations were overstated for purposes of a solvency analysis.

Lehman wrote down its Archstone investment by over $350 million during the second quarter of 2008.[1316] However, the Examiner finds that there is sufficient evidence to support a finding that Lehman's cumulative write-downs did not fully reflect the decline in the value of Archstone equity, in light of the deterioration of the fundamentals supporting the assumptions in Lehman's Archstone model. The evidence supports a finding that Lehman's valuation of its Archstone equity was overstated, for purposes of a solvency analysis, by $200 million to $500 million as of the end of the second quarter of 2008.

Lehman wrote down its Archstone investment by approximately $125 million during the third quarter of 2008.[1317] As with the prior quarter, the Examiner finds there is sufficient evidence to support a finding that Lehman's cumulative write-downs did not fully reflect the deterioration in the value of Archstone equity during this period. The Examiner finds that there is sufficient evidence to support a finding that Lehman's Archstone equity valuation was overstated, for purposes of a solvency analysis, by $140 to $400 million as of the end of the third quarter of 2008.

[1316] Lehman, Global Real Estate 2008 Mark Downs, at p. 8 [LBHI_SEC07940_7620384].
[1317] *Id.* at p. 12.

The Examiner also considered Product Control's role in the price testing of the Archstone valuations. Jonathan Cohen, the senior GREG product controller, told the Examiner that Product Control was not provided with the data underlying the assumptions and inputs used in the Archstone model that supported the business desk's valuations.[1318] Cohen told the Examiner that Product Control did not have the resources or capabilities to adequately review the Archstone business desk's valuations.[1319] Cohen acknowledged that he deferred to the business desk's valuation of Lehman's Archstone positions because Cohen considered the desk personnel to be more knowledgeable about that investment.[1320] The Examiner finds that there is sufficient evidence to support a finding that Lehman's Product Control Group did not serve as an effective independent check on Lehman's valuation of its Archstone positions.

Although there is sufficient evidence to demonstrate that Lehman's valuations of its Archstone equity positions were unreasonable for purposes of a solvency analysis beginning as of the end of the first quarter of 2008, there is insufficient evidence to support a colorable claim that any Lehman officer acted with an intent to produce incorrect values, or conducted the valuation process in a reckless manner. Lehman's valuations of its Archstone positions were not the product of actions (or omissions) that would support a claim of a breach of fiduciary duty.

[1318] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 10.
[1319] *Id.*
[1320] *Id.*

(2) Lehman's Acquisition of Archstone

(a) Background on Archstone

Prior to the acquisition in October 2007, Archstone was a publicly traded REIT.[1321] It was engaged primarily in the acquisition, development, redevelopment, operation and long-term ownership of high-rise and garden apartment communities in desirable, high-barrier-to-entry markets.[1322] Archstone's strategy was to focus on its core markets, characterized by: (1) protected locations with high barriers to entry; (2) expensive single-family home prices; and (3) a strong, diversified economic base with significant employment growth potential.[1323] Archstone's portfolio of properties included high-end apartment buildings in metropolitan areas such as New York, Washington, D.C., San Francisco, Seattle and Boston.[1324] As of December 31, 2007, Archstone owned 154 apartment communities, representing 46,566 units, including units under construction.[1325] Prior to the acquisition, Archstone was the second largest publicly traded apartment REIT in the U.S., as measured by market capitalization[1326] and enterprise value.[1327]

[1321] Archstone, Annual Report for 2007 as of Dec. 31, 2007 (Form 10-K) (filed on Apr. 1, 2008), at p. 3.
[1322] *Id.* at p. 9.
[1323] *Id.*
[1324] *Id.* at pp. 9-10.
[1325] *Id.* at p. 20.
[1326] Market capitalization refers to the total market value of a company's outstanding shares, which is calculated by multiplying the number of shares outstanding by the stock price per share.
[1327] Lehman, Presentation to Tishman Speyer, Project Easy Living Discussion / Valuation Materials [Draft] (May 21, 2007), at p. 8 [LBEX-DOCID 1695374]. Enterprise value refers to the total value of the business, taking into account market capitalization, outstanding debt, cash available and other assets.

(b) Acquisition of Archstone

Lehman and Tishman Speyer sponsored the purchase as a joint venture and negotiations to acquire Archstone evolved throughout May 2007. The first offer price was $64.00/share on May 2, 2007. This offer was reduced to $60.00/share on May 23, 2007. The final offer of $60.75/share was agreed to on May 29, 2007 (the "Commitment Date"), and publicly announced on the same day.[1328] The decrease from the initial offer price occurred because: (1) due diligence revealed the existence of certain tax protection agreements that impaired the value of some Archstone properties; (2) due diligence indicated that the yields on Archstone's developments were lower than Lehman and Tishman Speyer expected; and (3) developments in the capital markets.[1329] According to a May 18, 2007 memo provided to Lehman's Investment Committee, Lehman projected it would earn in excess of $1.3 billion in profit over 10 years on its Archstone investment.[1330]

Based on the terms of the commitment, Archstone's capital structure was projected to have (broadly speaking) three separate components: asset-level debt,

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[1328] Lehman, Transaction Timeline provided to the New York Stock Exchange (June 20, 2007), at pp. 4-5 [LBEX-DOCID 2139993]; Archstone, Current Report as of Aug. 17, 2007 (Form 8-K) (filed on Aug. 20, 2007), at p. 14.

[1329] Lehman, Transaction Timeline provided to the New York Stock Exchange (June 20, 2007), at p. 4 [LBEX-DOCID 2139993]; e-mail from Steven R. Hash, Lehman, to David S. Lazarus, Lehman (May 23, 2007) [LBEX-DOCID 1863672].

[1330] Memorandum from Mark A. Walsh, et al., to Exec. Committee of the LBHI Bd. of Directors, re: $23.4 billion debt and equity financing commitment in connection with the potential acquisition of Archstone-Smith Trust (May 18, 2007), at p. 3 [LBEX-DOCID 1722291]; Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 9.

entity-level debt and equity. The asset-level debt — which Lehman referred to as mortgage, mezzanine and assumed debt — would be secured by mortgages on Archstone's properties.[1331] Conversely, term loans would be unsecured obligations and were therefore categorized as entity-level debt.[1332] The equity was split into two categories – bridge equity and permanent equity. When the Archstone deal closed on October 5, 2007 (the "Closing Date"), the asset-level debt was secured by mortgages on Archstone's properties and was comprised of $9.5 billion of first lien mortgage debt, $1.1 billion of mezzanine mortgage debt and $1.4 billion of existing mortgage debt (referred to in the table below as assumed debt).[1333] Archstone had $4.6 billion of bridge equity and $500 million of permanent equity.[1334]

The purchase price (after taking into account assumed liabilities and transactions costs) was $23.6 billion.[1335] In connection with the closing of the Archstone acquisition, $1.4 billion of properties from Archstone's portfolio were sold and the proceeds were used to repay acquisition debt.[1336] This, in effect, reduced Archstone's enterprise value

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[1331] Lehman, Easy Living Q2 Model Risk (June 15, 2008), at all property level debt tab [LBEX-DOCID 4456413].

[1332] Lehman categorized the debt as entity-level debt. Entity-level debt is structurally subordinate to asset-level debt because the proceeds of an asset sale would first pay off asset-level debt, and then any remaining proceeds would go toward entity-level debt.

[1333] Lehman, Archstone: Financial Summary (June 14, 2008), at p. 5 [LBEX-DOCID 012476].

[1334] *Id.*

[1335] Lehman, Easy Living Model Risk (June 15, 2008) at tab S&U cell M51 [LBEX-DOCID 4456413].

[1336] Lehman, Archstone Q2 2008 Update (June 12, 2008), at p. 10 [LBEX-DOCID 2929329]. The $1.4 billion resulted in the sale of a 90% interest in these properties; Archstone retained the remaining 10% interest in these properties post closing.

from $23.6 billion to $22.2 billion as of the Closing Date.[1337] The following sets forth Archstone's initial capitalization:

Archstone Initial Capitalization[1338]

	$ in millions				
	Lehman $ Amount	Total $ Amount	Lehman % of Security	Security % of Total	% of Lehman Investment
Mortgage Debt	272	9,529	3%	43%	5%
Mezzanine Debt	506	1,097	46%	5%	9%
Assumed Debt	0	1,391	0%	6%	0%
Term Loans	2,253	4,764	47%	21%	42%
Preferred Equity	0	292	0%	1%	0%
Total Debt and Preferred Equity	3,031	17,073	18%	77%	56%
Bridge Equity	2,142	4,600	47%	21%	40%
Permanent Equity	246	500	49%	2%	5%
Total Equity	2,388	5,100	47%	23%	44%
Total Capitalization	5,419	22,173	24%	100%	100%

(i) Analyst Reaction

Industry analysts initially perceived that Lehman and Tishman Speyer had agreed to acquire Archstone at a favorable price.[1339] The Wall Street Journal reported that "[i]nvestors and analysts reacted coolly to Tishman Speyer Properties and Lehman

[1337] Lehman, Archstone July 2008 Update (July 29, 2008), at p. 4 [LBHI_SEC07940_ICP_008533]. The sources and uses tab in each of the two models that the Examiner's financial advisor reviewed — Lehman, Bridge Equity Discounting Sensitivity (Mar. 17, 2008) [LBEX-DOCID 1626080] and Lehman, Easy Living Model Risk (June 15, 2008) [LBEX-DOCID 4456413] — show a total sources number of $23.6 billion being adjusted down by $1.42 billion due to "90% Sale: OC/SD JV" (sale of properties in the Orange Country/San Diego area). The total proceeds from the sale were $1.578 billion (see cell O42 of the S&U tab in the models), but because Archstone owned 90% of the properties, it received $1.42 billion (*i.e.*, 0.9 * 1.578 billion). The sale price was $23.6 billion, less property sales of $1.4 billion, equaling $22.2 billion. In analyses of its investment in Archstone post-closing, Lehman repeatedly referred to an initial enterprise value (or initial capitalization) of $22.2 billion.

[1338] Lehman, Archstone: Financial Summary (June 14, 2008), at p. 5 [LBEX-DOCID 012476].

[1339] E-mail from Steven Fiscler, Lehman, to Edwin Mejia, Lehman, *et al*. (May 30, 2007) [LBEX-DOCID 2786297].

Brothers Holdings Inc.'s bid for apartment giant Archstone-Smith Trust, saying the offer is too low given the recent pricing in the commercial real estate world."[1340]

Analyst sentiment changed shortly thereafter. A Wall Street Journal article, "Alltel, Archstone Investors Get Credit Willies," published in early July 2007 and circulated in an e-mail[1341] from Jonathan Cohen to Keith Cyrus, a Vice President in GREG's Bridge Equity unit, specifically mentioned Archstone and reported that "[a] few private-equity firms may be getting a case of buyers remorse. The gap between the offering price and the current share price in a number of large agreed-upon leveraged buyouts is swelling. That indicates a fear on the part of merger investors that the private-equity acquirers may end up walking away from the deals or negotiating a lower price."[1342] An article published in the Wall Street Journal on August 1, 2007, which was circulated by Christopher O'Meara (then CFO) in an e-mail to Gerard Reilly (Global Product Controller), David Goldfarb (Global Head of Strategic Partnerships, Principal Investing, and Risk), Ian Lowitt (then Co-Chief Administrative Officer), Paolo

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[1340] Alex Frangos, Archstone Bid Gets Cool Reply: Tishman Speyer's Offer Is Seen As Too Low Given the Pricing In Commercial Real Estate, Wall St. J., May 30, 2007, at p. B9, attached to e-mail from Steven Fiscler, Lehman, to Edwin Mejia, Lehman, et al. (May 30, 2007) [LBEX-DOCID 2786297]. A number of shareholder derivative actions were brought in state and federal court alleging, among other things, that Archstone's trustees violated their fiduciary duties to shareholders in approving Archstone's acquisition. The state court cases were consolidated into one case in state court. The consolidated action eventually settled, and the dismissal of the federal action was part of that agreement.

[1341] E-mail from Jonathan Cohen, Lehman, to Keith Cyrus, Lehman (July 3, 2007) [LBEX-DOCID 1437297].

[1342] Posting of Dana Cimilluca to Deal Journal, http://blogs.wsj.com/deals/2007/07/02/alltel-archstone-investors-get-credit-willies (July 2, 2007, 9:55 EST).

Tonucci (Global Treasurer) and Edward Grieb (then Global Financial Controller),[1343] observed that a "credit crunch" was causing buyers to pull out of certain markets altogether or to demand sharply higher yields.[1344] The article suggested that Lehman might find it advantageous to cancel the acquisition and pay Archstone a $1.5 billion break-up fee.[1345] A Wall Street Journal article published on August 18, 2007 also noted that it might make sense for Lehman to cancel the Archstone deal rather than "try to swallow all that debt."[1346] When asked in a contemporaneous e-mail if this was "a good assessment of the situation," Jonathan Cohen responded that it was "spot on."[1347]

[1343] E-mail from Christopher M. O'Meara, Lehman, to David Goldfarb, Lehman, *et al.* (Aug. 1, 2007) [LBEX-DOCID 210157].

[1344] Ryan Chittum & Kemba J. Dunham, *Credit Crunch takes its Toll: Commercial Real Estate Feels the Effects of Fewer Buyers for Pooled Mortgage Securities,* Wall St. J., Aug. 1, 2007, at p. B11, attached to e-mail from Christopher M. O'Meara, Lehman, to David Goldfarb, Lehman, *et al.* (July 31, 2007) [LBEX-DOCID 210157] ("Low-cost loans with lenient terms have propelled the commercial-real-estate market to what many feared was an unsustainable level. . . . In the past few weeks, though, nervous buyers of these commercial securities have pulled out of the market altogether or demanded sharply higher yields, fearing that many transactions are too risky. . . . Investors are fretting over the commercial sector despite strong fundamentals because they see similarities to problems that led to the crash of the subprime residential-mortgage market.").

[1345] *Id.* (citing Citigroup, Archstone–Smith Trust: Could the Buyer Cut Their Losses and Walk Away? (July 26, 2007), at p. 1 [LBEX-DOCID 1192001]) ("A report Friday from Citigroup analyst Jonathan Litt speculated that Lehman might find it advantageous to cancel the deal and pay Archstone-Smith a $1.5 billion breakup fee rather than holding the debt involved in the deal."). The article incorrectly reported that Lehman was responsible for paying the entire break-up free, as opposed to the Archstone acquirers.

[1346] Alex Frangos, *If It Actually Happens*, Wall St. J., Aug. 18, 2007, at p. A2. The article notes that Archstone's shareholders were expected to "sign off on the deal" on August 21, 2007, and that "[t]hings looked different when the deal was announced in May. Shareholders complained then that the price, at $60.75 a share, was too low as buildings were still trading at record prices. . . . Given how real-estate stocks have sunk since May, the buyout price now seems a steal. Nonetheless, some say it might make more sense for the buyers to cancel the deal and pay as much as $1.5 billion in termination fees to Archstone-Smith, rather than try to swallow all that debt."

[1347] E-mail from Jonathan Cohen, Lehman, to Kenneth Lobo, Lehman (Aug. 20, 2007) [LBEX-DOCID 4320989].

(ii) Lehman's Syndication Efforts

After a financial institution agrees to provide financing to a borrower (such as in connection with an acquisition), it can seek to sell all or a portion of that debt to institutional investors prior to the date on which it is contractually obligated to provide such financing. The sale of such debt to other financial institutions or investors is commonly referred to as syndication.[1348] This term was also used by Lehman to refer to the projected sale of its Archstone bridge equity position.

Lehman's initial plan as of early May 2007 was to syndicate 50% of Lehman's Archstone debt and bridge equity positions to other banks within one to two weeks of the Commitment Date.[1349] Lehman also projected that Archstone would enter into agreements prior to closing to sell $9.2 billion of properties at closing, and Archstone would use the proceeds to immediately repay a portion of the acquisition financing provided by Lehman and its partner banks.[1350] Lehman was highly confident that it would be able to syndicate an additional $9 to $11 billion of debt before the closing, in part because of the "unlimited price flex" that was a standard feature in its debt where

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[1348] Barry Bobrow *et al.*, The Primary Market, *in The Handbook of Loans Syndications & Trading* 155, 159-160 (Allison Taylor and Alicia Sansone eds. 2007).

[1349] Memorandum from Mark A. Walsh, Lehman, to Exec. Committee of LBHI Board of Directors, re: $21.3 billion debt and equity financing commitment in connection with the potential acquisition of Archstone-Smith by Lehman Brothers and Tishman Speyer Properties (May 7, 2007), at p. 4 [LBEX-DOCID 147230].

[1350] *Id.*

it provided bridge equity.[1351] Price flex, which is addressed in greater detail below, is designed to allow the originating lender to syndicate the debt without suffering a loss. In light of this plan, Lehman projected that it would only have to fund $2 billion to $6 billion at closing.[1352] Within two to three weeks of closing, Lehman planned to sell 50% of its remaining Archstone mezzanine debt[1353] and bridge equity positions, with the remainder being sold over the following six months.[1354] Lehman determined that there was substantial institutional demand for the Archstone bridge equity, based on its conclusion that this equity was a direct investment in high-quality, cash flow generating real estate assets.[1355]

Given the potential size of the Archstone investment, Lehman brought BofA to the acquisition, and on the Commitment Date each institution agreed to provide half of the debt financing and to purchase half of the bridge equity.[1356] BofA, however, did not

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[1351] Lehman, Easy Living Talking Points for Executive Committee and Rating Agencies (May 18, 2007), at p. 2 [LBEX-DOCID 200792].

[1352] Lehman, Easy Living Talking Points for Executive Committee and Rating Agencies (May 18, 2007), at p. 2 [LBEX-DOCID 200792], attached to e-mail from Paolo Tonucci, Lehman, to Christopher M. O'Meara, Lehman, et al. (May 18, 2007) [LBEX-DOCID 215761].

[1353] As discussed below, mezzanine debt in the context of Archstone refers to asset-level debt that is subordinate to the first mortgage debt.

[1354] Lehman, Easy Living Talking Points for Executive Committee and Rating Agencies (May 18, 2007), at p. 2 [LBEX-DOCID 200792].

[1355] *Id.* at p. 1.

[1356] Lehman, Term Sheet (Bridge Equity) Project Easy Living (May 28, 2007) [LBEX-DOCID 1624526]; Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 8.

purchase a permanent equity position.[1357] On June 11, 2007, Barclays agreed to purchase 15% of the debt and 15% of the bridge equity, and on July 2, 2007, agreed to increase its participation to 25% of both the debt and the bridge equity.[1358] Barclays' commitments came out of BofA's share and did not affect Lehman's potential exposure to Archstone.[1359] As of July 2, 2007, commitments for debt (excluding mortgage and assumed debt) and bridge equity were as follows: Lehman - 47%, BofA - 28%, and Barclays - 25%.[1360]

On July 27, 2007, Mark A. Walsh, Head of GREG, reported that the institutional market for investments backed by commercial real estate was "virtually closed."[1361] Also on July 27, D.E. Shaw informed Lehman that its risk committee had rejected a proposed acquisition of a portion of Archstone's bridge equity "given the sell-off in the reit market and the volatility of the credit markets."[1362] Lehman's Treasury personnel became concerned that, as a result of the market "implosion," it might be necessary to

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[1357] Memorandum from Lehman to Commitment Committee, Lehman, *et al.*, re: $18.3 billion debt and equity financing commitment in connection with the potential acquisition of Archstone-Smith Trust (May 22, 2007), at p. 9 [LBEX-BARFID 0011582].

[1358] *Compare* Letter from Scott M. Weiner, Barclays, to Lehman and Bank of America, re: Archstone Joint Equity Commitment Letter (June 11, 2007), at p. 1 [LBEX-DOCID 2073685] (redline showing execution copy) *with* Letter from Michael Mazzei, President, Barclays, to Lehman and Bank of America, re: Debt Syndication Commitment Letter (July 2, 2007), at p. 2 [LBEX-DOCID 1451573] (redline showing execution copy).

[1359] Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at pp. 8-9.

[1360] Lehman, Project Easy Living Debt Funding Detail (Oct. 5, 2007), at Summary tab [LBEX-DOCID 598184]. Prior to July 2, 2007, Lehman and BofA adjusted the amounts of their respective debt and bridge equity commitments as set forth above.

[1361] E-mail from William Hughes, Lehman, to Alex Kirk, Lehman (July 27, 2007) [LBEX-DOCID 174304].

[1362] E-mail from Mark A. Walsh, Lehman, to Ian T. Lowitt, Lehman, *et al.* (July 27, 2007) [LBEX-DOCID 155079].

provide $9 billion in funding for the Archstone transaction, rather than the previously budgeted $6.8 billion.[1363]

On September 5, 2007, Freddie Mac agreed to purchase approximately $1 billion of Archstone mortgage debt in connection with the closing of the acquisition.[1364] On September 17, 2007, Fannie Mae committed to purchase $7.1 billion of Archstone mortgage debt.[1365] Walsh and Lisa Beeson, Head of Real Estate Mergers and Acquisitions in Lehman's Investment Banking Division, told the Examiner that the Archstone acquisition would not have closed without this financing.[1366] Walsh and Beeson told the Examiner that Fannie Mae's and Freddie Mac's decision confirmed the underlying soundness of the acquisition.[1367]

As of the closing, Lehman, BofA and Barclays had syndicated only $71 million of bridge equity, which represented 1.5% of the aggregate $4.6 billion bridge equity

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[1363] E-mail from Jonathan Cohen, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (July 27, 2007) [LBEX-DOCID 1904232].

[1364] *See* Lehman and Freddie Mac, Archstone Smith Holdco Floating Rate Pool Term Sheet (Sept. 5, 2007), at p. 1 [LBEX-DOCID 4452813]; Lehman and Freddie Mac, Archstone Smith Sellco Floating Rate Pool Term Sheet (Sept. 5, 2007), at p. 1 [LBEX-DOCID 4452811].

[1365] Letter from Larry J. Kravetz, Lehman, to Fannie Mae, re: Lehman loan to Entities controlled by Tishman Speyer and Lehman Brothers (Sept. 17, 2007), at p. 2 [LBEX-DOCID 2704241].

[1366] Examiner's Interview of Mark A. Walsh, Oct. 22, 2009, at p. 9; Examiner's Interview of Lisa Beeson, Oct. 23, 2009, at p. 6.

[1367] *Id.* The Freddie Mac and Fannie Mae commitments were allocated pro rata to Lehman (47%), BofA (28%) and Barclays (25%). Lehman, Project Easy Living Debt Funding Detail (Oct. 5, 2007), at Summary tab [LBEX-DOCID 598184].

commitment.[1368] After the closing, Lehman, BofA and Barclays did not syndicate any bridge equity and only syndicated $43 million of term loans.[1369]

(iii) Bridge and Permanent Equity at Closing

At closing, Lehman paid $2.1 billion for bridge equity, and its plan was to sell the entire position over the short- to medium-term to institutional investors.[1370] Lehman also acquired a $250 million permanent equity position, which was held by its Investment Management Division ("IMD").[1371] As noted above, the Archstone bridge equity referred to a limited partner interest while permanent equity referred to a general partner interest. The general partner interest benefited from a promote feature

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[1368] The lending group received expressions of interest from D.E. Shaw and Abu Dhabi Investment Authority, but these investors ultimately chose not to participate in the Archstone transaction. E-mail from Mike Mazzei, Barclays, to Mark A. Walsh, Lehman (Nov. 19, 2007) [LBEX-DOCID 1787730]. The Abu Dhabi Investment Authority expressed an interest in acquiring $250 to $550 million of bridge equity. Memorandum from Coburn Packard, Lehman, and Arash Dilmanian, Lehman, to Brett Bossung, Lehman, and Mark Newman, Lehman, Archstone Acquisition Update (Sept. 17, 2007), at p. 4 [LBEX-DOCID 2073832]. Lehman sold $50 million to the Irvine Company, $20 million to Consolidated Investor Group, and $1 million to Larry Cohen, a high net worth individual associated with Tishman Speyer. Lehman, Archstone Smith Multifamily JV Debt and Equity Redemption Schedule (Jan. 3, 2008), at Redemptions tab [LBEX-DOCID 2502413], attached *to* e-mail from Keith Cyrus, Lehman, to Paul A. Hughson, Lehman, *et al.* (Jan. 3, 2008) [LBEX-DOCID 2646616].

[1369] Lehman, Pro Forma Capitalization Company Balance Sheet (May 30, 2008), at p. 2 [LBEX-DOCID 4329013] attached to e-mail from Rachel Hamilton, Lehman, to Paul A. Hughson, Lehman, *et. al.* (May 31, 2008) [LBEX-DOCID 4329012].

[1370] E-mail from Jonathan Cohen, Lehman, to Clement Bernard, Lehman (Mar. 3, 2008) [LBHI_SEC07940_984508]. *See* Section III.A.1.b.1.a of this Report, which discusses in more detail Lehman's strategy with respect to bridge equity investments.

[1371] E-mail from Jeffrey Goodman, Lehman, to Donald E. Petrow, Lehman (Jan. 28, 2008) [LBEX-DOCID 3753206].

that provided for the general partners to receive enhanced distributions of 20% once the limited partners had received a rate of return on equity of 8% per year.[1372]

(iv) Capital Structure at Closing

As discussed above, as of the Closing Date, Lehman owned Archstone mortgage debt, mezzanine debt, term loans, bridge equity and permanent equity. The overwhelming majority of Lehman's positions (86%) fell into two categories: term loans (42%) and bridge/permanent equity (44%).[1373] Therefore, 86% of Lehman's investment was subordinated to over half (54%) of Archstone's capital structure.[1374] This placement in the capital structure exposed Lehman – particularly its equity positions – to the risk of significant impairment and the potential of material gain in the value of its investments if Archstone's enterprise value declined or increased over time.

The Archstone equity positions were subordinated to over three-quarters (77%) of the initial capital structure.[1375] As a result, a decline in enterprise value of less than 25% would result in a complete loss in the value of the equity. The effect of leverage

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[1372] Tishman Speyer, Lehman, and Bank of America, Term Sheet (Bridge Equity): Project Easy Living (May 30, 2007), at pp. 5-6 [LBEX-DOCID 1624527]; Memorandum from Lehman to Exec. Committee of LBHI Bd. of Directors, re: $23.4 billion debt and equity financing commitment in connection with the potential acquisition of Archstone-Smith Trust (May 18, 2007), at p. 5 [LBEX-DOCID 1722291]. A general partner would no longer benefit from the promote fees in the event of failed syndication. *Id.* Failed Syndication is defined as: "If the syndication of all of Lehman's equity interest in the Joint Venture has not been completed prior to the end of the Syndication Period, then (i) such syndication shall be deemed a "Failed Syndication"; (ii) Lehman shall be entitled to assume sole control over the syndication and shall be permitted to sell its equity position to any investor in Lehman's sole discretion; and (iii) Lehman shall have the sole authority to reduce or eliminate the promote and administrative fees otherwise payable to Sponsor." *Id.*

[1373] Lehman, Archstone: Financial Summary (June 14, 2008), at p. 5 [LBEX-DOCID 012476].

[1374] *Id.*

[1375] This figure was computed as $17 billion of debt divided by $22 billion of total capital.

works in the other direction as well, as a less than 25% increase in enterprise value results in a 100% increase in the value of the equity.

The Examiner's investigation included a solvency analysis of the LBHI Affiliates.[1376] Accordingly, the Examiner ascertained whether debtors owned any Archstone investment positions. As shown in the table below, LCPI, an LBHI Affiliate, owned $1.6 billion of Archstone entity-level debt as of May 2008. While bridge and permanent equity were not directly owned by an LBHI Affiliate or LBHI, any change in the value of such investments would affect LBHI's solvency.[1377]

Legal Entity Ownership of Archstone Positions as of May 2008[1378]

Company	**Item(s) Held**	**Par Value**	**% of Total Archstone Investment**
Lehman Brothers Holdings, Inc.	Mortgage and asset-level debt	$680 million	15%
Lehman Commercial Paper, Inc.	Revolver and term loans	$1.6 billion	34%
Luxembourg Trading Finance	Term B loans	$793.5 million	17%
Property Asset Management, Inc.	Bridge equity	$1.609 billion	34%

[1376] See Section III.B.3.c of the Report for further details.

[1377] This finding is based on the GFS data. *See* Lehman, Reconciliation Data May 2008 (June 13, 2008), at Sheet 1 tab [LBEX-LL 1104843].

[1378] *Id.* The GFS data does not split out IMD investments and thus the table does not include the permanent equity.

As of August 2008, Luxembourg Trading Finance had transferred $600 million in principal amount of Term Loan B to Luxembourg Residential Properties Loan Finance S.a.r.l., an LBHI Affiliate.[1379]

(v) Price Flex

The debt positions held by these LBHI Affiliates were covered by price flex.[1380] Price flex, as a general matter, is a mechanism that facilitates syndication or sale of a loan by the initial lender without the lender incurring a loss.[1381] As a mechanical matter, price flex may permit the initial lender to increase the interest rate to attract buyers of the debt (in which case the borrower is required to pay its lenders a higher interest rate), or require the borrower to reimburse the initial lender for any loss it may suffer as a result of syndicating or selling the debt to a third party at a price less than par.[1382]

Lehman, BofA and Barclays (the "Archstone Lenders") entered into a certain Side Letter, dated October 5, 2007 (as amended pursuant to that certain letter agreement between Archstone and the Archstone Lenders, dated November 27, 2007, the "Archstone Side Letter"), that set forth the price flex terms and conditions.[1383] The Archstone Side Letter provided that after March 24, 2008, the Archstone Lenders had the right to require Archstone to amend the pricing of the applicable loans (including

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[1379] Lehman, Reconciliation Data August 2008 (Sept. 17, 2008) [LBEX-LL 1104812].

[1380] Archstone, Side Letter agreement (Oct. 5, 2007), at pp. 1-2 [LBEX-WGM 007973].

[1381] Barry Bobrow *et al.*, The Primary Market, *in The Handbook of Loans Syndications & Trading* 155, 175 (Allison Taylor and Alicia Sansone eds. 2007).

[1382] Examiner's Interview of Clement Bernard, Oct. 23, 2009, at pp. 15-16. Price flex agreements are subject to the terms agreed upon among the lenders and the borrower.

[1383] Archstone, Side Letter agreement (Oct. 5, 2007), at p. 2 [LBEX-WGM 007973].

the spread or margin) or fees in order to achieve a successful syndication of such loans.[1384] Prior to March 24, 2008, the Archstone Lenders could make such changes only with Archstone's consent.[1385] In the event that the Archstone Lenders sold Archstone loans at a discount in accordance with the terms of the Archstone Side Letter, Archstone was obligated to reimburse the Archstone Lenders for such loss, which would be satisfied from an escrow account held at BofA ("Escrow Account").[1386]

The Escrow Account was initially funded with $39 million, and the amount held in the account was intended to equal the potential loss that the Archstone Lenders could suffer based on the market price of the unsold Archstone debt.[1387] BofA was obligated to "mark to market" such debt on the first day of each month, and Archstone was to "promptly deposit any additional amount required as a result of such mark."[1388] The only deposit made prior to LBHI's bankruptcy filing was made on February 29, 2008, in the amount of $33 million.[1389] The account's balance was approximately $74 million as

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[1384] *Id.*

[1385] *Id.* With respect to the Term Loan A, prior to March 24, 2008, the Archstone Lenders were permitted to increase the pre-default interest rate on Term Loan A to a specified level, and were not permitted to sell or syndicate more than $1.5 billion of the Term A Loans prior to such date without Archstone's consent. *Id.* Prior to March 25, 2008, the Archstone lenders were permitted to increase the pricing of the Mezzanine Loans by no more than 50 basis points over the spreads and indices referred to in the Archstone Side Letter. *Id.*

[1386] *Id.* at pp. 5-6.

[1387] *Id.* at p. 5.

[1388] *Id.* at pp. 5-6.

[1389] BofA, Project EZ Living OID Reserve Fund Money Market Savings (Feb. 29, 2008), at pp. 5-6 [LBEX-BofA 000001].

of the beginning of August 2008, which included interest earned on the balance.[1390] No withdrawals from the account were made prior to LBHI's bankruptcy filing.[1391]

In the case of Archstone, the bridge equity holders were the same institutions as the debt holders, and therefore, any sales of loans for less than par would necessarily impact the value of their equity positions. Lehman viewed price flex as effectively requiring equity to guarantee the value of the debt.[1392]

As the purpose and function of price flex is to permit the initial lender to sell the debt to a third party without suffering a loss, and the Examiner found that there was sufficient equity value after accounting for the effect of overvaluations to finance the cost of price flex, the Examiner did not find sufficient evidence to support a determination that Lehman's valuation of its Archstone debt positions covered by price flex was unreasonable.[1393]

[1390] BofA, Transactions for account: Bank of America as Administrative Agent Archstone - Operating Trust Expense Reserve Escrow Account (July 20, 2009), at p. 1 [LBEX-BofA 000007].

[1391] The Examiner, while taking into account the BofA marks that were reflected in the Archstone Escrow Account's balance for purposes of assessing the reasonableness of Lehman's valuations, determined that it was not a prudent use of resources to examine BofA's valuation of the Archstone loans.

[1392] Examiner's Interview of Clement Bernard, Oct. 23, 2009, at p. 15; Examiner's Interview of Paul A. Hughson, Dec. 21, 2009, at p. 3; Examiner's Interview of Abebual A. Kebede, Oct. 6, 2009, at p. 8.

[1393] The debt positions subject to price flex were generally carried by Lehman at 99% of funded value, and Lehman's conclusion as to any loss of value of these debt positions was incorporated into the bridge and equity positions. The Examiner did not investigate the reasonableness of Lehman's reporting of individual units of account (*i.e.*, the recording of the loss in value on debt positions in the debt position that incurred the loss or the equity position that funded the loss in value on debt positions).

(vi) Standard & Poor's Credit Rating

On September 26, 2007, S&P announced its expected ratings for Archstone's acquisition debt.[1394] S&P gave the proposed $5.1 billion secured credit facility a BB- rating with a recovery rating of 4.[1395] S&P also announced that its Archstone ratings remained on CreditWatch[1396] with negative implications and that it expected to lower its corporate credit rating to BB- from BBB+ if the acquisition closed as proposed.[1397] S&P explained that the expected downgrade was due to the "more aggressive financial profile," "weak" debt protections (measures to insure payment of debt), and the risk associated with Archstone's plan to increase development.[1398] S&P concluded that these weaknesses were "partly offset" by "good quality and above average historical operating performance of Archstone's portfolio" and that Archstone's management team was remaining in place.[1399]

[1394] S&P, Archstone-Smith Trust Ratings Remain on Watch Neg; $5.1 Billion Credit Facility Rated 'BB-' (Sept. 26, 2007), at p. 1 [LBEX-DOCID 1711704], attached to e-mail from Francis X. Gilhool, Lehman, to Paul A. Hughson, Lehman, *et al.* (Sept. 26, 2007) [LBEX-DOCID 1854830].

[1395] *Id.* A BB- rating implies that the company is "less vulnerable in the near-term but faces major ongoing uncertainties due to adverse business, financial and economic conditions." S&P's Credit Ratings Definitions and FAQs, http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us (last visited Jan. 27, 2010). A recovery rating of 4 "denotes an expectation of average (*i.e.* 30%-50%) recovery in the event of default." S&P's Ratings Definitions, http://www.standardandpoors.com/ratings/articles/en/us/?assetID =1245200953923 (last visited Jan. 27, 2010).

[1396] The credit ratings were placed on CreditWatch with negative implications shortly after the agreement to acquire Archstone had been publicly announced. CreditWatch is an indicator of a potential change in a rating (up or down) based on recent events. In the current case, S&P indicated that the proposed privatization of Archstone would likely result in a downgrade of Archstone's rating.

[1397] S&P, Archstone-Smith Trust Ratings Remain on Watch Neg; $5.1 Billion Credit Facility Rated 'BB-' (Sept. 26, 2007), at p. 1 [LBEX-DOCID 1711704].

[1398] *Id.*

[1399] *Id.*

S&P noted that the purchase price implied a 4% capitalization rate[1400] and that an increase in capitalization rates to a "more conservative" 7% would reduce Archstone's equity value to zero.[1401] S&P also observed that the plan to reduce Archstone's debt over time was "heavily reliant on asset sales, which can be unpredictable" and opined that "we expect the future environment for multifamily asset sales and pricing to be less robust than it is currently."[1402]

On October 9, 2007, after the closing of the acquisition, S&P formally lowered its corporate rating on Archstone to BB-.[1403] S&P justified its rating based on several observations:[1404]

- Archstone's risk profile had increased "given the heightened construction and lease-up risk inherent in new development."
- "[E]xpected yields on new development would be negatively affected if the recent moderation in rents and NOI [net operating income] growth continues, or measurably deteriorates if the economy falls into a recession."
- Archstone's liquidity position was "currently sufficient to meet its capital needs" but the business plan relied "heavily on the generation of aggressive asset sale proceeds."

S&P concluded that the outlook was "stable" and that it would lower the rating "if it appears that the company will be unable to achieve sufficient asset sales to repay

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[1400] *See* Section III.A.2.f.4.a.ii of this Report for a discussion and analysis of exit capitalization rates.
[1401] *Id.*
[1402] *Id.* A capitalization rate is the ratio of income to value. As value is the denominator, the higher the capitalization rate, the lower the value of the real estate asset.
[1403] S&P, Various Rating Actions Taken On Archstone-Smith Operating Trust After Close of Merger (Oct. 9, 2007), at p. 2.
[1404] *Id.* at p. 3.

the bank debt and alleviate the debt burden, or if the company is unable to pull back development activity if the operating environment deteriorates."[1405]

(3) Lehman's Valuation of Archstone

After the Archstone acquisition, Lehman held $5.4 billion in Archstone positions — $3.0 billion of debt and $2.4 billion of equity.[1406] These amounts are referred to as Lehman's "funded exposure" because they represent the amount that Lehman invested, net of any repayments of debt by Archstone.[1407] By August 31, 2008, this funded exposure was reduced by $423 million due to Archstone's repayment of debt.[1408] The following table sets forth Lehman's funded exposure on a monthly basis:

[1405] *Id.*

[1406] Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBEX-BARFID 0013113].

[1407] As Archstone did not purchase any of its own equity, the funded amounts for bridge or permanent equity did not change.

[1408] Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113]; Lehman, Top Global Real Estate Exposures (Aug. 31, 2008), at p. 12 [LBHI_SEC07940_ICP_002615]. The $423 million reduction is computed by subtracting exposure of $4.975 billion as of August 2008 from $5.398 billion as of October 2007.

Archstone Funded Exposure by Month ($ million, Oct. 07–Aug. 08)[1409]

	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	June	July	Aug
Term Loan A & B	2,232	2,220	2,153	2,090	2,045	1,977	1,975	1,963	1,927	1,893	1,980
Development Loan	236	217	195	200	200	200	200	194	194	132	N/A
Revolver	0	0	0	211	211	158	203	237	184	114	141
Mezzanine Loan	542	542	542	529	529	529	527	527	527	496	466
Bridge Equity	2,142	2,142	2,142	2,142	2,142	2,142	2,142	2,142	2,142	2,142	2,142
Permanent Equity	246	246	246	246	246	246	246	246	246	246	246
Total	**5,398**	**5,367**	**5,278**	**5,418**	**5,373**	**5,252**	**5,293**	**5,309**	**5,220**	**5,023**	**4,975**

As of the closing date, Lehman wrote down its Archstone positions in an amount equal to $230 million of fees it received in connection with the acquisition.[1410] Thereafter, Lehman took three valuation-related write-downs on its Archstone positions.[1411] At the end of March 2008, Lehman took a $200 million write-down on the bridge equity and a $50 million write-down on permanent equity.[1412] In May 2008, Lehman took a $90 million write-down on bridge equity and a $10 million write-down on permanent equity.[1413] Finally, in August 2008, Lehman took a $110 million write-down on bridge equity and a $15 million write-down on permanent equity.[1414] Lehman's basis for taking these write-downs is discussed below.

Beginning on November 15, 2007, Lehman wrote down its Archstone position in amounts equal to the difference between the rate that Lehman charged GREG for use of

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[1409] Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113]; Lehman, Top Global Real Estate Exposures (Aug. 31, 2008), at p. 12 [LBHI_SEC07940_ICP_002615].
[1410] Lehman, Archstone Origination Fees Marked into Position, at p. 1 [LBEX-BARFID 0024639].
[1411] Lehman, Global Real Estate 2008 Mark Downs, at pp. 10, 21 [LBEX-BARFID 0013162].
[1412] Lehman, Archstone Origination Fees Marked into Position, at p. 1 [LBEX-BARFID 0024639].
[1413] Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113].
[1414] *Id.*

the balance sheet to finance Archstone debt positions, and the higher rate of interest Lehman charged Archstone on these debt positions.[1415] This difference is called the excess carry.[1416] Jonathan Cohen told the Examiner that Paul Hughson, GREG's Head of Credit Distribution, decided to use excess carry to reduce the bridge equity mark, because Hughson did not want to show profits on Archstone positions.[1417]

The first chart below shows Lehman's Archstone marks by month, and the second chart shows the corresponding valuation of Archstone positions by month:

Lehman's Archstone Marks by Month ($ million, Oct. 07 – Aug. 08)[1418]

	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	June	July	Aug
Term Loan A & B	99.0	99.0	98.9	98.9	98.9	98.8	98.9	98.8	98.8	99.2	98.2
Development Loan	99.2	99.1	99.0	98.5	96.0	95.5	95.5	94.3	94.3	91.3	N/A
Revolver	N/A	N/A	N/A	99.1	99.1	98.1	98.5	99.2	98.9	99.0	99.3
Mezzanine Loan	98.9	98.9	98.9	98.9	98.9	98.8	98.9	98.8	98.8	99.0	98.9
Bridge Equity	90.7	90.5	90.2	89.6	89.6	79.9	79.6	75.1	74.9	74.6	69.0
Permanent Equity	100.0	100.0	100.0	100.0	100.0	79.9	79.6	75.1	74.9	74.6	69.1
Weighted Average Mark	**95.7**	**95.6**	**95.5**	**95.3**	**95.1**	**90.1**	**90.1**	**88.0**	**87.7**	**87.2**	**84.3**

Lehman's Valuation of Archstone Positions ($ million, Oct. 07 – Aug. 08)[1419]

	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	June	July	Aug
Term Loan A & B	2,210	2,197	2,130	2,067	2,022	1,953	1,954	1,940	1,903	1,877	1,944
Development Loan	234	215	193	197	192	191	191	183	183	121	N/A
Revolver	0	0	0	209	209	155	200	235	182	113	140
Mezzanine Loan	536	536	536	523	523	522	521	521	521	491	461
Bridge Equity	1,942	1,939	1,933	1,919	1,919	1,712	1,706	1,609	1,604	1,597	1,477
Permanent Equity	246	246	246	246	246	197	196	185	184	184	170
Total	**5,168**	**5,133**	**5,038**	**5,161**	**5,111**	**4,730**	**4,768**	**4,672**	**4,577**	**4,382**	**4,192**

[1415] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 10.

[1416] *Id.*

[1417] *Id.*

[1418] Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113]; Lehman, Top Global Real Estate Exposures (Aug. 31, 2008), at p. 18 [LBHI_SEC07940_ICP_002615].

[1419] Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113]; Lehman, Top Global Real Estate Exposures (Aug. 31, 2008), at p. 18 [LBHI_SEC07940_ICP_002615].

A review of the weighted average mark is more instructive than the mark on any single position (*e.g.*, for the bridge equity or permanent equity), because it reflects Lehman's determination as to the value of all of its Archstone holdings in the aggregate. For example, an assessment of Lehman's bridge equity or permanent equity marks, viewed in isolation, would fail to separate the change in value due to the price flex mechanism, which resulted in the equity absorbing any loss of value of the debt.

As of closing, Lehman valued its debt positions at approximately 99, its bridge equity at approximately 91 and its permanent equity at 100.[1420] At closing, the weighted average mark across Lehman's Archstone portfolio was approximately 96, which indicates Lehman concluded that its entire investment was worth approximately 96% of what it paid.

Lehman's weighted average Archstone mark declined slightly between October 2007 and February 2008 from 95.7 to 95.1 due to application of the excess carry to reduce the marks. The weighted average mark declined to 90.1 in March, to 88.0 in May and to 84.3 in August 2008 as Lehman took the write-downs described above and continued to apply excess carry to reduce the marks.

[1420] Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113]; Lehman, Top Global Real Estate Exposures (Aug. 31, 2008), at p. 12 [LBHI_SEC07940_ICP_002615]. Lehman did not take a write-down on its commitment prior to closing. See the following section, which discusses Lehman's Archstone valuation prior to closing.

(a) Valuation Between Commitment and Closing

This section discusses Lehman's process with respect to the valuation of its commitment to finance the Archstone acquisition. Financial accounting rules required Lehman to mark its Archstone commitments to market.[1421] That is, even before closing, Lehman was required to determine the value of its commitments to provide financing and purchase debt.[1422]

On August 22, 2008, Gerard Reilly, the Head Product Controller, asked Abebual A. Kebede, GREG's Vice President of Valuation Control, to "put a memo together" on the valuation of the Archstone commitment, as "this will get a lot of focus."[1423] The Examiner did not locate any evidence that demonstrated or suggested that Lehman engaged in any systematic effort to value its Archstone commitments prior to this date.

Kebede e-mailed Hughson on August 22, 2007 to obtain Archstone information.[1424] Kebede wrote that Hughson's colleagues "were hesitant" to give him "any details," and Kebede asked Hughson for "details/support" to perform the required

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[1421] Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (June 1998), ¶ 17.

[1422] Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113]; Lehman, Top Global Real Estate Exposures (Aug. 31, 2008), at p. 12 [LBHI_SEC07940_ICP_002615].

[1423] E-mail from Gerard Reilly, Lehman, to Abebual A. Kebede, Lehman, *et al.* (Aug. 21, 2007) [LBEX-DOCID 2723016]. In an e-mail to Reilly on August 21, 2007, Kebede wrote: "Further to your query regarding the MTM [mark-to-market] of our commitment on Archstone I spoke with the deal managers this afternoon . . . ." E-mail from Abebual A. Kebede, Lehman, to Gerard Reilly, Lehman, *et al.* (Aug. 21, 2007) [LBEX-DOCID 2723016].

[1424] E-mail from Jonathan Cohen, Lehman, to Abebual A. Kebede, Lehman (Aug. 22, 2007) [LBEX-DOCID 2689684].

analysis and for the underwriting model.[1425] Hughson's reply did not address Kebede's request for additional information.[1426] Instead, Hughson responded that as the Archstone debt benefited from price flex, there was no need to value the debt, and that the bridge equity would initially be marked at 96.[1427] Jonathan Cohen's one-word response to this e-mail trail was "[u]nreal."[1428] Jonathan Cohen told the Examiner that his response referred to Hughson's failure to respond to Kebede's request for information.[1429]

On August 23, 2007, Kebede sent Jonathan Cohen a memo he described as a "first attempt on the Archstone valuation review."[1430] Kebede's valuation memo observed that while only a "minimal" amount of bridge equity had been syndicated, the "business" believed that the marks on the bridge equity were appropriate because the yields implied by the model Lehman used to assess the transaction were "in line with current market yields for similar investments."[1431]

[1425] *Id.*

[1426] *Id.*

[1427] *Id.*

[1428] *Id.*

[1429] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at pp. 10-11.

[1430] E-mail from Abebual A. Kebede, Lehman, to Jonathan Cohen, Lehman (Aug. 23, 2007) [LBEX-DOCID 2689696]. Kebede informed Jonathan Cohen: "We will need to update the conclusion once we decide on the marks." *Id.* The Examiner did not locate any updated valuation memo, and Jonathan Cohen did not recall any such update being undertaken.

[1431] Lehman, Archstone Smith Valuation Update (Aug. 23, 2007), at p. 2 [LBEX-BARFID 0011579].

(b) Valuation as of the Closing Date

As of the closing date, Lehman marked all of its debt positions at 99, its bridge equity at 91 and its permanent equity at 100.[1432] These write-downs were equal to the $230 million in underwriting, structuring and M&A advisory fees Lehman received in connection with the acquisition.[1433] Lehman allocated the fees as follows:

Allocation of Fees to Initial Archstone Marks[1434]

Debt	Fees Allocated to Mark	Resulting Mark
Term Loan A	(11.4)	99.0%
Term Loan B	(11.0)	99.0%
Development Loan	(2.4)	99.0%
Mezzanine Loan	(5.4)	99.0%
Revolver	(3.5)	99.0%
Bridge Equity	(199.5)	90.7%
Total	**(233.0)[1435]**	

Hughson told the Examiner that the fees were applied to the marks based on the state of the debt and equity markets and that these marks were approved by O'Meara and Tonucci.[1436]

[1432] Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113].

[1433] Lehman, Archstone Origination Fees Marked into Position, at p. 1 [LBEX-BARFID 0024639].

[1434] *Id.* Lehman's policy was to mark bridge equity fees (typically 4%) into the basis for its bridge equity positions (thus reducing the mark). Lehman, Global Real Estate Mark Downs (Feb. 1, 2008), at p. 5 [LBEX-DOCID 514139].

[1435] The Examiner notes that according to Lehman's records (and as is discussed throughout this Section), Lehman received $233 million of fees related to the Archstone transaction. However, when marking down Archstone to reflect fees, Lehman took a mark-down of $230 million. This difference $3 million difference is immaterial and represents less than 0.1% of Lehman's Archstone investment.

[1436] Examiner's Interview of Paul A. Hughson, Dec. 21, 2009, at p. 3.

On October 4, 2007, the day before the closing, Jonathan Cohen e-mailed Reilly as to the status of the loan syndication: "The term loan syndication is not going so well. No orders yet and it seems the investors want better pricing. Tishman is reluctant to accept the discount as it will impact equity."[1437] Reilly replied, "[w]hat would be the logic in not marking down the term loan?"[1438] Jonathan Cohen replied that the term loans were guaranteed to make a 1% profit,[1439] and the implied yields on the bridge equity investment remained within a reasonable range notwithstanding that, due to price flex, equity would incur losses in value that, absent price flex, would be incurred by the debt.[1440]

On October 9, 2007, Jonathan Cohen, responding to an e-mail asking about Hughson's views on where Archstone debt should be marked, wrote that Hughson "thinks 99, but if the firm wants him to mark it at where we could clear, then maybe at 96."[1441]

[1437] E-mail from Jonathan Cohen, Lehman, to Gerard Reilly, Lehman (Oct. 4, 2007) [LBEX-DOCID 1722336].

[1438] *Id.*

[1439] Lehman considered that it would make a 1% profit on the debt because it had allocated fees equaling 1% of the principal amount of its Archstone debt to such debt and concluded that it would not suffer a loss on the sale or syndication of such debt due to price flex. *Id.*

[1440] *Id.* Jonathan Cohen also informed Reilly that Hughson told him there "[a]pparently" was a "written document whereby we agreed NOT to sell the term loan at reduced prices." Jonathan Cohen told Reilly that this meant there was an agreement to not sell into the "depressed" market. E-mail from Jonathan Cohen, Lehman, to Gerard Reilly, Lehman (Oct. 5, 2007) [LBEX-DOCID 2723114].

[1441] E-mail from Jonathan Cohen, Lehman, to Derek Schneider, Lehman (Oct. 9, 2007) [LBEX-DOCID 2802572].

(c) Valuation as of the Fourth Quarter of 2007[1442]

The Examiner did not locate any formal valuation analyses undertaken by Lehman to value the Archstone positions as of November 30, 2007, the end of Lehman's fiscal year. Hughson, for example, did not recall any specific events that would have caused the need to change Archstone's valuation between October 5, 2007, and November 30, 2007.[1443] Hughson, Jonathan Cohen and Webster Neighbor, who worked in the Bridge Equity unit and operated the Archstone cash flow model that was used to mark the bridge equity position, could not recall any specific discussion or analyses regarding the valuation of the Archstone position as of November 2007.[1444]

E&Y completed a year-end audit of LBHI's financials for the period ending November 30, 2007.[1445] William Schlich, E&Y's lead audit partner, and Jerry Gruner, a senior manager on E&Y's Lehman audit team, told the Examiner that in the approximately two-month period following the close of the Archstone deal, E&Y concluded that the best indication of the fair market value of Lehman's equity investment in Archstone was the price Lehman paid to acquire those positions.[1446] Schlich and Gruner told the Examiner that BofA's and Barclays' participation in the

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[1442] Lehman's fourth quarter covered September 1, 2007, through November 30, 2007.

[1443] Examiner's Interview of Paul A. Hughson, Dec. 21, 2009, at p. 3.

[1444] *Id.*; Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 10; Examiner's Interview of Webster Neighbor, Nov. 17, 2009, at p. 3.

[1445] Lehman, Exhibit 23.01, at p. 255, attached to LBHI 2007 10-K. E&Y's work papers did not include any formal analysis of the Archstone positions.

[1446] Examiner's Interview of Ernst & Young, Nov. 11, 2009, at pp. 4-5.

same transaction with similar terms served as another indication that a November 30, 2007 valuation based on the closing price on October 5, 2007, was reasonable.[1447]

(d) Valuation Issues During the First Quarter of 2008[1448]

(i) Barron's Article

On January 21, 2008, Barron's published an article titled "Apartment House Blues" that questioned the value of Archstone's equity.[1449] According to the article, the Archstone transaction "could prove disastrous for Wall Street firms and other equity investors."[1450] The article noted that Archstone had a "heavy load" of debt - almost five times the amount of AvalonBay, a comparable publicly traded REIT.[1451] In light of the 30% decline in the share prices of REITs since October 2007, the article stated that Wall Street was "concerned . . . that rent increases will slow, even in relatively strong markets," and that Archstone was a "classic example of a good company with a bad balance sheet . . . . [T]he value of Archstone equity could be zero."[1452] This potential loss of all equity value was premised on an observation that the implied capitalization rates for REITs, based on current stock prices, had risen to an average of 7%, and even the

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[1447] *Id.* at p. 5.

[1448] Lehman's first quarter covered December 1, 2007, through February 29, 2008.

[1449] Andrew Bary, *Apartment-House Blues*, Barron's, Jan. 21, 2008, at p. 1, *available at* http://online.barrons.com/article/SB120070919702802265.html#articleTabs_panel_article%3D1.

[1450] *Id.*

[1451] *Id.*

[1452] *Id.* at pp. 1-2.

"highly regarded" AvalonBay[1453] REIT had an implied capitalization rate of 6.3%.[1454] (The value of real estate is inversely related to changes in capitalization rate – all other factors being equal, an increase in capitalization rates results in decrease in value.)[1455] To estimate an enterprise value for Archstone, the article applied a 6% capitalization rate to "an optimistic $850 million of net operating income for this year" to arrive at $14 billion, which was lower than the face value of Archstone's debt; this "would imply a wipe-out of the $5 billion of equity."[1456] The article further noted that the use of a 5.5% capitalization rate, which it considered to be "aggressive," still "results in no equity value."[1457]

a. Archstone's Response to the Barron's Article

On January 19, 2008, the Friday before Barron's piece was published, R. Scot Sellers, Archstone's CEO, wrote an e-mail to Lehman, Tishman Speyer and Archstone personnel, to set forth a "compilation of talking points that should be helpful in addressing many of the allegations in the article."[1458] In this e-mail, Sellers made the following arguments:

[1453] As discussed below in the Comparable Companies portion of the Analysis section, Lehman deemed AvalonBay to be one of the three "primary comps" to Archstone.

[1454] Andrew Bary, *Apartment-House Blues*, Barron's, Jan. 21, 2008, at p. 2, *available at* http://online.barrons.com/article/SB120070919702802265.html#articleTabs_panel_article%3D1.

[1455] Shannon P. Pratt & Roger J. Grabowski, *Cost of Capital: Applications and Examples* 564 (3d ed. 2008).

[1456] Andrew Bary, *Apartment-House Blues*, Barron's, Jan. 21, 2008, at p. 2, *available at* http://online.barrons.com/article/SB120070919702802265.html#articleTabs_panel_article%3D1.

[1457] *Id.*

[1458] E-mail from R. Scot Sellers, Archstone, to David Augarten, Tishman Speyer, *et. al.* (Jan. 19, 2008) [LBHI_SEC07940_111678]. Jonathan Cohen told the Examiner that Lehman knew the article was going to

- Public markets are not good predictors of real estate values;[1459]
- Values ascribed by public markets are not transactionable;[1460]
- Replacement costs are a good indicator of value;[1461]
- Weakening single family home markets will increase rent growth;[1462]
- Archstone assets are more desirable than other real estate assets;[1463]
- The article "missed" the value of Archstone's platform and development franchise.[1464]

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be published and that the author did not want to incorporate Archstone's and Lehman's view as to value. Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 10.

[1459] E-mail from R. Scot Sellers, Archstone, to David Augarten, Tishman Speyer, *et. al.* (Jan. 19, 2008) [LBHI_SEC07940_111678]. The "principle mistake in the article is the assumption that public market share prices are in any [way] predictive of real estate values, or represent an 'efficient' market." Sellers goes on to argue "how wrong the public market gets valuations and even directionality from time to time" and cites examples where Archstone bought back its own stock at large discounts to the "value" of the assets when there was a period of illiquidity. He also cited Archstone's "solid" operating fundamentals. *Id.*

[1460] *Id.* "Using a comparison of public market pricing to value our portfolio may seem intuitive to someone who doesn't understand public markets well, but it is flawed for several reasons. First, you simply could not purchase these companies today at anywhere close to current share prices." As support, Sellers cites an example where Archstone was rebuffed in its attempt to acquire another REIT during the last cycle with a cash offer at a "material premium" to the existing stock price. He further states that publicly traded REITs such as AvalonBay and Equity Residential were trading at 35% to 50% below replacement cost and that replacement costs were "unlikely to come down much, if at all, due to the tremendous demand for raw materials from large construction initiatives around the world" and that land prices within Archstone's markets were "unlikely to change much either." *Id.*

[1461] *Id.* "Replacement costs are an especially important benchmark in supply-constrained markets, because of the difficulty of adding new supply. By definition, as demand increases in these markets, it can only be met by developing new units at replacement costs, which in turn requires rents that produce a market rate of return on these costs." *Id.* Replacement cost refers to the cost to replace an asset, such as a building, at the cost that one would incur today, which may be different from the fair market value of the asset. *Id.*

[1462] *Id.* Sellers states that fundamentals for apartments were expected to become stronger due to the deteriorating fundamentals for new single family homes (*i.e.*, people will be more likely to rent than buy). *Id.*

[1463] *Id.* Investors "place a very high value on the ability to acquire these types of [Archstone's] assets, at any point in the real estate cycle." "We are in a period of more limited transactional volume today, but there is still significant demand to purchase the assets we own at very attractive prices, and we will continue to consummate transactions with qualified buyers and partners as we move forward." *Id.*

Sellers closed the e-mail by stating that this was a time to "acquire great assets at attractive prices," because he did not "anticipate seeing a lot of distress in the markets, due to the strong operating fundamentals in our business" and he expected that interest rates would come down.[1465]

b. Lehman's Response to the Barron's Article

Lehman personnel met with representatives from Tishman Speyer, BofA and Barclays over the weekend of January 19, 2008, to discuss the Barron's article.[1466] While Lehman, BofA and Barclays decided not to issue a formal response, Lehman analyzed public company information, compiled data on recent Archstone asset sales and comparable asset sales, and reviewed Archstone's business plan.[1467]

In a January 21, 2009 e-mail, one of the Lehman participants in the meeting wrote to his colleagues that the implied capitalization rates of publicly traded REITs were "not representative of the company's portfolio. That being said, if we actually thought the

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[1464] *Id.* "Private real estate investors understand the tremendous value of this platform/franchise, and are willing to pay for it . . . but the public markets don't get this for some reason." Sellers states that both Archstone and AvalonBay were able to "consistent[ly]" create value in supply constrained markets over the course of many years "yet public market investors have never been willing to recognize this." *Id.*

[1465] *Id.*

[1466] E-mail from Scott A. Levin, Lehman, to Steven R. Hash, Lehman, *et al.* (Jan. 21, 2008) [LBEX-DOCID 1488801].

[1467] *Id.* Lehman also identified the following assets that the Barron's article did not appear to incorporate into its analysis: assets held for sale, development pipeline, platform value in Germany, ground leases and other assets. *Id.*

appropriate cap rate for the company's assets was 6.0%, there would not be much equity value in the company (please do not share that information)."[1468]

Shortly after the Barron's article was published, Jonathan Cohen sent an e-mail to Donald E. Petrow, a Senior Vice President and Global Head of Real Estate Risk Management, in which he wrote: "The issue is obviously now that the public thinks the equity could be worthless and we are sitting at a price of 90 while the IMD perm equity position is at par. If we are good at these prices, [] the onus is on us to support that with current info."[1469]

A rebuttal to the Barron's article was presented to Lehman's Executive Committee on January 22, 2008.[1470] The rebuttal stated that the "actual facts contradict the Barron's thesis" and made the following arguments:[1471]

- The 10 most recent trades in Archstone's market occurred at an average capitalization rate of 4.6%, which was significantly lower than the capitalization rates of 6% and above discussed in the Barron's article;[1472]

[1468] *Id.* In the e-mail, Levin notes that Archstone created models that illustrated that public markets undervalue REITs compared to private markets and "cap rates for institutional quality apartment buildings in high barrier-to-entry markets have moved relatively little." To support these observations, Levin explained that:

> Archstone's comparables were trading at less than the value of the individual real estate assets;
> A focus on capitalization rates ignores Archstone's non-real estate assets, such as development assets;
> Archstone's capitalization rates would hold steady due to the portfolio's high-quality assets; and
> Apartment buildings are more stable investments compared to other real estate. *Id.*

[1469] E-mail from Jonathan Cohen, Lehman, to Donald E. Petrow, Lehman (Jan. 22, 2008) [LBEX-DOCID 1468672].

[1470] E-mail from Jonathan Cohen, Lehman, to RE Control US, Lehman (Jan. 22, 2008) [LBEX-DOCID 1587277].

[1471] Lehman, Archstone "ASN" - Talking Points (Jan. 22, 2008), at p. 1 [LBEX-DOCID 1625626].

[1472] *Id.*

- Archstone recently sold two assets out of its Washington, D.C. portfolio at a capitalization rate of 4.1%;[1473]
- Underlying fundamentals were strong (as evidenced by actual and projected rent growth of 5%);[1474]
- The stock market was valuing apartment REITs as if they were worth 30% below their net asset value. Lehman noted that the public market "often has these pricing anomalies;"[1475]
- "Barron's gave zero value for the company as a platform and its development pipeline and looked only at a draconian view of asset value."[1476]

On January 22, 2008, after receiving the rebuttal arguments that were presented to the Executive Committee, Jonathan Cohen wrote in an e-mail that the Barron's article was "[n]ot Armageddon as originally thought."[1477]

(ii) January 2008 Archstone Update

In January 2008, Tishman Speyer provided a memo titled "Archstone Business Plan and Syndication Update," to Lehman, BofA and Barclays.[1478] The memo outlined a plan to "ramp up Archstone's disposition program in 2008" by deleveraging Archstone on an accelerated basis and generating net sales proceeds to pay down the Term Loan A

[1473] *Id.*

[1474] *Id.* The rebuttal also provided reasons why asset pricing remained relatively strong, which included: "a) Agencies continue to finance actively (low treasury rates); b) Fewer renters moving to owned housing because of credit crunch (albeit some for sale housing overhang in rental pool; [and] c) Pricing of stand alone assets will never stray too far from replacement cost before local developers buy. This is an important fact and can largely explain the difference between where stocks trade versus asset value."

[1475] *Id.*

[1476] *Id.*

[1477] E-mail from Jonathan Cohen, Lehman, to Gary J. Fox, Lehman (Jan. 22, 2008) [LBEX-DOCID 1587278].

[1478] Memorandum from David Augarten, Tishman Speyer, *et al.*, to R. Scot Sellers, Archstone, *et al.*, Archstone Business Plan and Syndication Update (Jan. 30, 2008), at p. 1 [LBEX-DOCID 1696101].

on an accelerated schedule.[1479] The lenders were asked "to delay the syndication of Term Loan A for a period of time to allow the Company ample time to execute the Plan before any additional OID [original issue discount] was incurred."[1480]

Lehman, BofA and Barclays met to discuss Archstone's business plan on or about January 30, 2008.[1481] The successful execution of an accelerated disposition plan was viewed as "a critical first step to solving many of the problems faced by the equity holders and lenders today."[1482] Tishman Speyer described the "problems" that the lenders and equity holders faced as follows:

- "We still have $4.5 billion of equity left to syndicate and have lost momentum with most of the large investors who were interested in the deal."[1483]
- "There is no urgency for investors to invest in the deal today given the amount of equity left to syndicate (i.e. there is plenty of 'supply')."[1484]
- "Investors are concerned that the Company is not worth what we paid for it because cap rates have crept upwards in most markets. Although the recent

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[1479] *Id.*

[1480] *Id.* Original issue discount refers to the reduction in the value of loans that must be incurred to effectuate a transaction between a willing buyer and willing seller (including the borrower and the initial lender). Frank K. Reilly & Keith C. Brown, *Investment Analysis and Portfolio Management* 528 (6th ed. 2000). For example, OID of 1% would result in a lender advancing $99 and holding a claim of $100 for repayment of principal. OID generally refers to the difference between the stated principal amount of a debt instrument (*i.e.*, the principal that the borrower must repay) and the amount that the lender actually advanced. *Id.* However, in this instance, the term appears to refer to the discount at which the debt would need to be sold by the lenders to a third party investor.

[1481] Memorandum from David Augarten, Tishman Speyer, *et al.*, to R. Scot Sellers, Archstone, *et al.*, re: Archstone Business Plan and Syndication Update (Jan. 30, 2008), at p. 1 [LBEX-DOCID 1696101].

[1482] *Id.*

[1483] *Id.*

[1484] *Id.*

Barron's article grossly overstated the increase in cap rates, it still did not help investor perception of the value of the Company."[1485]

- The current deal model shows returns that were "well below" the targeted returns.[1486] At the time, the model assumed the entity-level debt was worth 97 cents on the dollar and that each $100 million reduction in the value of the entity-level debt reduced the equity returns by 19 basis points (due to the features of the price flex agreement).[1487]

- The capital structure was not "fixed" due to the inability to syndicate the entity-level debt.[1488] It was difficult to syndicate the debt due to the high level of debt and the inability of the operating business to service its debt obligations.[1489]

- "The lenders wanted to syndicate the term loan as quickly as possible, but Archstone was still viewed as a 'risky' credit with leverage at 76% (of acquisition cost) and an operating business that was not covering its debt service."[1490]

- Archstone was "hampered" by an overleveraged balance sheet and had "limited liquidity" to fund its existing development pipeline and to invest in new business opportunities "unless it [could] sell assets and refresh its Revolver capacity over time."[1491]

The Tishman Speyer memo explains that to "fix" these problems, Archstone must "find ways to increase the value of company and improve its liquidity."[1492] Tishman Speyer proposed that one way of achieving this goal for Archstone was to allocate more capital to "higher returning" development and value-added investments

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[1485] *Id.*
[1486] *Id.*
[1487] *Id.*
[1488] *Id.*
[1489] *Id.*
[1490] *Id.*
[1491] *Id.*
[1492] *Id.* at p. 2.

while selling certain of its core portfolio apartment complexes.[1493] While it would be "challenging to achieve all of these goals in the near term," achievement of these goals would make the equity and debt "much more saleable."[1494] The memo further notes that there were "very few" apartment asset sales since the fall, which made it "hard to precisely estimate value" in most markets.[1495] According to Tishman Speyer, the Archstone assets that were being marked were expected to be sold at values 10% below recent appraisals and 9% below the values that were the basis for underwriting the acquisition.[1496]

(iii) Valuation as of February 29, 2008

Lehman did not take any valuation-related write-downs during the first quarter of 2008, ending February 29.[1497] On February 2, 2008, Jonathan Cohen noted: "For now, I think we are still good at our 90 mark [referring to the bridge equity mark]. Will likely revisit, but the only place it goes is south."[1498]

In a March 3, 2008 e-mail to Clement Bernard, the CFO of FID, Jonathan Cohen explained that the methodology used by Lehman to value its bridge equity positions,

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[1493] *Id.*

[1494] *Id.*

[1495] *Id.* at p. 3.

[1496] *Id.*

[1497] Jonathan Cohen responded to a question regarding first quarter markdowns that there was "[n]othing thru P&L. We used maybe 15mm or so from excess carry on the term and mezz loans to mark equity. We never show that in the mark down summary." E-mail from Jonathan Cohen, Lehman, to Clement Bernard, Lehman (June 8, 2008) [LBEX-DOCID 4320133].

[1498] E-mail from Jonathan Cohen, Lehman, to Robert Shaw, Lehman (Feb. 7, 2008) [LBEX-DOCID 2801006].

including Archstone, in February 2008 was "generally based on initial capitalization structure on day 1, which also includes assumptions of the projected entity level cash flows and estimated yields that we would sell the bridge equity to investors. . . . Since it was always expected to be carried short-term, there was never a robust analysis put in place at the independent servicer to value the equity. . . . That said, these investments are actively monitored from the business side (Paul Hughson) to see if there is any yield impairment to the ultimate equity investor."[1499]

Jonathan Cohen gave a presentation to the head of FID, Andrew J. Morton, in March 2008 to discuss Product Control's review of the reasonableness of Lehman's first quarter Archstone valuations.[1500] The presentation materials include an overview of how Lehman conducted bridge equity valuations, and set forth the internal rate of return[1501] ("IRR") that was implied by Lehman's Archstone mark.[1502] The presentation materials for the meeting with Morton note the following:[1503]

[1499] E-mail from Jonathan Cohen, Lehman, to Clement Bernard, Lehman (Mar. 3, 2008) [LBEX-DOCID 1721456].

[1500] E-mail from Jonathan Cohen, Lehman, to Andrew J. Morton, Lehman (Mar. 13, 2008) [LBEX-DOCID 1437587] (discussing these issues further).

[1501] The internal rate of return is the discount rate that equates the series of cash flows to an initial investment. *See* Appendix 12, Valuation - Archstone, for an illustrative example of Lehman's IRR model.

[1502] *Id.*

[1503] Abebual A. Kebede, Lehman, Real Estate Inventory Valuation (Mar. 10, 2008) [LBEX-DOCID 1707877], attached to e-mail from Abebual A. Kebede, Lehman, to Clement Bernard, Lehman, *et al.* (Mar. 10, 2008) [LBEX-DOCID 1854362].

- The pricing methodology for bridge equity positions is described as gauging the yield at which Archstone positions would be palatable to target investors given the origination assumptions.[1504]

- The valuation needs to be based on the collateral values because syndication has stalled.[1505]

- Concerns specific to Archstone bridge equity include increases in capitalization rates and the presence of price flex on the debt.[1506]

Hughson and Neighbor did not recall creating any documents that described their methodology or analysis to support not taking any valuation-related Archstone write-downs in the first quarter.[1507] Jonathan Cohen told the Examiner that Product Control did not perform adequate analysis regarding the February 2008 mark.[1508]

(iv) First Quarter 2008 Earnings Call and Lenders' Discussion Regarding Modifying the Archstone Strategy

During Lehman's first quarter 2008 earnings call on March 18, 2008, Erin Callan, CFO of Lehman, stated: "With respect to Archstone, I want to make a comment here again in the interest of transparency ahead of questions, we currently hold 2.3 billion of

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[1504] *Id.* at Summary tab.

[1505] *Id.* at Issues tab.

[1506] *Id.* at Major concerns tab. Price flex was listed as a bridge equity valuation concern, because it had a negative impact on valuation of the equity - price flex transferred loss of value of the debt to the bridge equity.

[1507] Examiner's Interview of Paul A. Hughson, Dec. 21, 2009, at p. 3; Examiner's Interview of Webster Neighbor, Nov. 17, 2009, at p. 3. However, Lehman appears to have prepared a sensitivity analysis shortly after the first quarter ended, as it was based on a version of the model used to assess Lehman's investment in Archstone as of March 3, 2008, as well as the underlying DCF model as of early March 2008. Jeffrey Wechsler, Lehman, Bridge Equity Discounting Sensitivity (Mar. 4, 2008) [LBEX-DOCID 1391229], attached to e-mail from Jeffrey Wechsler, Lehman, to Jonathan Cohen, Lehman (Mar. 4, 2008) [LBEX-DOCID 1468681]; Lehman, Bridge Equity Discounting Sensitivity (Mar. 17, 2008), at Discounting Sens. tab [LBEX-DOCID 1626080].

[1508] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 7.

the non-investment grade debt related to that transaction and 2.2 billion of equity, both currently carried materially below par. We are actively delevering that company through asset dispositions at attractive levels and improving their financial profile."[1509]

At that time, Lehman marked all of its Archstone debt positions at 99 (with the exception of the development loan at 96), bridge equity at 90, and its permanent equity at 100, for a weighted average mark for its portfolio of 95.1. As previously discussed, the reduction in the mark through February 2008 was attributable to marking the fees and excess carry into the bridge equity position. Jonathan Cohen told the Examiner that he was not consulted before this earnings call and that he would not have used the word "material."[1510] Hughson told the Examiner that he agreed with Callan's characterization as to where Lehman was marking its Archstone positions, because the mark on the overall positions implied a 5% below-funded-amount mark for debt and equity positions.[1511]

(e) Valuation Issues During the Second Quarter of 2008[1512]

(i) March 2008 Archstone Update

According to the Tishman Speyer March 2008 Archstone Update, it became "very difficult" for Archstone to sell assets as market participants became "decidedly more

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[1509] Final Transcript of Lehman Brothers Holdings Inc. First Quarter 2008 Earnings Call (Mar. 18, 2008), at p. 6.
[1510] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 7.
[1511] Examiner's Interview of Paul A. Hughson, Dec. 21, 2009, at p. 3.
[1512] Lehman's second quarter started on March 1, 2008, and ended May 31, 2008.

cautious."[1513] The memo reports that "[a]ll of the large deals that we were trying to put together earlier this year have been unsuccessful to date."[1514] Over $1 billion of potential asset sales that were in negotiations fell apart after Bear Stearns's near collapse.[1515] Tishman Speyer expected it to be "challenging" for Archstone to sell assets until such time as market conditions stabilized.[1516]

In response to this difficult environment, the proposed revised asset disposition plan calls for a willingness to "accept slightly lower prices if necessary, in the near term, to free up some liquidity" and for the marketing of some of Archstone's "trophy" properties.[1517] The assets that were marketed at this time were determined to be worth 13% less than their appraised values.[1518] The implications of this determination are explained in the analysis section below.

In response to concerns that Archstone's liquidity situation was worsening due to the cost of servicing the acquisition debt, Archstone started to reduce its investment in capital expenditures.[1519] Tishman Speyer projected that, as a result of Archstone's inability to execute on the asset sale program, Archstone would run out of liquidity in

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[1513] Memorandum from David Augarten, Tishman Speyer, *et al.*, to R. Scot Sellers, Archstone, *et al.*, re: Archstone Update (Mar. 24, 2008), at p. 1 [LBEX-DOCID 2932586].
[1514] *Id.*
[1515] *Id.*
[1516] *Id.*
[1517] *Id.* at p. 2.
[1518] *Id.*
[1519] *Id.*

four months (July 2008) if Archstone did not sell assets.[1520] Tishman Speyer reported that Archstone's management was "in the process" of reviewing its development plan to assess what projects should be pursued, renegotiated or cancelled and that Archstone's peers were also "scaling back" development plans in the short-term.[1521]

(ii) March 2008 Valuation

On March 11, Product Control asked the bridge equity desk for a sensitivity analysis based on the model that the desk used to value the Archstone position.[1522] Product Control received the underlying model, as well as the sensitivity analysis, on March 17.[1523]

Discussions regarding a potential $200 million write-down on Archstone bridge equity appear to have begun in mid-March 2008.[1524] Jonathan Cohen reported to Bernard on March 20, 2008 that the bridge equity desk was "running numbers and stressing cap rates," and the preliminary view was that a write-down of $200 million could be taken by the end of the month.[1525] An impetus for this potential write-down was the aforementioned $1 billion of potential asset sales that did not close in the

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[1520] *Id.*

[1521] *Id.* at p. 4.

[1522] E-mail from Jonathan Cohen, Lehman, to Jeffrey Wechsler, Lehman, *et al*. (Mar. 11, 2008) [LBEX-DOCID 1468690]. Jonathan Cohen asked for a sensitivity analysis that showed a mark as low as 60. *Id.*

[1523] E-mail from Jeffrey Wechsler, Lehman, to Jonathan Cohen, Lehman (Mar. 17, 2008) [LBEX-DOCID 4310701].

[1524] E-mail from Jonathan Cohen, Lehman, to Clement Bernard, Lehman, *et al*. (Mar. 20, 2008) [LBEX-DOCID 1854627].

[1525] *Id.*

aftermath of Bear Stearns's near collapse.[1526] Jonathan Cohen told the Examiner that by this time, Archstone's bridge equity was essentially "hung," meaning that it was being held on Lehman's books as opposed to being sold to investors.[1527]

Lehman ultimately took a $200 million write-down on its bridge equity and a $50 million write-down on its permanent equity in March 2008.[1528] As illustrated in the previous table titled "Lehman's Archstone Marks by Month," the resulting mark for both positions after the write-down was 80% of funded value (or a mark of 80). In arriving at this valuation, Lehman determined that Term Loan A was worth 100 cents on the dollar while Term Loan B and the Revolver were worth 90 cents on the dollar.[1529] Lehman's sensitivity analysis showed that Lehman projected an internal rate of return ("IRR") on its equity investment of 16.5% employing the exit capitalization rate used when Lehman decided to participate in the acquisition, and 14.6% assuming a 50 basis points decrease in that exit capitalization rate.[1530] The Examiner's financial advisor observed that this analysis shows that Lehman's lower valuation for its Archstone positions was based on Lehman's determination that either the risk associated with

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[1526] *Id.*

[1527] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 10.

[1528] Lehman, Global Real Estate 2008 Mark Downs, at p. 8 [LBHI_SEC07940_7620384].

[1529] E-mail from Lonnie Rothbort, Lehman, to Jonathan Cohen, Lehman (May 16, 2007) [LBEX-DOCID 1438381]; Lehman, Bridge Equity Discounting Sensitivity (Apr. 1, 2008), at p. 1 [LBEX-DOCID 1432509], attached to e-mail from Jonathan Cohen, Lehman, to Lonnie Rothbort, Lehman (May 16, 2008) [LBEX-DOCID 1567463].

[1530] Lehman, Archstone Q2 2008 Update (June 12, 2008), at p. 15 [LBEX-DOCID 2929329].

Archstone generating its projected cash flows increased or it was appropriate to reduce the projected cash flows.

According to a presentation created by Lehman's Product Control Group, the March write-down was taken based on the following rationale:[1531]

- "Buyers walked away from $1 billion in property sales";
- "Increase in cap rate (widened exit cap rates by 50 bps)";
- "Increased premium to investors until company is de-levered through asset sales";[1532]
- "No current cash on cash return for equity investors"; and
- "Liquidity."

Hughson told the Examiner that he agreed with the write-down in March, but did not necessarily agree with the statements in the Product Control presentation.[1533] Hughson stated that his team considered "everything that was happening at the time" and incorporated it into the model in marking Archstone positions.[1534] Hughson stated that his team marked the positions "to the current state of play in the market," including exit capitalization rates, and the team's marks reflected his best judgment as to the value of the Archstone positions at that time.[1535]

[1531] Lehman, Global Real Estate Product Control, Real Estate Americas Potential Write-downs (May 2008), at p. 80 [LBHI_SEC07940_2258765].

[1532] This reflects the increased risk to equity holders until the significant debt on Archstone's books was reduced through property sales.

[1533] Examiner's Interview of Paul A. Hughson, Dec. 21, 2009, at p. 4.

[1534] *Id.*

[1535] *Id.*

(iii) April 2008 Downgrade by S&P

In April 2008, S&P lowered its corporate credit rating for Archstone from BB- to B, changed its outlook to "negative" and then withdrew the ratings.[1536] The rationale for the downgrade was the "more challenging credit environment, which has slowed asset sales" and "could hinder [Archstone's] ability to dispose of assets in as profitable and timely a fashion as it had initially considered."[1537]

A contemporaneous e-mail exchange between product controllers Jonathan Cohen and Bernard discusses the potential "consequence" of S&P downgrade to the value of Lehman's positions.[1538] In an e-mail dated April 29, 2008, Jonathan Cohen wrote to Bernard that he doubted "the rating change changes investors' perception" because the debt had the benefit of price flex and the equity valuation assumed Term Loan B could be sold at 90 cents on the dollar.[1539]

(iv) Einhorn Speech in April 2008

On April 8, 2008, David Einhorn, President of the hedge fund Greenlight Capital, gave a speech before the Grant's Spring Investment Conference that questioned

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[1536] S&P, Tishman Speyer, Archstone-Smith, And Related Entity Ratings Lowered, Then Withdrawn (Apr. 28, 2008), at p. 1 [LBHI_SEC07940_120171]. Lehman received notice of the pending downgrade before it was made public. There was a dialogue within Lehman regarding the potential to change S&P's decision regarding the downgrade or to keep it from becoming public. E-mail from Francis X. Gilhool, Lehman, to John J. Niebuhr, Lehman, *et al.* (Apr. 25, 2008) [LBHI_SEC07940_120164].

[1537] *Id.*

[1538] E-mail from Clement Bernard, Lehman, to Jonathan Cohen, Lehman (Apr. 29, 2008) [LBEX-DOCID 1488843].

[1539] *Id.* Jonathan Cohen argued the below par price of 90 already took into account the decrease in credit quality.

Lehman's valuations of Archstone.[1540] Einhorn observed that Archstone's comparable companies' trading prices had fallen 20-30% since the Archstone deal was announced. Einhorn concluded that "the high leverage in the privatized Archstone-Smith would suggest the need for a multi-billion dollar write-down."[1541]

(v) May 2008 Valuation

Unlike previous quarters, a substantial number of materials were prepared as part of the May valuation process in anticipation of the second quarter close. This Section first addresses the materials prepared as part of the valuation process, and then addresses the materials prepared in advance of the earnings call. In its second quarter earnings call, Lehman discussed its equity valuation and the methodology it used to mark its investment.

On May 16, 2008, Bridge Equity personnel provided an update on "the recent activity around Archstone" and included a discussion of Lehman's valuation methodology ("May 16 Archstone Update").[1542] The valuation methodology consisted of three components: a discounted cash flow analysis, an analysis based on the implications of the sale of assets from Archstone's core portfolio and a comparison of

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[1540] David Einhorn, Presentation to Grant's Spring Investment Conference: Private Profits and Socialized Risk (Apr. 8, 2008), *available at* http://www.foolingsomepeople.com/main/mroom/Grants%20Conference%2004-08-2008.pdf.

[1541] *Id.*

[1542] Memorandum from Keith Cyrus, Lehman, *et al.*, to Donald E. Petrow, Lehman, *et al.*, re: Archstone Update (May 16, 2008), at p. 1 [LBEX-DOCID 1416761].

Lehman's valuation of Archstone to the value of Archstone's publicly traded peers based on their stock prices.[1543]

The discounted cash flow analysis, which is described in further detail below, was based on various underwriting scenarios.[1544] The required rate of return for an investment in Archstone's equity was viewed as similar to the returns provided by core-plus funds, which Lehman determined ranged from 12% to 15%.[1545]

The May 16 Archstone Update does not include any analysis of Archstone's sales, but it includes a listing of sales "accomplishments" that reports the company had sold $1.9 billion of assets and that it had $496 million of assets under contract.[1546] The May 16 Archstone Update notes that Archstone was generally selling its lower quality assets and that Archstone was perceived to be a "distressed" seller.[1547] Lehman determined that Archstone's liquidity position and overall markets would improve over time.[1548]

The analysis comparing Lehman's valuation of Archstone to the value of one of its peers was based on valuation analyses published by a third-party research firm that

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[1543] *Id.* at p. 3 [LBEX-DOCID 1416761]; Lehman, Archstone Update 2008 (May 16, 2008), at pp. 4-14 [LBEX-DOCID 1488847].

[1544] In the model, the primary sensitivity analysis was performed on the timing of asset sales and the exit capitalization rate applied to the long-term hold portfolio. *Id.*

[1545] Memorandum from Keith Cyrus, Lehman, *et al.*, to Donald E. Petrow, Lehman, *et al.*, re: Archstone Update (May 16, 2008), at p. 3 [LBEX-DOCID 1416761].

[1546] Lehman, Archstone Update 2008 (May 16, 2008), at p. 1 [LBEX-DOCID 1488847].

[1547] Memorandum from Keith Cyrus, Lehman, *et al.*, to Donald E. Petrow, Lehman, *et al.*, Archstone Update (May 16, 2008), at p. 3 [LBEX-DOCID 1416761].

[1548] *Id.*

Lehman frequently referenced. The May 16 Archstone Update notes that the capitalization rate a third-party research firm applied to AvalonBay, which was generally viewed as the closest comparable company to Archstone, was higher than the capitalization rate Lehman used for Archstone.[1549] This analysis also included a comparison of Lehman's marks over time on Archstone equity to changes in equity value of Archstone's peers since the Commitment Date.[1550]

On May 27, 2008, Lehman's Product Control Group presented its view of the Archstone sensitivity analysis to Lehman's CFO, Callan.[1551] This analysis suggested a range of additional write-downs ranging from $78 million to $615 million.[1552] As Lehman had already taken $436 million of write-downs, the highest potential write-down of $615 million would result in total write-downs of over $1 billion. Kebede participated in this meeting and recalled being disturbed by Callan's reaction upon being told that the cumulative Archstone write-down could be greater than $1 billion - Callan did not ask any questions and only wrote something in her notebook.[1553] Kebede

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[1549] Lehman, Archstone Update 2008 (May 16, 2008), at p. 9 [LBEX-DOCID 1488847].

[1550] *Id.*

[1551] Lehman, Real Estate Product Control Update (May 27, 2008), at p. 1 [LBEX-DOCID 4344653] (the presentation to Callan).

[1552] The current valuation model, per Lehman's Product Control Group, used a 5.62% rent growth assumption and an 18% internal rate of return. Lehman, Real Estate Product Control Update (May 27, 2008), at p. 6 [LBEX-DOCID 4344653] (presented to Callan). The sensitivity analysis stressed the rent growth assumption from 100 to 200 basis points and the IRR assumption from 18% to 20%. This analysis suggested a range of incremental write-downs between $78 million (no stress on the rent growth rate assumption and an IRR of 19%) to $615 million (200 basis points decrease in the rent growth rate assumption and an IRR of 20%). *Id.*

[1553] Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009, at p. 10.

told the Examiner that he expected that the CFO, upon hearing such a report, would have asked at least a few questions in order to understand the basis of the possible write-down.[1554]

Lehman took an additional $100 million write-down in its Archstone positions in May 2008, which reduced the bridge equity mark to 75 and the overall value of Lehman's Archstone positions to 88% of funded value.[1555] E&Y reviewed Archstone's marks as part of its quarterly evaluation, and concluded that "the process by which the Archstone . . . positions are valued as well as the related inputs, assumptions, and calculated values appear reasonable for the purpose of assessing reasonableness for our quarterly review."[1556]

(vi) Second Quarter 2008 Earnings Conference Call

a. Preparation and Lehman's Methods of Analyzing Reasonableness of Valuations Prior to the Call

In advance of the second quarter 2008 earnings call, GREG prepared a presentation (referred to by Lehman as the "Q2 Book") that sets forth several methods of analysis used by Lehman to assess the reasonableness of reported Archstone

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[1554] *Id.*

[1555] Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113].

[1556] Memorandum from Nicholas McClay, Ernst & Young, to Files, Ernst & Young, re: Quarterly Review Valuation Procedures for Archstone & SunCal Real Estate Investments (July 9, 2008), at p. 2 [EY-SEC-LBHI-DF-MFIN 000048]. *See* Section III.A.2.b.2.b for a detailed discussion of E&Y's review.

valuations as of May 2008.[1557] The presentation illustrates how the mark of 75 for bridge equity was determined and includes the following methods, which are detailed in the Examiner's analysis of Lehman's Archstone valuations below:[1558]

- Valuation of Archstone based on sum of the parts;
- Comparison of Archstone's fundamentals to its peer group;
- Analysis of sales of Archstone's apartment complexes;
- Comparison of Lehman's valuation of its Archstone equity investment relative to the change in value of Archstone's publicly traded peers.[1559]

b. Discussion During the Second Quarter 2008 Earnings Call

During Lehman's 2008 second quarter earnings call, Lowitt discussed Lehman's valuation of its Archstone equity investment and the methodology that was used to determine such value.[1560] Lowitt stated: "We have arrived at Archstone's enterprise value primarily using a discounted cash value analysis, which supports a mid-teens

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[1557] Lehman, Archstone Update — Q2 2008 (June 12, 2008), at pp. 1-3 [LBEX-DOCID 2902980], *attached to* e-mail from Webster Neighbor, Lehman, to Brett Bossung, Lehman, *et al.* (June 12, 2008) [LBEX-DOCID 2902980]; Examiner's Interview of Webster Neighbor, Nov. 17, 2009, at p. 5.

[1558] Lehman, Archstone Q2 2008 Update (June 12, 2008), at p. 15 [LBEX-DOCID 2929329]. The May 30, 2008 mark implied an IRR of 16.9% under the scenario that stressed the exit capitalization rate by 100 basis points. The implied IRR was further reduced to approximately 15% by stressing the exit platform value between $500 million and $1 billion. E-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman, *et al.* (June 14, 2008) [LBEX-DOCID 1865693]. An e-mail exchange between Neighbor and Hughson explains some of the other sensitivity analyses that were considered. Combinations of assumptions that resulted in a 15% IRR included: (1) 75 basis point increase in the exit capitalization rate and 25 basis point decrease in rent growth rate, (2) 50 basis point increase in the exit capitalization rate and 75 basis point decrease in rent growth rate, and (3) 25 basis point increase in the exit capitalization rate and 125 basis point increase in rent growth. *Id.*

[1559] Unlike the analysis discussed in the prior section, this analysis took into account the effect of Archstone's large debt in its capital structure.

[1560] Final Transcript of Lehman Brothers Holdings Inc. Second Quarter Earnings Call (June 16, 2008), at pp. 13-14.

IRR."[1561] He explained that, "We cross-checked that using a number of different methodologies, including sum of the parts, replacement costs and recent comparable transactions based on both cap rates and price per unit, the most important including asset sales from the Archstone portfolio."[1562] Lowitt provided further details regarding Archstone's asset sales:

- Archstone sold approximately $2 billion of assets to-date and was under contract or in active negotiation to sell an additional $2 billion;
- The $4 billion in transactions were at an average capitalization rate in the mid 4% range; and
- Many of the assets that were being sold were identified by Archstone as non-core or non-strategic and in certain cases did not represent the highest quality assets in Archstone's portfolio.[1563]

Lowitt explained that Lehman's "valuation reflect[s] the company's business plan of only selling enough assets to reduce debt to a targeted level and to continue to increase value through its development, asset management, and revenue enhancement programs, which have and continue to be very successful. In that context, we have assumed that capitalization rates will be more than 100 BPS [basis points] higher when the properties are sold than when the transaction was entered into. Based on this analysis, we are very comfortable with our current Archstone mark."[1564]

[1561] *Id.* at p. 14.
[1562] *Id.*
[1563] *Id.*
[1564] *Id.*

Hughson told the Examiner that he received complaints from Barclays and BofA when the 75 equity mark was publicly disclosed, because it was lower than the mark they were using for their own Archstone equity positions.[1565] The Examiner's financial advisor observed that the cost of price flex implied by Lehman's mark was higher than the cost of price flex implied by the balance of the Escrow Account as of February 29, 2008.[1566]

(vii) Lehman's Revised Plan to Sell Archstone Positions

In May 2008, Lehman acknowledged that it would not meet its debt and bridge equity syndication goals and generated new projections.[1567] Lehman's initial plan was to syndicate all debt and bridge equity while retaining only permanent equity.[1568] Lehman initially projected it would meet these goals by October 2008, as illustrated by the following graph:

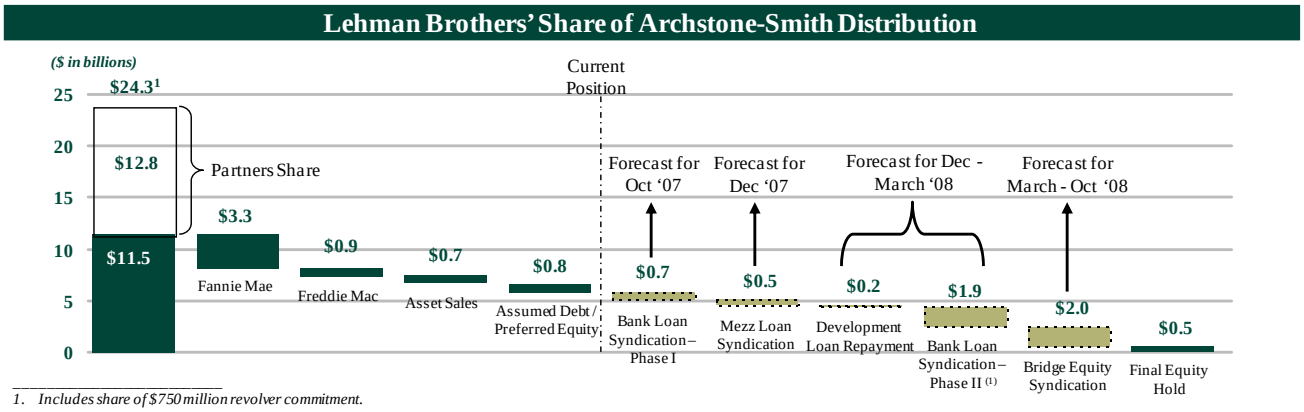
[1565] Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 12.

[1566] BofA, Transactions for Bank of America as Administrative Agent Archstone - Operating Trust Expense Reserve Escrow Account (July 20, 2009), at p. 1 [LBEX-BofA 000007]; Lehman, Easy Living Q2 Model Risk (June 15, 2008), at Sources and Uses tab [LBEX-DOCID 4456413].

[1567] Lehman, Archstone-Smith Trust (May 21, 2008), at p. 1 [LBEX-DOCID 019129]

[1568] Lehman, Standard & Poor's Real Estate Update (Oct. 10, 2008), at p. 19 [LBEX-DOCID 514267].

Lehman's Plan at Closing to Reduce its Archstone Exposure[1569]



1. *Includes share of $750 million revolver commitment.*

By May 2008, Lehman updated its plan, reflecting a determination that Archstone would need to sell assets to satisfy debt and thereby reduce leverage.[1570] Lehman pushed the goals it had expected to meet by October 2008 to fiscal year 2010.[1571] As set forth in the following Lehman graph, Lehman acknowledged it would still hold approximately $5.0 billion (notional) of Archstone debt and equity at the end of the 2008 fiscal year.[1572]

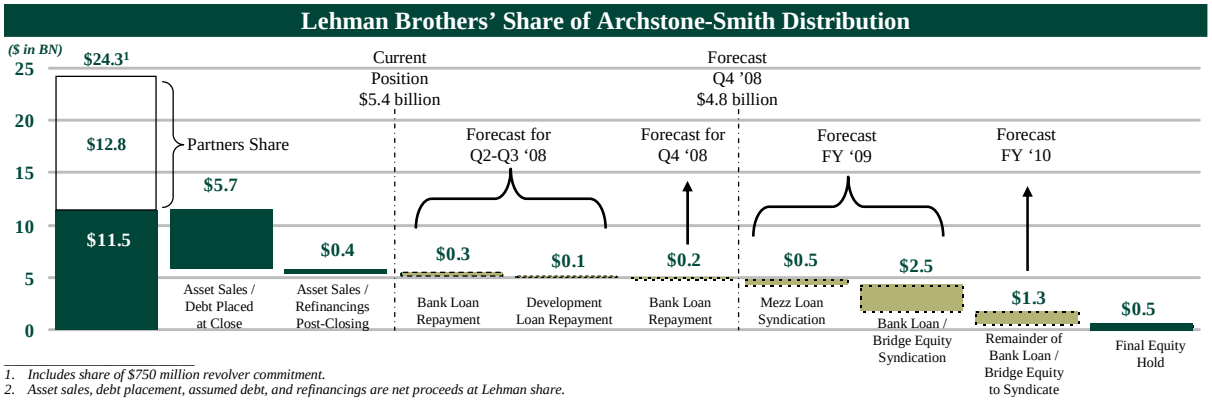
[1569] *Id.*

[1570] Lehman, Archstone-Smith Trust (May 21, 2008), at p. 1 [LBEX-DOCID 019129], attached to e-mail from Paul A. Hughson, Lehman, to Paolo R. Tonucci, Lehman (May 21, 2008) [LBEX-DOCID 074037].

[1571] Lehman, Archstone-Smith Trust (May 21, 2008), at p. 1 [LBEX-DOCID 019129].

[1572] *Id.*

Lehman's May 2008 Plan to Reduce its Archstone Exposure[1573]



1. *Includes share of $750 million revolver commitment.*
2. *Asset sales, debt placement, assumed debt, and refinancings are net proceeds at Lehman share.*

(f) Valuation Issues During the Third Quarter of 2008[1574]

After relatively small reductions in the marks reflecting excess carry in June and July 2008, Lehman took its final significant Archstone write-down in August 2008, reducing bridge equity by $110 million and permanent equity by $15 million.[1575] Kebede told the Examiner that this write-down was larger than he thought was warranted, and he did not know why the write-down was taken.[1576] An e-mail exchange between Neighbor and Hughson included the analysis and the underlying assumptions used to arrive at the $110 million write-down, and is discussed in the Examiner's analysis of the reasonableness of Lehman's Archstone marks.[1577]

[1573] *Id.*

[1574] Lehman's third quarter covered June 1, 2008, through August 31, 2008.

[1575] Lehman, Global Real Estate 2008 Mark Downs, at p. 12 [LBHI_SEC07940_7620384].

[1576] Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009, at p. 10.

[1577] In an e-mail to Hughson on September 12, 2008, Neighbor wrote that that the August mark was calculated using a stressed rental growth compound annual growth rate ("CAGR") of 4.9% and an increased exit capitalization rate of 5.57%. The platform value remained unchanged at $2 billion. E-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman (Sept. 12, 2008) [LBEX-DOCID 2903130]. Neighbor told the Examiner that he did not recall whether valuation work occurred in the third quarter of 2008 in particular, and he did not recall whether there was a third quarter Archstone write-down of $110

(i) Discussion Among Lenders in July 2008

The discussions among lenders in July 2008 covered the topics addressed in previous months, including progress on asset sales, the current liquidity situation and plans regarding development opportunities.[1578] As of July 9, 2008, Archstone had sold approximately $1.5 billion assets that were on average 12% below the originally appraised value.[1579] Archstone projected that it would have enough liquidity to operate through the end of the year.[1580] Archstone continued to invest in development opportunities but had difficulty finding joint venture deals that resulted in "attractive proposals."[1581]

(ii) August 2008 Valuation

As described above, Lehman took an additional write-down of $110 million in its bridge equity and $15 million in its permanent equity in August 2008.[1582] The Examiner's financial advisor reviewed the model that Lehman used for its August 2008 Archstone valuation, as discussed below.[1583]

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million on bridge equity and $15 million on permanent equity. Examiner's Interview of Webster Neighbor, Nov. 17, 2009, at p. 3. Neighbor also did not recall whether there was anything unusual in the Archstone valuation process in third quarter 2008 (or the first or second quarters of 2008). *Id.*

[1578] Memorandum from David Augarten, Tishman Speyer, *et al.*, to Mark Walsh, Lehman, *et al.*, re: Archstone Bank Meeting Agenda (July 9, 2008), at pp. 1-2 [LBEX-DOCID 1746835].

[1579] *Id.* at p. 2.

[1580] *Id.*

[1581] *Id.* at p. 1.

[1582] Lehman, Top Global Real Estate Exposures (Aug. 31, 2008), at p. 12 [LBHI_SEC07940_ICP_002615].

[1583] It appears that Neighbor adjusted to a more conservative CAGR of 4.90% from the base case of 5.62%. E-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman (Sept. 12, 2008) [LBEX-DOCID 2903130]. Neighbor also increased the exit capitalization rate assumption to an average of 5.57%, which was also more conservative than the base case of 4.82%.[1583] Neighbor left the platform value at $2 billion,

(g) Product Control's Review of Archstone Valuations

Jonathan Cohen told the Examiner that Lehman's Product Control Group "didn't do much to price test" Archstone in 2007 or early 2008, and the group did not look at the platform value in the model until the second or third quarter of 2008.[1584] According to Cohen, the product controllers did not receive adequate information to test the business desk's valuations, and the Product Control Group did not have its own model or the required knowledge to test the assumptions (*i.e.*, rent growth rates) underlying the valuations.[1585] Cohen did not recall discussing the model with the business desk prior to March 2008.[1586] Abebual Kebede, when shown the model and asked to explain how it worked, said that the Examiner should speak with Neighbor.[1587] Cohen stated that he never saw anything supporting certain assumptions that Lehman used when determining its Archstone valuations (*e.g.*, a capitalization rate of 4.1%).[1588] Cohen stated that prior to the first quarter 2008 earnings call, he did not review alternative

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which resulted in a write-down of $110 million for Archstone bridge equity in August. For the third quarter, Lehman assumed a target IRR of 15.59%. E-mail from Webster Neighbor, Lehman, to Abebual A. Kebede, Lehman, *et al.* (Sept. 11, 2008) [LBEX-DOCID 1861565]. These assumptions are all reviewed below in the analysis section.

[1584] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 10.

[1585] *Id.* The Archstone bridge equity position was included in price testing files for PTG equity positions. Examiner's Interview of Eli Rabin, Oct. 21, 2009, at p. 9. However, that model was not used to price test the Archstone positions. Lehman, Real Estate Product Control Update (May 27, 2008), at p. 115 [LBHI_SEC07940_2258765].

[1586] *Id.*

[1587] Examiner's interview of Abebual A. Kebede, Oct. 13, 2009, at p. 11.

[1588] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at pp. 10-11.

methodologies that would serve as checks on the IRR model discussed on the call, and Cohen was not sure if anyone below him did this either.[1589]

In view of the foregoing, the Examiner finds that there is sufficient evidence to support a finding that the Product Control Group did not serve as an effective, independent check on Lehman's valuation of its Archstone positions.

(4) Examiner's Analysis of Lehman's Valuation Process for its Archstone Positions

This Section of the Report sets forth the Examiner's analysis of the reasonableness of Lehman's valuations of its Archstone positions, as of the end of each quarter, and beginning with the fourth quarter of 2007. As the valuation of illiquid assets requires judgment, the Examiner recognizes that there are a range of reasonable determinations regarding the appropriate valuation inputs, and therefore a corresponding range of reasonable valuation outputs.

As discussed above, Lehman recorded the following values for its Archstone positions after the October 5, 2007 closing: $5.13 billion at the end of fourth quarter 2007 (95.6% of funded amount); $5.11 billion at the end of first quarter 2008 (95.1% of funded amount); $4.67 billion at the end of second quarter 2008 (88.0% of funded amount); and $4.19 billion at the end of third quarter 2008 (84.3% of funded amount).[1590]

[1589] *Id.*

[1590] *See* Chart, Lehman's Valuation of Archstone Positions (U.S. $ million, Oct 07-Aug 08), at page 1 of this Report. Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113]; Lehman, Top Global Real Estate Exposures (Aug. 31, 2008), at p. 18 [LBHI_SEC07940_ICP_002615].

Lehman used various methods over time to determine or benchmark the valuation of its Archstone positions. In order to provide the appropriate context for the valuation analysis, this Section begins with a discussion of the methods Lehman employed in 2007 and 2008 to value its Archstone positions. These methods included: (i) Discounted Cash Flow ("DCF"); (ii) valuation of Archstone's individual assets ("Sum of Parts"); and (iii) an analysis based on the value of publicly traded comparable companies ("Comparable Company"). Although Lehman did not consistently utilize these methods in valuing its positions between October 2007 and the end of the third quarter of 2008, the Examiner's financial advisor considered each approach for each period in order to conduct a consistent review.

The following discussion of these methods, and, in particular, the information and assumptions used to determine value pursuant to the operation of these methods, is set forth to establish a foundation for the analysis by the Examiner's financial advisor of Lehman's valuations of its Archstone positions. Accordingly, while the following Section considers the component parts of these methods as applied by Lehman, it does not address the reasonableness of the valuations themselves. That analysis, which is undertaken on a quarter-by-quarter basis, follows thereafter.

(a) Discounted Cash Flow Valuation Method

The DCF model was the primary methodology Lehman used to value its Archstone positions.[1591] Lehman's valuation model was not strictly a DCF model. Instead of calculating a value, Lehman's model stipulates a value, solves for the discount rate and then assesses the reasonableness of that discount rate.[1592] Lehman referred to this approach as the Internal Rate of Return Method ("IRR Method").[1593] The Examiner's financial advisor determined that Lehman's IRR Method was a reasonable methodology because both the traditional DCF model and Lehman's IRR Method arrive at the same value if the same assumptions are used.[1594] Accordingly, this Section uses the terms DCF model and IRR Method interchangeably.

The DCF model determines the value of an asset by reducing future expected cash flows to their present value by applying a discount rate.[1595] In this manner, the two key components in the DCF model are future expected cash flows and the discount rate. The change in the value of an asset is positively correlated with the change in expected

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[1591] Lowitt stated that the DCF model was Lehman's primary valuation method for valuing its Archstone positions during Lehman's second quarter 2008 earnings. Final Transcript of Lehman Brothers Holdings Inc. Second Quarter Earnings Call (June 16, 2008), at p. 14 [LBHI_FIN 0007]; Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009, at p. 3.

[1592] Lehman, Project Easy Living: Tishman Speyer - Archstone-Smith Multifamily JV, LP (Mar. 17, 2008) [LBEX-DOCID 1626080]; Lehman, Easy Living Q2 Model Risk (June 15, 2008), at CF-Detail tab [LBEX-DOCID 4456413].

[1593] Memorandum from Keith Cyrus, Lehman, *et al.*, to Donald E. Petrow, Lehman, *et al.*, Archstone Update (May 16, 2008), at p. 3 [LBEX-DOCID 1416761].

[1594] *See* Appendix 12, Valuation - Archstone.

[1595] Aswath Damodaran, *Corporate Finance, Theory and Practice* 750 (2nd ed. 2001); Eugene F. Brigham & Joel F. Houston, *Fundamentals of Financial Management* 395 (8th ed. 1998).

cash flows – *i.e.*, an increase in future expected cash flows results in an increase in value, and a decrease in expected future cash flows results in a decrease in value.[1596] Conversely, the change in value of an asset is negatively correlated with a change in discount rate – *i.e.*, a decrease in the discount rate results in an increase in value, and an increase in the discount rate results in a decrease in value.[1597] Consequently, the Examiner's financial advisor's analysis of Lehman's DCF Method focused on both Lehman's determinations for expected future cash flows and the discount rate.

The future expected cash flows Lehman used in its DCF Method were based on a number of different assumptions,[1598] but three in particular drove the results: rent growth, exit capitalization rates and exit platform value.[1599] Given their importance, the Examiner's financial advisor focused on these three factors.

(i) Rent Growth

The rent growth assumption refers to the expectation that the rent Archstone charged its tenants would increase over time.[1600] Lehman's valuation analysis incorporated a projection of rent growth for each individual property within

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[1596] *Id.*

[1597] *Id.*

[1598] Lehman, Project Easy Living: Tishman Speyer - Archstone-Smith Multifamily JV, LP (Mar. 17, 2008) [LBEX-DOCID 1626080].

[1599] Lehman, Archstone Q2 2008 Update (June 12, 2008), at pp. 16-17 [LBEX-DOCID 2929329].

[1600] Lehman, Project Easy Living: Tishman Speyer - Archstone-Smith Multifamily JV, LP (Mar. 17, 2008) [LBEX-DOCID 1626080]; Lehman, Easy Living Q2 Model Risk (June 15, 2008) [LBEX-DOCID 4456413].

Archstone's portfolio.[1601] The rent growth rates for the individual apartment complexes were combined to arrive at a weighted average growth rate for the entire portfolio.[1602] Lehman also performed a sensitivity analysis during the second and third quarters of 2008 to test how lower projected growth rates across many of the apartment complexes would affect the portfolio's value.[1603] The Examiner's financial advisor's analysis of the rent growth assumption focused on this sensitivity test.

Lehman's base case DCF analysis projected rent for apartment complexes expected to be held through the year 2014 to increase at a compound annual growth rate ("CAGR") during the period beginning 2008 and ending in 2014.[1604] Lehman's first quarter 2008 DCF model used a CAGR of 5.72%, the second quarter model decreased the CAGR to 5.62% and the third quarter model further decreased the CAGR to 4.90%.[1605] A CAGR of 5.62% means rent was projected to increase on average 5.62% per year across the portfolio of assets expected to be held through 2014.

[1601] Lehman, Project Easy Living: Tishman Speyer - Archstone-Smith Multifamily JV, LP (Mar. 17, 2008), at Drivers tab [LBEX-DOCID 1626080]; Lehman, Easy Living Q2 Model Risk (June 15, 2008), at Drivers tab [LBEX-DOCID 4456413].

[1602] *Id.*

[1603] Lehman, Archstone Q2 2008 Update (June 12, 2008), at p. 17 [LBEX-DOCID 2929329]; Lehman, Real Estate Product Control Update (May 27, 2008), at p. 115 [LBHI_SEC07940_2258765]; Lehman, Archstone Sensitivity Analysis — 08-22-08" (Sept. 12, 2008) [LBEX-DOCID 2852318], attached to e-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman (Sept. 12, 2008) [LBEX-DOCID 2903130].

[1604] In Lehman's DCF model, the projection period was from 2008 to 2014. The DCF model includes a projection period over which specific cash flows are estimated, and a terminal period that assigns a value based on expected future cash flows after the expected projection period.

[1605] Lehman, Project Easy Living: Tishman Speyer - Archstone-Smith Multifamily JV, LP (Mar. 17, 2008) [LBEX-DOCID 1626080]; Lehman, Easy Living Q2 Model Risk (June 15, 2008), at Drivers tab [LBEX-DOCID 4456413]; Lehman, Archstone Sensitivity Analysis — 08-22-08 (Sept. 12, 2008) [LBEX-DOCID 2852318], attached to e-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman (Sept. 12,

In December 2007, Bridge Equity personnel were "taking a fresh look at rental growth rates."[1606] The data such personnel collected illustrated that the long-term rental growth rates Lehman used in its DCF analysis were 1.9 to 3.5 percentage points higher than third-party rent growth projections for apartments within Archstone's primary markets.[1607] To put this in perspective, if the third-party projected rent growth rate for one of Archstone's primary markets was 2.0%, Lehman's DCF model projected rent growth rates for Archstone properties in that market of between 3.9% and 5.5%.[1608] On average, the difference between Lehman's assumptions and third-party projections for Archstone's primary markets was 2.9%.[1609] Keith Cyrus, a Vice-President in the Bridge Equity group, observed in a January 4 e-mail that "Archstone's assets should generally exceed the market average, but I want to make sure our assumptions are still sound in light of recent market conditions."[1610] In an e-mail dated February 6, 2008, Kenneth Siebers, a Tishman Speyer employee, wrote to Cyrus: "We have made it very clear in

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2008) [LBEX-DOCID 2903130]. The Examiner's financial advisor notes that these growth rates are base case figures used in the first quarter and second quarter valuations. As discussed below, Lehman considered lower rent growth rate assumptions in its second quarter 2008 valuation.

[1606] E-mail from Keith Cyrus, Lehman, to Kevin Siebers, Tishman Speyer, *et al.* (Jan. 4, 2008) [TSREV00003176].

[1607] Lehman, Archstone (Jan. 4, 2008), at p. 1 [TSREV00003177], attached to e-mail from Keith Cyrus, Lehman, to Kevin Siebers, Tishman Speyer, *et al.* (Jan. 4, 2008) [TSREV00003176].

[1608] The low end of the range (3.9%) was computed by adding 2.0% with 1.9%. The high end of the range (5.5%) was computed by adding 2.0% with 3.5%.

[1609] *Id.*

[1610] E-mail from Keith Cyrus, Lehman, to Kevin Siebers, Tishman Speyer, *et al.* (Jan. 4, 2008) [TSREV00003176].

every analysis that the growth rates have not been updated."[1611] Consistent with Siebers' e-mail, there was no material change in the rent growth rates used in Lehman's DCF model through March 31, 2008.

Webster Neighbor also compared the rent growth rates used in Lehman's DCF analysis to third-party projections in an e-mail to Jonathan Cohen and other product controllers on April 1, 2008.[1612] This comparison showed that the projected rent growth rate Lehman used in its DCF analysis continued to be approximately 3 percentage points higher than what the model referred to as third-party projections for properties in the same markets.[1613] Neighbor's e-mail described Lehman's rent growth assumptions as generally consistent with this 10-year historical average for properties within Archstone's primary markets.[1614]

The Examiner's financial advisor observed, however, that within Lehman's second quarter DCF model, there was a sensitivity analysis that indicated the model's base case rent growth rate of 5.62% was 1.25 percentage points higher than what the model referred to as the 10-year historical average of 4.37%.[1615] The third quarter DCF

[1611] E-mail from Kevin Siebers, Tishman Speyer, to Keith Cyrus, Lehman, *et al.* (Feb. 6, 2008) [TSREV00003335].

[1612] Lehman, Spot Value Variance: Tishman Speyer - Archstone - Smith Multifamily Fund (Apr. 1, 2008), at Market Data tab [LBEX-DOCID 1525380], attached to e-mail from Webster Neighbor, Lehman, to Jonathan Cohen, Lehman, *et al.* (Apr. 1, 2008) [LBEX-DOCID 1468705].

[1613] *Id.*

[1614] *Id.*

[1615] Lehman, Easy Living Q2 Model Risk (June 15, 2008) [LBEX-DOCID 4456413]. This model contained "Rent Growth Rate Sensitivities." One of the sensitivities was labeled "10-Year Historical Avg." The "10-Year Historical Avg" was 125 basis points lower than the "base case" for all of Archstone's markets.

model's base case rent growth of 4.90% was closer to, but still higher than, the 10-year historical average.[1616]

a. Net Operating Income

The rent growth assumption was one of many assumptions Lehman used in its DCF calculation to arrive at the projected revenue for each Archstone property; the analysis also included assumptions for various types of expenses.[1617] The DCF model projected future expenses and subtracted these from future expected revenue to arrive at projected net operating income ("NOI") for each Archstone property.[1618] NOI represents the "bottom line" or operating profits generated by a business entity and is a fundamental driver of cash flows in the DCF Method.

The materials presented to Lehman's Commitment Committee in May 2007 regarding the potential Archstone acquisition set forth actual and projected NOI growth

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[1616] The Examiner's financial advisor identified the third quarter base case rental growth rate set forth in Lehman's third quarter model. Lehman's Easy Living corporate third quarter model (Aug. 22, 2008), at Drivers tab [LBEX-DOCID 3119444]. Lehman's third quarter model, unlike the second quarter model, did not include an active comparison to the 10-year historical average. *Id*. The Examiner's financial advisor determined that, as the 10-year historical rental growth would not have materially changed between the second quarter and third quarter of 2008, the financial advisor used the 10-year historical average that was set forth in Lehman's second quarter model for purposes of assessing the third quarter model's base case rental growth rate.

[1617] Lehman, Project Easy Living: Tishman Speyer - Archstone-Smith Multifamily JV, LP (Mar. 17, 2008) [LBEX-DOCID 1626080]; Lehman, Easy Living Q2 Model Risk (June 15, 2008), at Drivers tab [LBEX-DOCID 4456413]. The chart shows that a change in the projected rent growth rate of 1.0 percentage points resulted in a change in the NOI growth rate of 1.24 percentage points (from 6.71% to 7.95%). As will be discussed, a similar manipulation using the third quarter model resulted in a 1.25 percentage points reduction.

[1618] Lehman, Project Easy Living: Tishman Speyer - Archstone-Smith Multifamily JV, LP (Mar. 17, 2008) [LBEX-DOCID 1626080]; Lehman, Easy Living Q2 Model Risk (June 15, 2008), at Drivers tab [LBEX-DOCID 4456413].

rates for publicly traded apartment REITS, including Archstone.[1619] However, these materials did not have similar data for rent growth.[1620] The Examiner's financial advisor reviewed NOI growth rates for the purpose of analyzing the rent growth assumption because: (1) rent growth contributes to NOI growth; (2) Lehman focused on NOI growth when it was deciding whether to commit to the Archstone acquisition; and (3) the Examiner's financial advisor determined that NOI is a relevant benchmark for assessing the reasonableness of Lehman's rent growth assumption.[1621]

Lehman's DCF analysis projected NOI to increase at a higher rate than rent growth due to the combined effect of other revenue and expense assumptions.

[1619] Memorandum from Mark Walsh, Lehman, *et al.*, to Bridge Loan Comm. & Inv. Comm., Lehman, $23.4 billion debt and equity financing commitment in connection with the potential acquisition of Archstone-Smith by Lehman Brothers and Tishman Speyer Properties (May 16, 2007), at pp. 21, 25 [LBEX-DOCID 1674960], attached to e-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman (Aug. 22, 2008) [LBEX-DOCID 1684700]. Neighbor referred to this attachment as the "Final CC Memo," which included information regarding NOI growth rates.

[1620] E-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman (Aug. 22, 2008) [LBEX-DOCID 1684700]. The attachments included what was referred to by Neighbor in the e-mail as the "Final Exec Memo," Memorandum from Lehman to Mark Walsh, Lehman, *et al.*, $23.4 billion debt and equity financing commitment in connection with the potential acquisition of Archstone-Smith Trust (May 18, 2007), at p. 1 [LBEX DOCID 1722291], the "Exec Update Memo," Memorandum from GREG, Mark Walsh, *et al.*, Lehman, to Commitment Comm., Lehman, re: [$18.3] billion debt and equity financing commitment in connection with the potential acquisition of Archstone-Smith Trust (May 22, 2007), at p. 1 [LBEX-DOCID 1721764], the "Final CC Memo," Memorandum from Lehman, to Bridge Loan Comm. & Inv. Comm., Lehman, $23.4 billion debt and equity financing commitment in connection with the potential acquisition of Archstone-Smith by Lehman Brothers and Tishman Speyer Properties (May 16, 2007), at p. 1 [LBEX-DOCID 1674960], and the "CC Update Memo," Memorandum from GREG: Mark Walsh, Lehman, *et al.* to Exec. Comm., Lehman, re: $21.3 billion debt and equity financing commitment in connection with the potential acquisition of Archstone-Smith by Lehman Brothers and Tishman Speyer Properties (May 7, 2007), at p. 1 [LBEX-DOCID 1674758].

[1621] The Examiner's financial advisor observed that Lehman applied a sensitivity analysis in the second and third quarter models to the rent growth rate assumption apparently as a proxy for a sensitivity test of the NOI growth rate assumption. Lehman, Easy Living Q2 Model Risk (June 15, 2008), at CF-Detail tab [LBEX-DOCID 4456413]; Lehman, Easy Living Q2 Model Risk (June 15, 2008), at CF-Detail tab [LBEX-DOCID 4456413]; Lehman, Easy Living Corporate Q3 Model (Aug. 22, 2008), at CF-Detail tab [LBEX-DOCID 3119444].

Lehman's first quarter DCF model projected NOI growth to be 7.63% per year and the second quarter model projected such annual growth to be 7.95%.[1622] Lehman generally applied these growth rates to the same set of apartment complexes, which is referred to as a "same store" comparison.[1623]

The acquisition memorandum provided to the Commitment Committee set forth the actual same store NOI growth between 1994 and 2006 for publicly traded apartment building REITS, including Archstone, and projected same-store NOI growth for 2007 through 2009.[1624] The average annual same store growth rate for these REITs between

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[1622] The first quarter 2008 DCF model projected NOI growth of 8.52% for assets with a five-year holding period and 7.63% for assets with a seven-year holding period. The second quarter 2008 DCF model projected NOI growth of 8.52% for assets with a five-year holding period and 7.95% for assets with a seven-year holding period. The Examiner's financial advisor observed that NOI growth was projected to be higher than rent growth in part because rent was projected to grow higher than expenses - which were projected to grow at 3% per year - and in part because there were other drivers of revenue growth.

[1623] Lehman, Project Easy Living: Tishman Speyer - Archstone-Smith Multifamily JV, LP (Mar. 17, 2008) [LBEX-DOCID 1626080]; Lehman, Easy Living Q2 Model Risk (June 15, 2008) [LBEX-DOCID 4456413]. Same store comparison means that properties acquired or sold during the studied time period are excluded from the analysis such that the only properties considered are those held for the entire time period. The Examiner's financial advisor observed that the spreadsheets did not contain a same-store calculation for the projected NOI mentioned above. However, the spreadsheets do show that the aforementioned growth rates were applied to the long-term hold core portfolio and were not affected by the sale or acquisition of properties. While this meets one definition of a same-store analysis, sometimes apartment complexes are excluded from the same-store analysis for other reasons (*e.g.*, when there are improvements made to the property). The Examiner's financial advisor concluded that the spreadsheets did not contain the ability to incorporate this definition of same store for the projected cash flows. However, the spreadsheets do contain a same-store analysis for the 2007 to 2008 time period in the "Budget Compare" tab. Over 81% (78 out of 96) of the 7 year long-term hold core portfolio assets were classified as same-store in this analysis. The Examiner's financial advisor determined that the projected growth rates can be compared to benchmarks of same-store sales, subject to the previously discussed limitations.

[1624] Memorandum from GREG: Mark Walsh, Lehman, *et al.*, to Bridge Loan Comm. & Inv. Comm., Lehman, re: $23.4 billion debt and equity financing commitment in connection with the potential acquisition of Archstone-Smith by Lehman Brothers and Tishman Speyer Properties (May 16, 2007), at p. 21 [LBEX-DOCID 1488740], attached to e-mail from Ketaki Chakrabarti, Lehman, to Paul Higham, Lehman, *et al.*(May 18, 2007) [LBEX-DOCID 1378569].

1994 through 2009 was less than half the growth rate used in Lehman's first quarter 2008 and second quarter 2008 DCF models.[1625] In this manner, Lehman's base case DCF analysis used NOI growth rates that were more than double the average growth rate for apartment REITs over the fifteen-year period from 1994 and 2009.

A second quarter 2008 Lehman presentation states that Archstone's same store NOI increased cumulatively by 17.2% between 2001 and 2007,[1626] and that Archstone's growth during this period was higher than any of its peers.[1627] This 17.2% cumulative growth rate over six years converts to a CAGR of 2.7% per year.[1628] Accordingly, Lehman's projected NOI CAGRs for Archstone's long-term portfolio of 7.63% (first quarter model) and 7.95% (second quarter model) were almost three times larger than Archstone's historical same store NOI CAGR of 2.7%.

b. Sensitivity Analysis

The Examiner's financial advisor performed a sensitivity analysis using Lehman's second and third quarter 2008 DCF models[1629] to show how a reduction in the

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[1625] *Id.*

[1626] Lehman, Archstone Q2 2008 Update (June 12, 2008), at p. 9 [LBEX-DOCID 2929329].

[1627] *Id.*

[1628] NOI increased from a base of 100 in 2001 to 117.2 by 2007, which means that Archstone's same store NOI in 2007 was 1.172 times higher in 2007 than it was in 2001. The Examiner's financial advisor converted the 17.2% cumulative growth rate to a CAGR through the following calculation: $1.172^{(1/6)} - 1 = 2.68\%$

[1629] Lehman, Easy Living Q2 Model Risk (June 15, 2008) [LBEX-DOCID 4456413] (second quarter model); Lehman, Easy Living Corporate Q3 (August 22, 2008) [LBEX-DOCID 311944] (third quarter model).

projected rent growth rate assumption affected the projected NOI growth rate.[1630] The table below sets forth the results of this analysis, and demonstrates that a reduction in the assumed rent growth has a slightly larger impact on the corresponding NOI growth rate. For example, as shown in the table below, reducing the second quarter model's rent growth rate by 100 basis points, from 5.62% to 4.62%, results in a 124 basis point reduction in the NOI growth rate, from 7.95% to 6.71%.

Rent and NOI Growth Rate Sensitivity

Change in Rent Growth[1631]	Q2 Model Rental Growth Rate CAGR	Q2 Model NOI Growth Rate CAGR	Q3 Model Rental Growth Rate CAGR	Q3 Model NOI Growth Rate CAGR
Rate used in Model	5.62%	7.95%	4.90%	7.04%
-25 bps	5.37%	7.64%	4.65%	6.73%
-50 bps	5.12%	7.33%	4.40%	6.42%
-75 bps	4.87%	7.02%	4.15%	6.10%
-100 bps	4.62%	6.71%	3.90%	5.79%
-125 bps	4.37%	6.40%	3.65%	5.47%
-150 bps	4.12%	6.08%	3.40%	5.15%
-175 bps	3.87%	5.76%	3.15%	4.83%
-200 bps	3.62%	5.45%	2.90%	4.50%

[1630] Lehman, Easy Living Q2 Model Risk (June 15, 2008) [LBEX-DOCID 4456413]; Lehman, Easy Living Corporate Q3 Model (Aug. 22, 2008). A sensitivity analysis could not be performed on the first quarter model due to the structure of that model. By contrast, the second quarter and third quarter models had a functionality that enabled the user to enter in different sensitivity assumptions for certain variables. The Examiner's financial advisor entered in the rent growth assumptions of 0 bps through -200 bps at 25 bps intervals and observed the output of the model for NOI growth rates based on the change in rent growth assumptions.

[1631] The model included a function that permitted their user to lower the rent growth numbers. This column represents the amount by which the Examiner's financial advisor reduced the rent growth assumption for purposes of understanding the relationship between the rental growth rate and the NOI growth rate.

The reasonableness of Lehman's rent growth assumption is considered in later sections that address Lehman's valuations as of specific dates.

(ii) Exit Capitalization Rate

The capitalization rate is equal to the discount rate minus the expected long term growth rate in expected future cash flows.[1632] As noted above, the expected growth rate in future expected cash flows and the discount rate are the two primary components of a DCF analysis. The capitalization rate combines both components into one variable.

The capitalization rate can be used to value an asset, which is calculated by dividing next year's expected cash flows by the capitalization rate.[1633] Because the capitalization rate is the denominator in this equation, the valuation is inversely correlated with the capitalization rate. That is, holding all else constant, an increase in the capitalization rate results in a decrease in the asset's value and a decrease in the capitalization rate results in an increase in the asset's value.

Within the real estate industry, it is standard to separately calculate and consider two types of capitalization rates: an entering rate and an exit rate.[1634] The entering (also called "going-in") capitalization rate is determined based on the expected future cash flows in the first year after the valuation date. The exit capitalization rate is determined

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[1632] Shannon P. Pratt & Roger J. Grabowski, *Cost of Capital: Applications and Examples* 25 (3d ed. 2008).
[1633] *Id.* at 596.
[1634] *Id.* at 585.

based on the expected future cash flows in the first year after the end of the projection period, which may occur many years after the valuation date.

Lehman's base case DCF analysis assumed the exit capitalization rate for the portfolio would be approximately 70 basis points higher than the going-in capitalization rate.[1635] That is, Lehman projected the discount rate to increase and/or the long-term growth rate in future cash flows to decrease by approximately 70 basis points over the course of the projection period (which ended in 2014).[1636] The Examiner's financial advisor, in analyzing Lehman's projected exit capitalization rates, assumed that such rate would be 70 basis points higher than the corresponding going-in capitalization rate.[1637]

[1635] Webster Neighbor explained the assumption Lehman used regarding the exit capitalization rate in an e-mail to Jonathan Cohen and Abebual Kebede on April 1, 2008. Neighbor wrote that "of the $17.8 bn of stabilized real estate, we plan on holding almost 80% ($14.7 bn) for the 7 yrs. We own these assets at a 4.08% cap (on our allocated value), and plan on selling them 7 years from now at a blended 4.79% cap (in other words, we underwrote as our base case 71 bps of cap widening over the 7 years." E-mail from Webster Neighbor, Lehman, to Jonathan Cohen, Lehman, *et al.* (Apr. 1, 2008) [LBEX-DOCID 1468705]; *see also* Lehman, Archstone Overview (Apr. 1, 2008) [LBEX-DOCID 4320895]. The reference to "allocated value" in the quote refers to the purchase price allocation, which is discussed in Appendix 12, Valuation - Archstone.

[1636] Lehman, Project Easy Living: Tishman Speyer - Archstone-Smith Multifamily JV, LP (Mar. 17, 2008) [LBEX-DOCID 1626080]; Lehman, Easy Living Q2 Model Risk (June 15, 2008) [LBEX-DOCID 4456413].

[1637] To benchmark the reasonableness of this assumption, the Examiner's financial advisor reviewed data published by PwC in its Korpacz Real Estate Investors Survey. PricewaterhouseCoopers, Rough Road Ahead for Investors: Korpacz Real Estate Investor Survey (First Quarter 2008), at p. 37 [LBEX-BARFID 0011591]; PricewaterhouseCoopers, Investors Face Ups and Downs: Korpacz Real Estate Investor Survey (Second Quarter 2008), at p. 39 [LBEX-BARFID 0011679]. The Examiner's financial advisor compared the differences between the entering and exit cap rates as reported by PricewaterhouseCoopers in their Real Estate Investor Survey (Korpacz reports) over this time period. The Examiner's financial advisor observed that the increase between the going-in capitalization rates and the exit capitalization rates over this time period were generally consistent with Lehman's assumption.

(iii) Exit Platform Value

The exit platform value assumption refers to Archstone's ability to generate value from asset management fees, future promotes[1638] and its ability to build apartment buildings in the future for sale to third parties (which is referred to as its "merchant building platform").

Lehman's DCF analysis valued the exit platform at $2.0 billion as of 2014.[1639] This determination was supported by the following analysis included in Lehman's model.[1640]

Exit Platform Valuation

	Valuation Range ($ in millions)		
	Low	Midpoint	High
Merchant Building Platform	1,571	1,767	1,963
Annuitized Fee Stream	540	595	661
Value of Future Promotes	111	125	138
Total Platform Value	2,221	2,486	2,762

As the table shows, approximately 71% of the exit platform valuation was attributable to the merchant building platform,[1641] approximately 24% of the exit

[1638] Lehman, Project Easy Living: Tishman Speyer - Archstone-Smith Multifamily JV, LP (Mar. 17, 2008), at Intro tab [LBEX-DOCID 1626080]; Lehman, Easy Living Q2 Model Risk (June 15, 2008), at Intro tab [LBEX-DOCID 4456413]. Promote refers to the allocation of equity returns amongst different equity investors in a joint venture. The value of future promotes was based on the assumption that (1) Archstone would negotiate transactions with a promote feature and (2) these "promote" investments would result in Archstone receiving higher returns than other equity holders.

[1639] The Examiner's financial advisor observed that the value as of earlier dates would be lower due to the time value of money and risk associated with the future expected cash flows. In other words, whereas the value in 2014 would be $2.0 billion, the value in 2008 would be less than $1 billion.

[1640] Lehman, Project Easy Living: Tishman Speyer - Archstone-Smith Multifamily JV, LP (Mar. 17, 2008) [LBEX-DOCID 1626080]; Lehman, Easy Living Q2 Model Risk (June 15, 2008), at Intro tab [LBEX-DOCID 4456413].

[1641] The merchant platform value represented 70.7% of the total based on the low valuation range and 71.1% of the total based on the midpoint and high valuation ranges. The merchant building platform

platform value was attributable to the annuitized fee stream,[1642] and the remaining 5% was attributable to future promotes.[1643]

Lehman's second quarter DCF analysis included sensitivity analyses that reduced the exit platform value from $2 billion to $0, in increments of $500 million.[1644]

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valuation was based on the following assumptions: (1) Archstone would generate $283 million of net income from its merchant building platform in 2017; (2) the valuation as of 2017 assumed the merchant building platform could be sold at a value that was eight to ten times the $283 million of net income in 2017; and (3) the valuation as of 2017 was discounted to reflect a valuation as of 2014 by applying a 13% annual discount rate. Lehman, Project Easy Living: Tishman Speyer - Archstone-Smith Multifamily JV, LP (Mar. 17, 2008), at Intro tab [LBEX-DOCID 1626080]; Lehman, Easy Living Q2 Model Risk (June 15, 2008), at Intro tab [LBEX-DOCID 4456413]. The eight times to ten times multiple was based on the long-term historical average homebuilder multiple. The 13% discount rate was based on the merchant building cost of equity. The most important assumption in this analysis was the projected $283 million of net income in 2017. The Examiner's financial advisor observed that this is the most important assumption because without earnings, there would be no need to apply a valuation multiple or discount a valuation as of 2017 to 2014. This net income figure was based on the following assumptions: (1) Archstone would invest $1.4 billion in developing new apartment complexes in 2017; (2) Archstone would generate NOI equal to 6% of this investment; and (3) the apartment complexes would be sold at a 4.5% capitalization rate. Lehman, Project Easy Living: Tishman Speyer - Archstone-Smith Multifamily JV, LP (Mar. 17, 2008) [LBEX-DOCID 1626080]; Lehman, Easy Living Q2 Model Risk (June 15, 2008) [LBEX-DOCID 4456413].

[1642] The Examiner's financial advisor observed that the value of annuitized fee streams represented 24.3% of the total based on the low valuation range and 23.9% of the total based on the midpoint and high valuation ranges. The annuitized fee stream valuation was based on two assumptions: (1) Archstone would generate $31.8 million of annual net income derived primarily from future joint ventures and asset management; and (2) this income stream would increase 17 to 20.8 times as much as the current amount. Lehman, Project Easy Living: Tishman Speyer - Archstone-Smith Multifamily JV, LP (Mar. 17, 2008) [LBEX-DOCID 1626080]; Lehman, Easy Living Q2 Model Risk (June 15, 2008) [LBEX-DOCID 4456413]. Approximately 47% of the annuitized net income was projected to be from future joint ventures and asset management, assuming that Archstone would earn asset management fees of 0.35% off of $1.5 billion of assets. The 20.8 multiple was based on the average forward price-to-earnings multiple for Real Estate Asset Management companies. The 17.0 multiple reflected an 18.3% discount to the 20.8 multiple. Lehman, Easy Living Q2 Model Risk (June 15, 2008), at Intro tab [LBEX-DOCID 4456413].

[1643] The Examiner's financial advisor observed that the remaining 5% of the exit platform value was based on the value of future promotes, which was calculated based on the following assumptions: (1) Archstone would generate $114 million of future promotes by 2014; (2) the $114 million of future promotes would be realized ratably over a 7-year period; (3) the appropriate tax rate was the long-term capital gains tax rate of 15%; and (4) the appropriate valuation multiple was between 8.0 and 10.0, which was lower than the equity valuation convention of 12.0 to 15.0 as of the time this assumption was originally made. Lehman, Project Easy Living: Tishman Speyer - Archstone-Smith Multifamily JV, LP (Mar. 17, 2008) [LBEX-DOCID 1626080]; Lehman, Easy Living Q2 Model Risk (June 15, 2008) [LBEX-DOCID 4456413].

The Examiner's financial advisor observed that the sensitivity analyses were not assumptions Lehman used in its valuation determination; rather the sensitivities showed the resulting discount rate assuming Lehman's valuation of Archstone's equity remained the same while adjustments were made to the rent growth, exit capitalization rate and exit platform value assumptions.

A memo written by Tishman Speyer employees and sent to Archstone's management and its investors during the second quarter of 2008 discussed the tension between managing Archstone's liquidity needs and maintaining the value of the exit platform.[1645] This memo suggests that Archstone's platform value may have declined during 2008 due to changes in market conditions.[1646] The Examiner's financial advisor determined that it is difficult to benchmark the reasonableness of Lehman's exit

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[1644] *Id.*

[1645] Memorandum from David Augarten, Tishman Speyer, *et al.*, to R. Scot Sellers, Archstone, *et al.*, Archstone Update (Mar. 24, 2008), at p. 4 [LBEX-DOCID 2932586]: "While it is helpful to understand how much time we have if we cut back on our capex and development expenditures, there are several negative consequences of doing so. First, if we are not making any new investments because of liquidity issues it will have a negative impact on the platform value. It will also have a negative impact on the overall equity returns of the deal and make it harder to syndicate equity at some future date. Finally, a decision to defer all new development expenditures in 2008 would lead to an exodus of the Company's top development talent, which would impact our ability to successfully complete projects already underway and would diminish the value of the Company's platform. We certainly understand that times have changed and most developers are scaling back their development plans in the short term. We believe that we need to strike a careful balance between not doing any incremental development in 2008 and proceeding with everything currently budgeted. If we can focus our efforts on those deals with the most attractive returns, we should be able to maintain some near term liquidity while also preserving our platform value and retaining our development talent. We will also always put construction financing in-place prior to the start of any new ground-up development in order to minimize the potential equity commitment to each project. In these tough times, we will be most successful if we can find the right balance between managing for liquidity and maximizing the long term return on invested capital."

[1646] *Id.*

platform value assumption because there were no comparable sales of this type of intangible asset, and no sales of Archstone's bridge equity positions which would reflect the platform's valuation as ascribed by contemporaneous market participants. Accordingly, given the absence of evidence supporting a finding that Lehman's assumption as to the value of Archstone's exit platform was unreasonable, the Examiner's financial advisor did not adjust Lehman's exit platform value in the quarter-by-quarter analysis discussed below.

(iv) Discount Rate

The discount rate assumption refers to the discount applied to convert future cash flows to their present value.[1647] The discount rate incorporates both the time value of money and the non-diversifiable risk associated with the asset.[1648] Holding all else constant, an increase in the discount rate assumption results in a decrease in value, just as a decrease in the discount rate assumption results in an increase in value.[1649]

Lehman used a discount rate assumption of approximately 12% in May 2007,[1650] 13% to 14% in August 2007,[1651] 14.6% as of the first quarter of 2008,[1652] and a 15%

[1647] Aswath Damodaran, *Corporate Finance, Theory and Practice* 750 (2nd ed. 2001); Eugene F. Brigham & Joel F. Houston, *Fundamentals of Financial Management* 395 (8th ed. 1998).

[1648] *Id.*

[1649] Lehman, Real Estate Product Control Update (May 27, 2008), at p. 115 [LBHI_SEC07940_2258765].

[1650] Memorandum from Mark A. Walsh, Lehman, et al., to LBHI Bridge Loan Committee & Investment Committee, re: Debt and Equity Financing Commitment Proposal for the Potential Acquisition of Archstone-Smith (May 16, 2007), at p. 9 [LBEX-DOCID 1674960].

[1651] Abebual A. Kebede, Lehman, Archstone Smith Valuation Update [Draft] (Aug. 23, 2007) [LBEX-DOCID 2689696]; Lehman, Project Easy Bridge Equity Discounting Sensitivity Spreadsheet (Mar. 17, 2008) [LBEX-DOCID 1626080].

discount rate during the second and third quarters of 2008.[1653] Lehman used the returns provided by core-plus funds, typically 12%-15%, as the benchmark for its DCF model discount rate.[1654]

The Examiner's financial advisor did not locate materials that specifically support Lehman's discount rate assumptions of between 13% and 15%.[1655] Hughson and Neighbor told the Examiner that the discount rates were based on judgment and that there was no specific supporting documentation.[1656] A Product Control Group May 2008 analysis indicated that an appropriate discount rate could be in the range of 18% to 20%.[1657]

The Examiner's financial advisor is not aware of any contemporaneous data that suggests the discount rates used by Lehman were unreasonable, provided that this

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[1652] Lehman, Archstone Bridge Equity Discounting Sensitivity (Apr. 1, 2008), at p. 1 [LBEX-DOCID 4346983].

[1653] E-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman, *et al.* (June 14, 2008) [LBEX-DOCID 1865693]; Lehman, Archstone Sensitivity Analysis (Aug. 22, 2008), at p. 1 [LBEX-DOCID 2852318], attached to e-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman (Sept. 12, 2008) [LBEX-DOCID 2903130].

[1654] Memorandum from Keith Cyrus, Lehman, *et al.*, to Donald E. Petrow, Lehman, Archstone Update (May 16, 2008), at p. 3 [LBHI_SEC07940_5521903].

[1655] The investigation seeking that information included detailed requests for information from Lehman and a review of the FID drives and Lehman's SOX drives.

[1656] Examiner's Interview of Abebual A. Kebede, Sept. 29, 2009, at p. 6.

[1657] Lehman, Archstone Q2 2008 Update (June 12, 2008), at p. 15 [LBEX-DOCID 2929329]. An e-mail from Jeff Wechsler to Abebual Kebede on May 27, 2008, included this analysis which showed a mark-down from the funded value of $945 million at a discount rate of 20.95%. Lehman, Archstone Risk Analysis (May 27, 2008), at Base Case tab [LBEX-DOCID 4447789], attached to e-mail from Jeffrey Wechsler, Lehman, to Abebual Kebede, Lehman, *et al.* (May 27, 2008) [LBEX-DOCID 4327665]. Earlier in the chain of e-mails, Kebede asked Wechsler to prepare this analysis as "15% and 12% IRRs are probably less useful at this point." Kebede also asked for CAGR sensitivities at 5.12% and 4.62% but this request apparently was not fulfilled.

discount rate was applied to expected future cash flows. Expected future cash flows refer to a probability weighted average of projected future cash flows.[1658] Product Control was less familiar with the underlying assumptions for the analysis,[1659] but the Examiner's financial advisor observed that it appears that Product Control used the higher discount rates of 18% to 20% in their sensitivity analysis as a substitute for reducing projected future cash flows to arrive at expected future cash flows.

(b) Sum of the Parts Method

Lowitt stated on the second quarter earnings call that Lehman used a Sum of the Parts analysis as a cross-check to its DCF analysis. Lehman performed a Sum of the Parts analysis based on its purchase price allocation.[1660] The purchase price allocation was a valuation exercise that allocated $22 billion (representing the purchase price for purposes of this analysis) to Archstone's assets. Lehman assigned $17.8 billion to Archstone's core portfolio, $1.4 billion to projects in development (referred to as "Development" in the following table), $1 billion to the platform (comprised of Archstone's ability to generate value from asset management fees, future promotes and

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[1658] Shannon P. Pratt & Roger J. Grabowski, *Cost of Capital: Applications and Examples* 17 (3d ed. 2008). For example, the Examiner's financial advisor noted that if there were 2 projected scenarios: a 50% chance that cash flow will be $10 and a 50% chance that cash flow will be $20 in Year 1, the expected cash flow for Year 1 is $15, which is computed as follows: (50% x $10) + (50% x $20) = $15. It is appropriate to apply the 15% discount rate to $15 of projected cash flow in this example. It would be inappropriate to apply the 15% discount rate to $20 (which would result in an overvaluation) or $10 (which would result in an undervaluation) of projected cash flow in this example.

[1659] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at pp. 5-6.

[1660] Final Transcript of Lehman Brothers Holdings Inc. Second Quarter Earnings Call (June 16, 2008), at p. 14 [LBHI_FIN 00007]. *See* Appendix 12, Valuation - Archstone, for a summary of Lehman's purchase price allocation analysis.

the merchant building platform), and $2 billion to other assets. The table below, prepared by Tishman Speyer as part of a sensitivity analysis, includes the value assigned to the various asset categories in the purchase price allocation (see the leftmost column).[1661]

Core Portfolio Cap Rate	4.11%	4.25%	4.50%	4.75%	5.00%	5.25%	5.50%	5.75%	6.00%
Cap Rate w/o Platform	*3.89%*	*4.02%*	*4.24%*	*4.46%*	*4.68%*	*4.90%*	*5.11%*	*5.33%*	*5.54%*
Core Portfolio	$17,789	$17,193	$16,238	$15,383	$14,614	$13,918	$13,285	$12,708	$12,178
Assets Held for Sale	596	596	596	596	596	596	596	596	596
Development	1,418	1,418	1,418	1,418	1,418	1,418	1,418	1,418	1,418
Germany	378	378	378	378	378	378	378	378	378
Ground Leases	208	208	208	208	208	208	208	208	208
Other Assets	374	374	374	374	374	374	374	374	374
Platform Value	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Cash / WC	411	411	411	411	411	411	411	411	411
Total Value	$22,173	$21,577	$20,622	$19,767	$18,998	$18,302	$17,669	$17,092	$16,562
Total Debt / Preferred	17,073	17,073	17,073	17,073	17,073	17,073	17,073	17,073	17,073
Equity	5,100	4,504	3,549	2,694	1,925	1,229	596	19	(511)
Variance	-	(596)	(1,551)	(2,406)	(3,175)	(3,871)	(4,504)	(5,081)	(5,611)

[1661] The table was obtained from an attachment to an e-mail that was sent by Siebers (of Tishman Speyer) to many people at Archstone, Lehman, BofA, Barclays and Tishman Speyer on January 31, 2008. Tishman Speyer, Spot Value Variance: Tishman Speyer - Archstone - Smith Multifamily Fund (Jan. 30, 2008) [LBEX-DOCID 1743458], attached to e-mail from Kevin Siebers, Tishman Speyer, to R. Scot Sellers, Archstone-Smith, *et al.* (Jan. 31, 2008) [LBEX-DOCID 1861936]. The table was part of the materials that were circulated by Siebers in advance of a February 1, 2008 meeting. A similar version of this chart is found at Lehman, Spot Value Variance, at p. 11 [LBHI_SEC07940_7548964]. *See* Appendix 12, Valuation - Archstone, for more details regarding the purchase price allocation.

While the table above summarizes the allocation of value to different asset categories, the initial intent of the table was to show the effect of an increase in capitalization rates on the core portfolio valuation. This can be seen in the columns with different capitalization rates listed on the first line. As shown in the table above, an increase in the capitalization rate for the core portfolio from 4.10% to 5.75% — assuming such an increase was reasonable — would eliminate virtually all equity value.

The Examiner's financial advisor's review of the Sum of the Parts analysis focused on the data in this table, and more specifically on the $17.8 billion core portfolio valuation and $1 billion platform valuation. Subsequent Sections that address Archstone valuations by date also address the Examiner's review of the Sum of Parts analysis and its implications for the reasonableness of Lehman's reported Archstone valuations for purposes of the solvency analysis.

(c) Comparable Company Method

The Q2 Book included an analysis that compared the value of Archstone to the value of Archstone's publicly traded comparable companies during the second quarter 2008.[1662] Lehman did not perform a similar analysis for any other quarters.

Paul Hughson told the Examiner that the values of publicly traded companies were "not relevant" for purposes of valuing Archstone once it became privately-held.[1663]

[1662] E-mail from Webster Neighbor, Lehman, to Brett Bossung, Lehman, *et al.* [LBEX-DOCID 2820780]; *see also* Lehman, Archstone Q2 2008 Update (June 12, 2008), at p. 8 [LBEX-DOCID 2929329], attached to e-mail from Webster Neighbor, Lehman, to Brett Bossung, Lehman, *et al.* [LBEX-DOCID 2820780].

Jonathan Cohen generally agreed with Hughson's conclusion.[1664] Lehman did use an analysis of comparable companies in its valuation due diligence prior to the Commitment Date.[1665] Hughson told the Examiner that this analysis did not matter once the acquisition closed.[1666] Jonathan Cohen told the Examiner that "he never thought about" replicating a comparable company analysis because it would require a lot of work.[1667]

Lehman's "FAS 157 Fair Value Measurements Policy" stated that a range of factors, including the "trading values on public exchanges for comparable securities," should be considered for purposes of valuing Lehman's private equity positions.[1668] Lehman, however, made a determination that such trading values were not relevant for purposes of valuing Archstone in a private market context. The Examiner recognizes that judgment is employed not only in selecting the inputs for a valuation analysis, but also in the selection of what analysis to perform. Although Lehman's stated policy required consideration of the trading values of Archstone's publicly owned peers, the evidence does not support a finding that Lehman's decision not to undertake such an analysis to determine the fair value of its Archstone equity positions was unreasonable.

[1663] Examiner's Interview of Paul Hughson, Dec. 21, 2009, at p. 2.

[1664] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 10.

[1665] Lehman, Project Easy Living: Discussion / Valuation Materials (May 21, 2007), at p. 8 [LBEX DOCID 1695374].

[1666] Examiner's Interview of Paul Hughson, Dec. 21, 2009, at p. 2.

[1667] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 9.

[1668] Lehman, Lehman Brothers Holdings Inc. Accounting Policy Manual (Nov. 21, 2007), at p. 3 [LBEX DOCID 1717234], attached to e-mail from Marie Stewart, Lehman, to Dilan Abeyratne, Lehman, *et al.* (Nov. 21, 2007) [LBEX DOCID 1926752].

However, given Lehman's policy and that the market's view as to the value of Archstone's peers (as expressed through their stock prices) is a useful indicator of value, the Examiner's financial advisor replicated the comparable company analysis that Lehman undertook in the Q2 Book, and conducted such analysis for the fourth quarter of 2007, and for the first, second and third quarters of 2008.[1669]

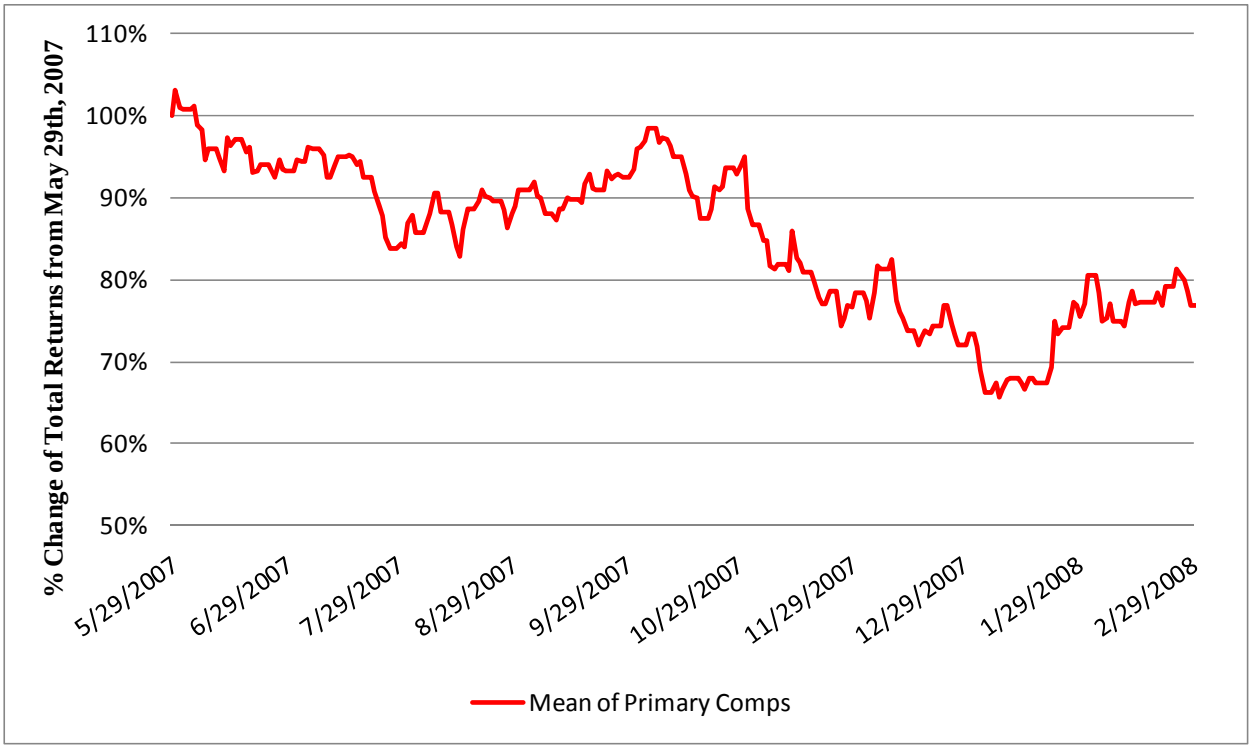
The Q2 Book's comparable company analysis involved three separate steps, which the Examiner's financial advisor replicated as discussed below. The Q2 Book's analysis first identified the change in total returns (*i.e.*, stock prices plus dividends) on equity for the companies that Lehman determined were the primary comparables to Archstone – AvalonBay, Essex Properties and BRE Properties.[1670] The Q2 Book observed a 17.8% decline in total returns on equity for Archstone's comparable companies during the period beginning on the Commitment Date and ending on June 10, 2008.[1671] The Examiner's financial advisor replicated this analysis for each of the four quarters of 2007, and the first and third quarters of 2008. As shown in the chart below, the average total returns on equity for the three primary comparable companies declined by over 20% during the period beginning on the Commitment Date and ending February 29, 2008.

[1669] The Examiner's financial advisor also analyzed the cost of taking Archstone private, and then compared that cost to the value of Archstone's equity at closing. This analysis is set forth in Appendix 12, Valuation - Archstone.

[1670] Lehman, Archstone Q2 2008 Update (June 12, 2008), at p. 8 [LBEX-DOCID 2929329].

[1671] *Id.* at p. 13 [LBEX-DOCID 2929329].

Total Returns on Equity for Archstone's Primary Comparable Companies



The second step in the Q2 Book's analysis was to convert the change in total returns on equity discussed above to a change in total returns on enterprise value.[1672] This step was necessary to normalize the different levels of debt that each company had (*i.e.*, to put the companies on an "apples to apples" basis).[1673] The Q2 Book's analysis observed that the enterprise value of Archstone's peers declined by 10.7% since the Commitment Date. The Examiner's financial advisor replicated this analysis for each of the other quarters and, for example, observed a decline in total returns on enterprise

[1672] Lehman, Archstone Q2 2008 Update (June 12, 2008), at p. 13 [LBEX-DOCID 2929329].

[1673] The Examiner's financial advisor observed that Lehman converted the total returns on equity to total returns on enterprise value by making the following determinations: (1) there was no decline in the value of debt for these companies and (2) the capital structure for these companies was 60% debt and 40% equity.

value for Archstone's primary comparable companies of approximately 13% during the period beginning the Commitment Date and ending the last day of the first quarter.[1674]

The third step in Lehman's analysis computed the change in Archstone's enterprise value from the Commitment Date based on Lehman's valuation of its Archstone positions.[1675] In other words, this calculation applies the Lehman's mark on its Archstone positions to Archstone's enterprise value. The Q2 Book reported this calculation illustrated that Archstone's enterprise value had declined 5.7% during the period beginning the Commitment Date and ending May 31, 2008.[1676] The Examiner's financial advisor replicated this analysis for each other quarter, and using this methodology, calculated a 2% decline in Archstone's enterprise value during the period beginning the Commitment Date and ending on the last day of the first quarter.[1677]

The Examiner's financial adviser conducted a sensitivity analysis for each quarter pursuant to which the change in enterprise value for Archstone based on Lehman's value of its Archstone positions (*e.g.*, 5.7% through the second quarter) was compared to

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[1674] The baseline value as of May 29, 2007, was $60 equity and $40 debt, which is consistent with a capital structure that was 60% equity and 40% debt. The value of the equity declined by 21.5% between the Commitment Date and end of the first quarter (based on the total returns mentioned above), which resulted in a revised equity value of approximately $47 ($60 multiplied by (100% - 21.5%) = $47). The value of the debt remained unchanged at $40. Therefore, the revised enterprise value was $87 ($47 of equity plus $40 of debt), which was 13% lower than the $100 baseline value as of May 29, 2007.

[1675] Lehman, Archstone Q2 2008 Update (June 12, 2008), at p. 13 [LBEX-DOCID 2929329].

[1676] *Id.* Lehman valuation as of the end of the second quarter resulted in a 24.9% decline in equity value and 0% decline in debt value, which resulted in 5.7% decline in enterprise value.

[1677] Lehman's valuation as of the end of the first quarter resulted in a 9.3% decline in equity value and 0% decline in debt value, which resulted in a 2.1% decline in enterprise value. The decline in enterprise value (approximately 2%) is lower than the decline in funded value of Lehman's Archstone positions (approximately 5%) because Lehman's Archstone positions were lower in Archstone's capital structure and therefore its value was more sensitive to changes in Archstone's enterprise value.

the change in enterprise value for Archstone's primary comparable companies (e.g., 10.7% through the second quarter).

In this manner, the sensitivity analysis illustrates what Archstone's enterprise value would have been as of each date if such value had declined in an amount equal to the average decline experienced by Archstone's publicly traded peers. The table below compares that value (in row "Enterprise Value" – Implied by Comparable Company Analysis) to Archstone's enterprise value as implied by Lehman's marks. The difference between those two values, multiplied by Lehman's Archstone equity ownership (expressed as a percentage), illustrates the difference between the value of Lehman's Archstone positions determined according to this comparable company analysis and Lehman's contemporaneous marks.

(i) Potential Overvaluation Based on Primary Comparable Companies

	Nov-07	Feb-08	May-08	Aug-08
Enterprise Value				
Implied by Lehman Marks	21.8	21.7	20.9	20.6
Implied by Comparable Company Analysis	19.3	19.3	20.4	20.4
Difference	(2.5)	(2.4)	(0.5)	(0.2)
Lehman's equity ownership	47%	47%	47%	47%
Impact on Lehman's positions ($ bn)	(1.2)	(1.1)	(0.2)	(0.1)

Given the Examiner's conclusion regarding the reasonableness of Lehman's decision to not employ the comparable company methodology, the following quarter-

by-quarter analysis of Lehman's Archstone valuations focuses on the reasonableness of Lehman's Sum of the Parts and DCF analyses.

(5) Examiner's Analysis of the Reasonableness of Lehman's Valuation of its Archstone Positions on a Quarterly Basis

The discussion below addresses the Examiner's analysis of the reasonableness, for purposes of a solvency analysis, of Lehman's Archstone valuations quarter-by-quarter beginning with the fourth quarter of 2007.

(a) Reasonableness as of the Fourth Quarter of 2007

Lehman determined that the value of its Archstone positions was $5.1 billion as of the end of the fourth quarter of 2007.[1678] This valuation reflected a 4.4% discount from Lehman's original Archstone investment.[1679]

The Archstone acquisition closed in October 2007, the second month of the fourth quarter. As of the Closing Date, Lehman reduced its Archstone marks by the $233 million in fees that it received in connection with the acquisition. Hughson told the Examiner that recording fees into the positions resulted in a valuation that reflected both Lehman's "best judgment as to the value of the underlying assets at the time of

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[1678] *See* Chart titled, "Lehman's Valuation of Archstone Positions (U.S. $ million, Oct 07-Aug 08)" in the preceding Section of this Report, with data from Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113] and Lehman, Top Global Real Estate Exposures (Aug. 31, 2008), at p. 18 [LBHI_SEC07940_ICP_002615].

[1679] *See* Chart titled "Archstone Marks by Month (Oct 07 - Aug 08)" in the preceding Section of this Report, with data from Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113] and Lehman, Top Global Real Estate Exposures (Aug. 31, 2008), at p. 18 [LBHI_SEC07940_ICP_002615]. The discount was computed by subtracting the total mark for November from 100 (*i.e.*, 100 minus 95.6 equals 4.4).

closing," including the state of debt markets, and Lehman's ability to syndicate the bridge equity and the value of underlying assets.[1680] Lehman did not take any other write-downs – other than for excess carry – on their Archstone positions during that quarter.[1681]

Hughson told the Examiner that he did not recall any details behind Lehman's Archstone valuation analysis for the fourth quarter of 2007.[1682] Hughson also did not recall any presentations that were prepared to explain the valuation or any events that would have led to a dramatic change in the valuation of Archstone positions between the Closing Date and the end of the fourth quarter.[1683] Jonathan Cohen told the Examiner that Product Control did little to review the reasonableness of Lehman's Archstone valuation during the fourth quarter.[1684] The Examiner's financial advisor did not locate any analyses that were purported to have been performed for Archstone valuations as of the fourth quarter of 2007.

William Schlich, lead audit partner at E&Y, told the Examiner that E&Y focused on Lehman's Product Control process when it reviewed Lehman's valuations for

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[1680] Examiner's Interview of Paul Hughson, Dec. 21, 2009, at p. 3.

[1681] The total variance was $230 million, which was calculated based on the October funded value of $5.398 billion, less the October reported valuation figure of $5.168 billion. *See* Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113]. The fees were therefore $230 million.

[1682] Examiner's Interview of Paul Hughson, Dec. 21, 2009, at p. 3.

[1683] *Id.*

[1684] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 10.

reasonableness.[1685] Schlich also told the Examiner that E&Y reviewed and understood the Archstone transaction, but did not do any independent testing or modeling of the Archstone valuation.[1686] Schlich explained that since the acquisition closed in October 2007, E&Y determined that the best indication of the value of Lehman's Archstone positions was the purchase price since it was based on the terms negotiated between willing buyers and a willing seller.[1687]

Lehman's valuation of Archstone during the fourth quarter of 2007 (and during the subsequent quarters) involved a significant amount of judgment because there were no material sales of Archstone debt or equity positions during the quarter (*i.e.*, SFAS 157 Level 1 inputs), nor were there any meaningful benchmarks for Archstone equity positions in a private market context (*i.e.*, SFAS 157 Level 2 inputs). The Examiner notes the short period between the Closing Date and the end of the fourth quarter, and that Archstone executed $1.5 billion of asset sales during the fourth quarter at a going-in capitalization rate below 4%. These sale prices were close to Archstone's budgeted prices. The Examiner finds that there is insufficient evidence to support a finding that

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[1685] Examiner's Interview of Ernst & Young, Nov. 11, 2009, at p. 4. William Schlich is E&Y's lead partner and Jerry Gruner is E&Y's senior manager on the Mortgage Capital team.

[1686] *Id.*

[1687] *Id.* at p. 5. The Examiner, in analyzing the reasonableness of Lehman's Archstone marks for each quarter, considered the scope and depth of Lehman's valuation efforts during each period. Given the statements made by Hughson and Jonathan Cohen, and the absence of quarter-end valuation materials, there is sufficient evidence to support a finding that Lehman did not undertake a substantive review of Archstone marks other than in connection with the Closing Date marks. With respect to the Lehman's fourth quarter valuation efforts, the Examiner has considered that the acquisition closed during the month before the quarter ended, and Fannie Mae and Freddie Mac purchased over $8 billion of Archstone first mortgage debt in connection with the closing.

Lehman's valuation of its Archstone positions was unreasonable as of the fourth quarter of 2007.

(b) Reasonableness as of the First Quarter of 2008

Lehman determined that the value of its Archstone positions was $5.1 billion as of the end of first quarter of 2008.[1688] This valuation reflected a 4.9% discount from Lehman's original investment in Archstone.[1689]

Lehman did not record any valuation-related write-downs during the first quarter of 2008.[1690] Lehman did record a relatively small reduction in Lehman's valuation between the fourth quarter of 2007 and the first quarter of 2008 (from 95.6% of funded value to 95.1% of funded value) primarily based on its decision to mark excess carry on the Archstone debt positions into the Archstone bridge equity position as discussed above.[1691] Jonathan Cohen told the Examiner that Hughson made the decision to use excess carry to reduce the bridge equity mark because Hughson did not want to show any profits on Archstone positions.[1692]

[1688] *See* Chart titled, "Lehman's Valuation of Archstone Positions (U.S. $ million, Oct 07 - Aug 08)" in the preceding Section of this Report, with data from Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113] and Lehman, Top Global Real Estate Exposures (Aug. 31, 2008), at p. 18 [LBHI_SEC07940_ICP_002615].

[1689] *See* Chart titled "Archstone Marks by Month (Oct 07-Aug 08)" in the preceding Section of this Report, with data from Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113] and Lehman, Top Global Real Estate Exposures (Aug. 31, 2008), at p. 18 [LBHI_SEC07940_ICP_002615]. The discount was computed by subtracting the total mark for November from 100 (*i.e.*, 100 - 95.1 = 4.9).

[1690] Lehman, Global Real Estate 2008 Mark Downs, at p. 10 [LBEX-BARFID 0013153].

[1691] E-mail from Paul Higham, Lehman, to Andy Lu, Lehman, *et al*. (Nov. 16, 2007) [LBEX-DOCID 4320525]. Lehman began recording excess carry into the bridge equity mark after November 14, 2007.

[1692] Examiner's Interview of Jonathan Cohen, Jan. 11, 2010, at p. 10.

(i) Barron's Article

Barron's published an article on January 21, 2008 suggesting that Archstone equity could be worthless.[1693] Lehman prepared an analysis that rebutted Barron's methodology and conclusions. This Subsection of the Report addresses the Examiner's analysis of the Barron's article and Lehman's rebuttal.

The Barron's article concluded that Archstone's equity may have been worthless based on Archstone's high level of debt and the capitalization rate implied by the stock prices of publicly traded apartment REITs.[1694] With respect to the capitalization rate, Lehman determined that the Archstone core portfolio (*i.e.*, stabilized apartment complexes) was acquired at a going-in rate of approximately 4%.[1695] The Barron's article observed that the going-in capitalization rate implied by the stock prices of Archstone's publicly traded peers by late January 2008 was over 7%.[1696] This steep increase in the going-in capitalization rate (*i.e.*, between the Commitment Date and January 2008) indicated a large decrease in Archstone's enterprise value and therefore a large decrease in the value of Lehman's equity investment in Archstone. The Barron article's thesis

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[1693] Andrew Bary, *Apartment-House Blues*, Barron's, Jan. 21, 2008, at p. 1, attached to e-mail from Glenn Schorr, UBS, to Keith A. Murray, UBS, *et al.* [LBEX-UBS 00886713], *available at* http://online.barrons.com/article/SB120070919702802265.html#articleTabs_panel_article%3D1.

[1694] *Id.* The Examiner's financial advisor calculated that Lehman's equity investment in Archstone would be practically worthless if the value of Archstone in its entirety declined by more than 24%.

[1695] Lehman, Archstone Update — Q2 2008 (June 12, 2008), at p. 2 [LBEX-DOCID 2902980].

[1696] Andrew Bary, *Apartment-House Blues*, Barron's, Jan. 21, 2008, at p. 1, attached to e-mail from Glenn Schorr, UBS, to Keith A. Murray, UBS, *et al.* [LBEX-UBS 00886713], *available at* http://online.barrons.com/article/SB120070919702802265.html#articleTabs_panel_article%3D1.

was that the increase in capitalization rates was large enough to reduce the value of equity investments in Archstone to zero.[1697]

As discussed above, Hughson told the Examiner that valuations based on the stock prices of comparable public companies were not relevant for purposes of valuing Archstone as a private company.[1698] Hughson also said that comparisons of Archstone to AvalonBay were inapposite because AvalonBay's assets were not as intrinsically valuable as Archstone's assets.[1699] However, after the Barron's article was published, Reilly, the Global Product Controller, asked Jonathan Cohen in an e-mail to "look at" the capitalization rate of AvalonBay when Lehman "bought Archstone" because AvalonBay was the "best comp."[1700]

The Examiner's financial advisor reviewed materials prepared by Lehman prior to its decision to commit to fund the Archstone acquisition, and compared

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[1697] Andrew Bary, *Apartment-House Blues*, Barron's, Jan. 21, 2008, at p. 1, *available at* http://online.barrons.com/article/SB120070919702802265.html#articleTabs_panel_article%3D1; David Einhorn, Presentation to Grant's Spring Investment Conference, Private Profits and Socialized Risk (Apr. 8, 2008), *available at* http://www.foolingsomepeople.com/main/mroom/Grants%20 Conference%2004-08-2008.pdf.

[1698] Examiner's Interview of Paul A. Hughson, Dec. 21, 2009, at p. 2.

[1699] Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 11. Hughson repeatedly emphasized that Archstone's assets were the best buildings, in the best markets, with the best management. *Id.* As an example, Hughson noted that AvalonBay's New York Metro properties included a large development in New Rochelle (a NYC suburb) directly abutting a major freeway (I-95), whereas Archstone's properties included a large development on West End Avenue in New York City. *Id.* Hughson explained that while a report might list AvalonBay and Archstone as both having properties in the New York metro area, a reasoned judgment of the value of each company required individual scrutiny of each company's specific assets. *Id.*

[1700] E-mail from Gerard Reilly, Lehman, to Jonathan Cohen, Lehman (Jan. 22, 2008) [LBEX-DOCID 2778713].

capitalization rates for AvalonBay and Archstone.[1701] Lehman's analysis determined that Archstone's stock historically traded at a lower Funds from Operations ("FFO") multiple than its peers. A comparison of FFO multiples serves to compare the value of an asset (in this case Archstone's stock) to the value of similar assets that were priced by the market.[1702] Lehman's analysis reveals that Archstone's stock was trading even with or slightly below its peers based on FFO multiples as of May 2007. Therefore, Lehman concluded that data demonstrated that market participants bought and sold Archstone's stock as if its growth prospects were slightly lower or in-line with its publicly traded peers.[1703]

Lehman prepared materials during this time period that also demonstrate Archstone and AvalonBay had comparable going-in capitalization rates and were valued similarly on a per apartment unit basis.[1704] Therefore, there is sufficient evidence to support a finding that changes in AvalonBay's capitalization rates between the Commitment Date and February 29, 2008 should be considered for purposes of assessing the reasonableness of Lehman's valuations of its Archstone positions.

[1701] Lehman, Project Easy Living: Discussion / Valuation Materials (May 21, 2007), at p. 8 [LBEX DOCID 1695374].
[1702] Aswath Damodaran, Investment Valuation: Tools and Techniques for Determining the Value of Any Asset 453 (2d ed. 2002).
[1703] Lehman, Project Easy Living: Discussion/Valuation Materials (May 21, 2007), at pp. 4, 8 [LBEX DOCID 1695374].
[1704] *Id.*

While the review by the Examiner's financial advisor of comparable companies, and AvalonBay specifically, generally supports the analysis set forth in the Barron's article, Lehman determined that such analysis was neither accurate nor reasonable.[1705] A rebuttal to the analysis in the Barron's article was presented to Lehman's Executive Committee on January 22, 2008.[1706] Lehman's rebuttal arguments were:

1. The 10 most recent sales in Archstone's markets occurred at an average going-in capitalization rate of 4.6%, which was significantly lower than the going-in capitalization rates of 6% discussed in the Barron's article.[1707]

2. Archstone sold two of its own apartment complexes out of its Washington DC portfolio that closed in January 2008 at a significantly lower going-in capitalization rate (4.1%) than the implied going-in capitalization rates used in the Barron's article (6% or higher).[1708]

3. Underlying fundamentals (as evidenced by actual 5% rent growth in 2007 and projected rent growth of 5% for 2008) were strong.[1709]

4. Stocks for apartment REITs were trading at a 30% discount to Net Asset Value.

5. Barron's did not include any value for many of Archstone's assets, including its platform.[1710]

The Examiner's financial advisor analyzed each of Lehman's rebuttal arguments.

[1705] E-mail from Scott A. Levin, Lehman, to Steven R. Hash, Lehman, *et al.* (Jan. 21, 2008) [LBEX-DOCID 1677086].

[1706] Lehman, Archstone "ASN" - Talking Points (Jan. 22, 2008), at p. 1 [LBEX-DOCID 1977228], attached to e-mail from Gerard Reilly, Lehman, to Clement Bernard, Lehman, *et al.* (Jan. 22, 2008) [LBEX-DOCID 1853344].

[1707] *Id.*

[1708] *Id.*

[1709] *Id.*

[1710] *Id.*

Rebuttal Argument #1: The 10 most recent sales in Archstone's markets occurred at an average going-in capitalization rate of 4.6%, which was significantly lower than the capitalization rates of 6% and higher discussed in the Barron's article. Lehman produced an internal analysis to demonstrate that the top 10 transactions in Archstone's markets resulted in a 4.6% average going-in capitalization rate.[1711] As this spreadsheet was circulated among Lehman employees at the time they were developing rebuttal analyses to the Barron's article, there is sufficient evidence to support a finding that this analysis served as Lehman's underlying analysis for Rebuttal Argument #1.

The spreadsheet had two sets of data. The first set identified the 10 transactions noted above, as well as the calculation of average going-in capitalization rates for 27 additional transactions for markets where Archstone did not own apartment buildings.[1712] All transactions in this first set had capitalization rates of 5.2% or lower.[1713] The first set was in the print range of the spreadsheet, meaning that it was the only section that would be printed (unless the user manually adjusted the print range).

[1711] Lehman, Project Easy Living: Recent Asset Sales" (Jan. 22, 2008), at Sales Comps tab [LBEX-DOCID 1482636], attached to e-mail from Jonathan Cohen, Lehman, to Gary J. Fox, Lehman (Jan. 22, 2008) [LBEX-DOCID 1437414]. This spreadsheet shows that the weighted average of the top 10 transactions was 4.2%. The Examiner's financial advisor computed the median of these 10 transactions as 4.6%. The Examiner's financial advisor observed that this spreadsheet appears to be the support for the 4.6% that was told to the Executive Committee.

[1712] *Id.*

[1713] *Id.*

The second set of transactions was outside of the print range of the spreadsheet. This second set included 250 additional transactions.[1714] Each of these transactions had a going-in capitalization rate of 5.3% or higher.[1715] These transactions were presented in order from lowest to highest capitalization rate.[1716] This second set included several transactions in or near Archstone's markets, including five transactions that had going-in capitalization rates of 6% or higher. If these transactions accurately reflected the capitalization rates for all of Archstone's properties, this would result in virtually no value for Archstone equity.[1717]

Rebuttal Argument #2: Archstone sold two apartment complexes out of its Washington D.C. metro portfolio that closed in January 2008 at a significantly lower going-in capitalization rate (4.1%) than the implied going-in capitalization rates used in the Barron's article (6% or higher).[1718] The spreadsheet described above included data for the sale of two Archstone properties in Arlington, Virginia (which is located a few miles outside of Washington, D.C.), and there are no other transactions listed for Archstone sales in the Washington,

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[1714] *Id.*

[1715] *Id.*

[1716] *Id.*

[1717] *Id.* The spreadsheet lists five transactions that were located in the same cities as Archstone's core assets: (1) Creekside ($177,823/unit & 9.1% cap rate) in San Jose, CA; (2) Woodbridge ($208,784/unit, 7.6% cap rate) in Sunnyvale, CA; (3) Hidden Willows ($199,107/unit, 7.2% cap rate) in San Jose, CA; (4) Solaire ($390,278/unit, 6.8% cap rate) in San Mateo, CA; and (5) Somerset on Garfield ($156,449/unit, 6.0% cap rate) in Montebello, CA.

[1718] Lehman, Presentation entitled "Archstone Q2 2008 Update" (June 12, 2008), at p. 10 [LBEX-DOCID 2929329]; Andrew Bary, *Apartment-House Blues*, Barron's, Jan. 21, 2008, at p. 1, *available at* http://online.barrons.com/article/SB120070919702802265.html#articleTabs_panel_article%3D1.

D.C. area.[1719] The capitalization rates for these two transactions were 4.42% and 4.73%.[1720] It is possible that the 4.1% going-in capitalization rate Lehman used in this rebuttal argument was computed using a different method than that used in the analysis presented to Lehman's Executive Committee.

Rebuttal Argument #3: Underlying fundamentals, as evidenced by actual 5% rent growth in 2007 and projected rent growth of 5% for 2008, were strong. This Rebuttal fairly describes Archstone's actual and projected rent growth for 2007 and 2008.

Rebuttal Argument #4: Publicly traded apartment REITs were trading below Net Asset Value as quantified by contemporaneous analysts. The basic premise of this argument, which was also articulated by Archstone's CEO, was that the public markets were inefficient and not indicative of value in the private market.[1721] Lehman pointed to Archstone's ability to sell individual apartment buildings in the private market at relatively low going-in capitalization rates. While this assertion has merit, it does not directly address the question of whether and to what extent the value of a private real estate company, Archstone, is equally susceptible to other factors that affect the stock price of its publicly traded peers. Lehman was not able to rebut this argument by

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[1719] Lehman, Project Easy Living: Recent Asset Sales (Jan. 22, 2008), at Sales Comps tab [LBEX-DOCID 1482636], attached to e-mail from Jonathan Cohen, Lehman, to Gary J. Fox, Lehman (Jan. 22, 2008) [LBEX-DOCID 1437414]. The two properties were Crystal Square and the Bennington. Lehman, Recent Asset Sales (Jan. 22, 2008), at Sales Comps tab [LBEX DOC ID 1482639].

[1720] Lehman, Recent Asset Sales (Jan. 22, 2008), at Sales Comps tab [LBEX DOC ID 1482639].

[1721] E-mail from R. Scot Sellers, Archstone, to David Augarten, Tishman Speyer, *et. al.* (Jan. 19, 2008) [LBHI_SEC07940_111678].

pointing to sales of Archstone equity during this quarter because there were no such sales.

Rebuttal Argument #5: Barron's did not include any value for many of Archstone's assets. As discussed above, Barron's concluded that there was zero equity value at a capitalization rate of 5.5%. Scott A. Levin, a Lehman banker who was responsible for the Archstone positions, wrote in an e-mail that "there would not be much equity value" if the appropriate capitalization rate was 6%.[1722] The Examiner's financial advisor observed that Levin referred to a higher capitalization rate at which point Archstone's equity lost substantially all of its value because Lehman and Tishman Speyer included assets in their valuation that were excluded by Barron.

The Barron's article was based on a simple premise – market participants were buying and selling apartment REITs as if the value of their underlying assets had deteriorated substantially. Some of Lehman's rebuttal arguments were persuasive (*e.g.*, Archstone had been able to sell apartment complexes at relatively low capitalization rates). Other responses, however, did not entirely rebut the argument that the capitalization rate implied by the stock price of publicly traded REITs were relevant in determining the value of Archstone equity.

[1722] E-mail from Scott A. Levin, Lehman, to Steven R. Hash, Lehman, *et al.* (Jan. 21, 2008) [LBEX-DOCID 1677086].

(ii) Discussions Among Archstone, Tishman and Lenders

Tishman Speyer, in a memo dated January 30, 2008, stated that investors who held debt and/or equity investments in Archstone faced many problems.[1723] These problems included:

- Investors were concerned that Archstone was not worth what Lehman (and others) had paid for it.[1724]
- Archstone was "hampered" by its high level of debt, which left it with limited funds to invest in its existing development pipeline and new business opportunities.[1725]
- Efforts to syndicate the $4.5 billion of remaining Archstone equity had "lost momentum" and there was "no urgency for investors to invest in the deal today given the amount of equity left to syndicate."[1726]
- It was difficult to syndicate the entity-level debt because Archstone was viewed as a risky credit and its ability to service its debt obligations was dependent on asset sales.[1727]

Tishman Speyer observed that fixing many of these problems required Archstone's management to find ways to increase the value of the company and improve the company's liquidity position.[1728] They also observed that it would be challenging to fix these problems in the near term.[1729]

[1723] Memorandum from David Augarten, Tishman Speyer, *et al.*, to R. Scot Sellers, Archstone, *et al.*, Archstone Business Plan and Syndication Update (Jan. 30, 2008), at p. 1 [LBEX-DOCID 1696101].
[1724] *Id.*
[1725] *Id.*
[1726] *Id.*
[1727] *Id.*
[1728] *Id.* at p. 2.
[1729] *Id.*

(iii) Lehman's Valuation During the First Quarter of 2008

The Bridge Equity business desk produced a sensitivity analysis on March 4, 2008, which indicated a February 2008 mark for bridge equity of 90.2[1730] The business desk provided the complete Archstone DCF model to Product Control on March 17, 2008 and this model had substantially the same mark for bridge equity at 89.9.[1731]

Shortly after the end of the first quarter, Jonathan Cohen gave a presentation to Andrew Morton, Lehman's Head of FID, that highlighted the "critical" need to continuously review the collateral valuation of bridge equity positions and that increases in capitalization rates were expected to reduce yields.[1732] These presentation materials listed Archstone as the top position and also noted "Major Pricing Concerns," which included "[p]rice flex on debt; increase in cap rates; liquidity."[1733] Cohen also observed after the publication of the Barron's article that the "onus" was on Lehman to support its valuation of Archstone positions "with current info." Aside from the business desk's sensitivity analysis, the Examiner's financial advisor did not locate any other substantive analysis by Lehman to support its Archstone marks as of the end of the first quarter.

[1730] Lehman, Bridge Equity Sensitivity Analysis (Mar. 4, 2008) [LBEX-DOCID 4345834], attached to e-mail from Jeffrey Wechsler, Lehman, to Jonathan Cohen, Lehman [LBEX-DOCID 4447709] (re: ASN Bridge Equity Discounting Sensitivity). Hughson could not recall any details about any Archstone valuation analysis done during the first quarter of 2008. Examiner's Interview of Paul Hughson, Dec. 21, 2009, at p. 3.

[1731] *See* Lehman, Project Easy Bridge Equity Discounting Sensitivity Spreadsheet (Mar. 17, 2008) [LBEX-DOCID 1626080].

[1732] Abebual A. Kebede, Lehman, Real Estate Inventory Valuation (Mar. 10, 2008) [LBEX-DOCID 1707877].

[1733] *Id.*

The Examiner's financial advisor analyzed the reasonableness of Lehman's first quarter 2008 valuation pursuant to the Sum of the Parts and DCF methodologies. The Sum of the Parts analysis is presented first because that analysis is relevant to the DCF calculation.

(iv) Sum of the Parts

Tishman Speyer performed a sensitivity analysis shortly after the Barron's article was published.[1734] This analysis illustrated how an increase in going-in capitalization rates would reduce the value of Archstone's core portfolio,[1735] assuming all other assets (including the platform) remained at their budgeted values.[1736] The table circulated as part of Tishman Speyer's sensitivity analysis is reproduced below:

[1734] Tishman Speyer, Spot Value Variance: Tishman Speyer - Archstone - Smith Multifamily Fund (Jan. 30, 2008) [LBEX-DOCID 1743458], attached to e-mail from Kevin Siebers, Tishman Speyer, to R. Scot Sellers, Archstone, *et al.* (Jan. 31, 2008) [LBEX-DOCID 1861936]. This document was part of the materials that were sent to the banks by Tishman Speyer on January 30, 2008.

[1735] Tishman Speyer, Spot Value Variance: Tishman Speyer - Archstone - Smith Multifamily Fund (Jan. 30, 2008) [LBEX-DOCID 1743458], attached to e-mail from Kevin Siebers, Tishman Speyer, to R. Scot Sellers, Archstone-Smith, *et al.* (Jan. 31, 2008) [LBEX-DOCID 1861936].

[1736] *Id.*

Tishman Speyer's Going-In Capitalization Rate Sensitivity Analysis

Core Portfolio Cap Rate	4.11%	4.25%	4.50%	4.75%	5.00%	5.25%	5.50%	5.75%	6.00%
Cap Rate w/o Platform	*3.89%*	*4.02%*	*4.24%*	*4.46%*	*4.68%*	*4.90%*	*5.11%*	*5.33%*	*5.54%*
Core Portfolio	$17,789	$17,193	$16,238	$15,383	$14,614	$13,918	$13,285	$12,708	$12,178
Assets Held for Sale	596	596	596	596	596	596	596	596	596
Development	1,418	1,418	1,418	1,418	1,418	1,418	1,418	1,418	1,418
Germany	378	378	378	378	378	378	378	378	378
Ground Leases	208	208	208	208	208	208	208	208	208
Other Assets	374	374	374	374	374	374	374	374	374
Platform Value	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Cash / WC	411	411	411	411	411	411	411	411	411
Total Value	$22,173	$21,577	$20,622	$19,767	$18,998	$18,302	$17,669	$17,092	$16,562
Total Debt / Preferred	17,073	17,073	17,073	17,073	17,073	17,073	17,073	17,073	17,073
Equity	5,100	4,504	3,549	2,694	1,925	1,229	596	19	(511)
Variance	-	(596)	(1,551)	(2,406)	(3,175)	(3,871)	(4,504)	(5,081)	(5,611)

Tishman Speyer, in a February 14, 2008 e-mail, wrote that the table above could be used to calculate the current valuation of equity investments in Archstone: "We can all estimate what the potential value loss is vs. the appraisals (10%) and/or what cap rate is appropriate for the core portfolio (4.25 - 4.50%?) as a way to triangulate what the real value of the portfolio is today. Then I think we use a real platform value . . .

probably $1B, and whatever gap exists is your 'plug' or potential loss. Of course there will be some range of opinions here."[1737]

The Examiner's financial advisor used the data in this table to conduct a sensitivity analysis. This sensitivity analysis adopts the Tishman Speyer's table's reduction in total equity and applies this reduction to Lehman's Archstone equity position. The Examiner's financial advisor then compared the reduction in Lehman's equity value computed under this analysis to Lehman's cumulative write-downs through the first quarter of 2008.[1738] This analysis produces a value that is relative to Lehman's valuation: a negative number indicates Lehman's valuation may have been too low; a positive number indicates Lehman's valuation may have been too high.

The Examiner's financial advisor deduced the capitalization rate Lehman assumed in its analysis, as illustrated in the table below. The core portfolio cap rate that results in an an incremental write-down closest to a value of 0 (*i.e.*, supporting Lehman's valuation) represents the going-in capitalization rate implicit in Lehman's analysis. Accordingly, the sensitivity analysis below illustrates that Lehman's first quarter 2008 valuation assumed a going-in capitalization rate just below 4.25% (because the incremental write-down was $17 million at this rate). The table below also indicates

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[1737] E-mail from Kevin Siebers, Tishman Speyer, to Keith Cyrus, Lehman, *et al.* (Feb. 14, 2008) [TSREV00003451].

[1738] This analysis included all reduction of value as write-downs, including the marking of fees and excess carry into the positions.

the extent to which Lehman's valuation of its Archstone positions would have been overvalued or undervalued based on the assumed going-in capitalization rate.

Going-In Capitalization Rate Sensitivity Analysis (Q1 2008)

Core Portfolio Cap Rate	4.11%	4.25%	4.50%	4.75%	5.00%	5.25%	5.50%	5.75%	6.00%
Reduction in Total Equity Value	0	596	1,551	2,406	3,175	3,871	4,504	5,081	5,611
Reduction in Lehman's Equity (46.8%)	0	279	726	1,127	1,487	1,813	2,109	2,379	2,627
Write-Downs Taken by Lehman as of Q1 2008	262	262	262	262	262	262	262	262	262
Incremental Write-Downs	(262)	17	464	865	1,225	1,551	1,847	2,117	2,365

On January 22, 2008, Jonathan Cohen observed, on the basis of data collected by others within Lehman, that AvalonBay's going-in capitalization rate had increased by over 30 basis points since the Archstone Commitment Date.[1739] As shown in the table above, applying this increase results in an Archstone capitalization rate approaching 4.50%, and a corresponding incremental write-down approaching $464 million. The Examiner's financial advisor also observed that a source referenced in Cohen's e-mail[1740] noted the capitalization rate for AvalonBay was between 4.75% and 5.0%, which would result in an incremental write-down between $865 million and $1.225 billion if this capitalization rate also applied to Archstone.

Lehman, in its rebuttal to the Barron's article, indicated that the 10 most recent transactions in Archstone's markets were executed at an implied average capitalization

[1739] As previously noted, Reilly considered AvalonBay to be the "best comp." E-mail from Keith Cyrus, Lehman, to Jonathan Cohen, Lehman, *et al.* (Jan. 22, 2008) [LBEX-DOCID 2778713]; Examiner's Analysis of the Reasonableness of Lehman's Valuation of its Archstone Positions on a Quarterly Basis.
[1740] *Id.*

rate of 4.6%.[1741] As discussed above, Lehman's transaction analysis excluded relevant transactions with higher capitalization rates, which indicated that the average capitalization rate was higher than 4.6%. As the table above illustrates, a capitalization rate of 4.75% (the first rate higher than 4.6% in the table) supports an $865 million incremental write-down and a 5.0% capitalization rate results in a $1.2 billion incremental write-down.

(v) DCF Method

The analysis by the Examiner's financial advisor of the DCF Method focused on Lehman's assumptions as for rent growth and exit capitalization rates.

In the first quarter, Lehman used an Archstone exit capitalization rate of approximately 4.8%, which was based on an increase of approximately 70 basis points over the going-in capitalization rate of 4.1%. As discussed above, the going-in capitalization rates had increased since the Commitment Date. The Examiner's financial advisor reran the DCF analysis using higher exit capitalization rates.

Lehman's rent growth assumption for assets held over the entire projection period was 5.72% per year, and the resulting NOI growth rate was 7.63% per year. Keith Cyrus identified that the long-term rent growth rate used in Lehman's DCF Method for the first quarter of 2008 was almost 3 full percentage points higher than third-party projected growth rates for other apartments within Archstone's markets.

[1741] Lehman, Archstone "ASN" - Talking Points (Jan. 22, 2008), at p. 1 [LBEX-DOCID 1977228].

The Examiner's financial advisor determined that Lehman's projected NOI growth rates were significantly (*i.e.*, hundreds of basis points) higher than Archstone's historical growth rate. Accordingly, and given the "problems" identified by Tishman Speyer in the January memo, there is sufficient evidence for a finding that Lehman's rent growth rate assumption was unreasonably high as of the first quarter of 2008.[1742]

As Lehman's first quarter 2008 valuation model could not support sensitivity testing, the Examiner's financial advisor used Lehman's second quarter model (which could run sensitivity analyses) as a proxy for the first quarter 2008 valuation model. The Examiner's financial advisor created four scenarios for purposes of sensitivity analysis, in which the two assumptions discussed above – rental growth rate and exit capitalization rate – were stressed to observe the effect of the same on the valuation of Lehman's Archstone positions. The Examiner's financial advisor did not sensitize Lehman's determination for platform value and discount rate, as such inputs were within the range of reasonableness for purposes of this valuation analysis. The table below sets forth the results of this sensitivity analysis, and "incremental write-down" denotes the additional write-down on Lehman's Archstone marks indicated by each scenario.

[1742] Memorandum from David Augarten, Tishman Speyer, *et al.*, to R. Scot Sellers, Archstone, *et al.*, Archstone Business Plan and Syndication Update (Jan. 30, 2008), at p. 1 [LBEX-DOCID 1696101].

DCF Method Sensitivity Analysis (Q1 2008)

Numbers in Millions unless stated otherwise

	Assumptions	Case 1	Case 2	Case 3	Case 4
Inputs	Rental Growth Rate Decrease	50 bps	100 bps	150 bps	200 bps
	Exit Cap Rate increase	25 bps	25 bps	50 bps	50 bps
	IRR	14.6%	14.6%	14.6%	14.6%
	Total Funded Amount of the Equity	$2,388	$2,388	$2,388	$2,388
	Lehman Reported Valuation for the Equity	$2,165	$2,165	$2,165	$2,165
	Weighted Average Mark of the Equity	90.7	90.7	90.7	90.7
	Write Down taken by Lehman within the Equity	$223	$223	$223	$223
Outputs	Implied Valuation	$2,128	$1,946	$1,605	$1,433
	Implied Mark	89.1	81.5	67.2	60.0
	Implied Incremental Write-Down	$37	$219	$560	$732

(vi) Examiner's Findings and Conclusions as to the Reasonableness of Lehman's Archstone Valuation as of the End of the First Quarter of 2008

As previously discussed, there were no material sales of Archstone debt or equity positions during the quarter, nor any meaningful benchmarks for Archstone equity positions in a private market context. Therefore, Archstone equity was an SFAS 157 Level 3 asset whose valuation required a significant amount of judgment.

For the reasons set forth above, the Examiner concludes that there is sufficient evidence to support a finding for purposes of a solvency analysis that Lehman's valuation for its Archstone bridge and permanent equity investment as of the end of the first quarter of 2008 was unreasonable. Recognizing that the valuation of such an illiquid investment requires the application of judgment to numerous factors and criteria, the Examiner concludes that the evidence supports a finding that Lehman's valuation of $2.165 billion for its Archstone bridge and permanent equity investment

was overvalued by $200 million to $450 million. Nevertheless, the Examiner does not find sufficient evidence to support a colorable claim that any Lehman officer acted with an intent to produce incorrect values, or conducted the valuation process in a reckless manner. Lehman's valuations of its Archstone positions were not the product of actions (or omissions) that would support a claim of a breach of fiduciary duty in this or subsequent quarters.

The low end of the range implies a going-in capitalization rate on Archstone's core portfolio (assuming no decrease in value for Archstone's other assets) between 4.25% and 4.50%, which is lower than the increase in going-in capitalization rates for Archstone's "best comp" using the same data source Lehman used in its due diligence for the Archstone acquisition. The low end employs a rent growth assumption that is 100 basis points lower than Lehman's assumption. The 100 basis point decrease in the rent growth assumption still results in rent growth rates above third party projections for Archstone's markets and NOI growth rates that are significantly higher than Archstone's historical performance.

The high end of the range implies a going-in capitalization rate on Archstone's core portfolio (assuming no decrease in value for Archstone's other assets) of approximately 4.50%, which is consistent with the increase in going-in capitalization rates for Archstone's "best comp." The high end employs an exit capitalization rate that is less than 50 basis points higher and a rent growth assumption that is less than 150

basis points lower than Lehman's assumptions. This less-than-50-basis-points increase in exit capitalization rates is somewhat higher than the increase in going-in capitalization rate for Archstone's "best comp," while this-less-than-150-basis-points decrease in the rent growth assumption still results in rent growth rates above third party projections for Archstone's markets and NOI growth rates that are significantly higher than Archstone's historical performance.

(c) Reasonableness as of the Second Quarter of 2008

Lehman determined that the value of its Archstone positions was $4.7 billion as of the end of the second quarter of 2008.[1743] This valuation reflected a 12.0% discount from Lehman's original Archstone investment.[1744]

The decrease in Lehman's Archstone valuation from a 4.9% reduction of funded value at the end of the first quarter of 2008 to a 12.0% reduction of funded value at the end of the next quarter was primarily due to $350 million of valuation-related write-

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[1743] *See* Chart titled, "Lehman's Valuation of Archstone Positions (U.S. $ million, Oct 07 - Aug 08)" in the preceding Section, with data from Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113] and Lehman, Top Global Real Estate Exposures (Aug. 31, 2008), at p. 18 [LBHI_SEC07940_ICP_002615].

[1744] *See* Chart titled "Archstone Marks by Month (Oct 07 - Aug 08)" in the preceding Section of this Report, with data from Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113] and Lehman, Top Global Real Estate Exposures (Aug. 31, 2008), at p. 18 [LBHI_SEC07940_ICP_002615]. The discount was computed by subtracting the total mark for November from 100 (*i.e.*, 100 – 88.0 = 12.0).

downs that were taken during the quarter. These write-downs were taken in two stages: $250 million in March and $100 million in May.[1745]

(i) Second Quarter Earnings Call

During its second quarter earnings call, Lehman disclosed that it valued its Archstone equity positions at 75% and most Archstone debt positions at 99%.[1746] Together, these resulted in a weighted average valuation of 88% of funded value for Lehman's Archstone positions.[1747]

Lehman disclosed that it "arrived at an Archstone enterprise value primarily using a discounted cash flow analysis, which supports a mid-teens IRR."[1748] Lehman also disclosed that this analysis "assumed that capitalization rates will be more than 100BPS [basis points] higher when the properties are sold than when the transaction was entered into" and "[b]ased on this analysis, we are very comfortable with our

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[1745] Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113]. Lehman's decision to take the March write-down was triggered by buyers walking away from over $1 billion of potential Archstone asset sales shortly after Bear Stearns's near collapse. E-mail from Jonathan Cohen, Lehman, to Clement Bernard, Lehman, *et al*. (Mar. 20, 2008) [LBEX-DOCID 1854627]. Cohen informed Bernard that "[b]efore month end also looking at archstone bridge equity. Approx $1bn of property sales to 2 different buyers fell thru this week with the horrible market conditions beginning with the bear stearns news. The desk is running numbers and stressing cap rates. It could be approx 200mm. We would be holding at approx 20% yield to investors assuming no asset mgmt fee, no promote and we get no preferred return from investor. I alerted gerry last night, but nothing is definitive at this point. Will update you when I get more info. Abe has more info if you need."

[1746] Final Transcript of Lehman Brothers Holdings Inc. Second Quarter Earnings Call (June 16, 2008), at p. 14 [LBHI_FIN 00007].

[1747] Lehman, GREG Update, at p. 3 [LBEX-DOCID 1417258]. Hughson told the Examiner that BofA and Barclays were upset with Lehman's public disclosure of it valuation. Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 12. Hughson also said that Lehman's investment was more valuable than BofA's and Barclays' investment, due to the higher fees Lehman received and Lehman's ownership of a general partner interest, which BofA and Barclays did not own. *Id.*

[1748] Final Transcript of Lehman Brothers Holdings Inc. Second Quarter Earnings Call (June 16, 2008), at p. 14 [LBHI_FIN 00007].

current Archstone mark."[1749] The Examiner's analysis of this Discounted Cash Flow valuation is addressed in the DCF Method subsection below.

Lehman disclosed that it "cross checked" its DCF analysis with "a number of different methodologies, including sum of the parts, replacement costs and recent comparable transactions based on both cap rates and price per unit, the most important including asset sales from the Archstone portfolio."[1750] The Examiner's financial advisor's analysis of sum of the parts and asset sales from Archstone's portfolio are addressed below. The Examiner did not place significant emphasis on the replacement costs methodology, as it is difficult to benchmark, is not a valuation analysis per se, and Lehman (and its partners) acquired Archstone at a material discount to replacement costs.[1751]

During the earnings call, Lowitt disclosed that Archstone sold approximately $2 billion of assets after the acquisition and was under contract or in active negotiation to sell in excess of an additional $2 billion of assets.[1752] Lowitt also stated that the average going-in capitalization rate for the $4 billion of actual and projected asset sales was in

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[1749] *Id.*

[1750] *Id.*

[1751] Lehman, Archstone Q2 2008 Update (June 25, 2008), at p. 1 [LBEX-DOCID 187370]. According to Lehman's analysis, Archstone's core portfolio was acquired for $328,000 per unit, which reflected a "material" 16% discount to estimated replacement cost of approximately $390,000 per unit.

[1752] Final Transcript of Lehman Brothers Holdings Inc. Second Quarter Earnings Call (June 16, 2008), at p. 14 [LBHI_FIN 00007].

the mid-4% range.[1753] Lehman's Q2 Book, which was prepared in advance of the earnings call, detailed these disclosures[1754] and the table below was created using this data. Consistent with Lehman's public disclosure, the average capitalization rate according to Lehman's analysis was 4.46%.[1755] This table illustrates that this 4.46% average going-in capitalization rate was influenced by the relatively low going-in capitalization rate of 3.62% for the $1.4 billion of asset sales that closed on the acquisition's Closing Date (labeled "October 5, 2007 Deals" in the table below). The analysis by the Examiner's financial advisor also illustrates that transactions that closed, were under contract, or were in negotiation in 2008 had an average going-in capitalization rate of approximately 5%.

Actual and Budgeted Capitalization Rates from Archstone Asset Sales[1756]

	$ in millions			Cap Rates		
	Budgeted Value	Sale Value	2008 NOI	Budget	Sales	Variance
October 5, 2007 Deals	1,306	1,391	50	3.86%	3.62%	6.56%
October 6, 2007 thru December 31	331	335	16	4.79%	4.73%	1.10%
Development Assets sold between January 1 and May 30	22	21	n/a	n/a	n/a	-3.72%
January 1 through May 30	164	155	8	5.12%	5.41%	-5.42%
Under Contract as of May 30	398	386	19	4.74%	4.88%	-2.95%
Deals in Negotiation as of May 30	1,546	1,415	71	4.58%	5.00%	-8.44%
Development: Under Contract or Deals in Negotiation	131	113	n/a	n/a	n/a	-13.52%
All (non-development) Deals	3,745	3,683	164	4.39%	4.46%	
All Deals	3,897	3,817				-2.06%
2007 Deals Cap Rate and Variance	1,637	1,726	66	4.05%	3.84%	5.46%
2008 Deals Cap Rate	2,108	1,957	98	4.65%	5.01%	
2008 Deals Variance	2,260	2,091				-7.50%

[1753] *Id.*

[1754] Lehman, Archstone Q2 2008 Update (June 12, 2008), at pp. 10-11 [LBEX-DOCID 2929329].

[1755] *Id.*

[1756] *Id.*

During the earnings call, Lowitt stated that many of the assets that "were identified for sale by the company as non-core or non-strategic, and in certain cases do not represent the highest quality properties in their portfolio."[1757] The sale of lower-quality properties would be expected to result in higher capitalization rates than Archstone's higher-quality properties.

The Examiner's financial advisor also compared the actual sales prices of assets to Lehman's projections of sale prices (or allocated) value for assets. As set forth in the table above, the sales value for assets sold in 2007 was over 5% above budgeted value, while assets sold, under contract, or in negotiation in 2008 were valued by third parties (as evidenced by their purchase offers) at more than 7% below budgeted value. A Lehman July 29, 2008 analysis of Archstone's asset sales included the same sales values, but different budgeted values.[1758] In particular, the budgeted value for assets under contract or deals in negotiation as of May 30 were higher in the July analysis, which resulted in larger variances of sales values relative to budgeted value. According to the July analysis, the assets that were under contract or in negotiation as of May 30 were approximately 12% below budgeted value as shown in the table below.

[1757] Final Transcript of Lehman Brothers Holdings Inc. Second Quarter Earnings Call (June 16, 2008), at p. 14 [LBHI_FIN 00007].

[1758] Lehman, Archstone July 2008 Update (July 29, 2008), at pp. 10-11 [LBHI_SEC_07940_ICP_008526].

Updated Actual and Budgeted Capitalization Rates from Archstone Asset Sales[1759]

	$ in millions			Cap Rates		
	Budgeted Value	Sale Value	2008 NOI	Budget	Sales	Variance
October 5, 2007 Deals	1,306	1,391	50	3.86%	3.62%	6.56%
October 6, 2007 thru December 31	331	335	16	4.79%	4.73%	1.10%
Development Assets sold between January 1 and May 30	22	21	n/a	n/a	n/a	-3.72%
January 1 through May 30	164	155	8	5.12%	5.41%	-5.42%
Under Contract as of May 30	441	386	19	4.27%	4.88%	-12.43%
Deals in Negotiation as of May 30	1,606	1,415	71	4.41%	5.00%	-11.88%
Development: Under Contract or Deals in Negotiation	131	113	n/a	n/a	n/a	-13.52%
All (non-development) Deals	3,849	3,683	164	4.27%	4.46%	
All Deals	4,001	3,817				-4.59%
2007 Deals Cap Rate and Variance	1,637	1,726	66	4.05%	3.84%	5.46%
2008 Deals Cap Rate	2,212	1,957	98	4.43%	5.01%	
2008 Deals Variance	2,364	2,091				-11.55%

The below budgeted sale prices support a determination that Archstone's enterprise value declined relative to the purchase price. The Examiner's financial advisor performed a sensitivity analysis to demonstrate the effect of this reduction in enterprise value on the potential overvaluation as of the second quarter of 2008. This analysis is conceptually similar to the sensitivity analysis based on changes in capitalization rates used in the Sum of the Parts method. This sensitivity analysis started with the values at closing: $22.2 billion for enterprise value and $5.1 billion for equity value.[1760] The sensitivity analysis reduced the $22.2 billion enterprise value in 2.5 percentage point increments. The reduction in enterprise value was applied to equity

[1759] Lehman, Valuation Overview (June 12, 2008), at pp. 10-11 [LBEX-DOCID 2929326], attached *to* e-mail from Webster Neighbor, Lehman, to Colleen Day, Lehman, *et al.* (June 12, 2008) [LBEX-DOCID 2871718]; Lehman, Archstone July 2008 Update (July 29, 2008), at pp. 10-11 [LBHI_SEC_07940_ICP_ 008526].

[1760] Tishman Speyer, Spot Value Variance: Tishman Speyer - Archstone - Smith Multifamily Fund (Jan. 30, 2008) [LBEX-DOCID 1743458], attached to e-mail from Kevin Siebers, Tishman Speyer, to R. Scott Sellers, Archstone-Smith, *et al.* (Jan. 31, 2008) [LBEX-DOCID 1861936].

due to the equity's position in the capital structure (*i.e.*, equity takes the first loss). The next step was to compare the decrease in equity value indicated by this analysis to the cumulative write-down Lehman took as of the second quarter of 2008. For example, as shown in the table below, a 5% reduction in enterprise value would warrant a write-down of $500 million. In such a case, because Lehman had already cumulatively reduced the value of its positions by approximately $600 million,[1761] this analysis indicates a $100 million write-up to Lehman's valuation would have been warranted. By contrast, a 7.5% reduction in enterprise value would imply an $800 million write-down, which is greater than Lehman's approximately $600 million cumulative write-down and therefore would indicate that Lehman's valuation was overstated by $200 million.[1762]

[1761] The actual reduction in the valuation through the end of the second quarter was $628 million. Lehman, GREG Update (May 30, 2008), at p. 3 [LBEX-DOCID 1417258]. For presentation purposes, all figures in this analysis are rounded to the nearest hundred million dollars.

[1762] The implied undervaluation with a 5% decline in enterprise value and implied overvaluation with a 7.5% decline in enterprise value indicates Lehman's valuation assumed Archstone's enterprise value declined somewhere between 5% and 7.5%. Lehman's own analysis shows their valuation assumed a 5.72% decline in enterprise value. Lehman, Archstone Q2 2008 Update (June 12, 2008), at pp. 10-11 [LBEX-DOCID 2929329].

Enterprise Value Sensitivity Analysis (Q2 2008)

	At Purchase ($ billions)	Reduction in Enterprise Value									
		5.0%	7.5%	10.0%	12.5%	15.0%	17.5%	20.0%	22.5%	25.0%	27.5%
Initial Enterprise Value	22.2	21.1	20.5	20.0	19.4	18.9	18.3	17.8	17.2	16.7	16.1
Face Value of Debt	17.1	17.1	17.1	17.1	17.1	17.1	17.1	17.1	17.1	17.1	17.1
Amount of Debt Covered	17.1	17.1	17.1	17.1	17.1	17.1	17.1	17.1	17.1	16.7	16.1
Equity Value	5.1	4.0	3.4	2.9	2.3	1.8	1.2	0.7	0.1	-	-
Lehman's Equity Value	2.4	1.9	1.6	1.3	1.1	0.8	0.6	0.3	0.0	-	-
Implied Write-Down		0.5	0.8	1.0	1.3	1.6	1.8	2.1	2.3	2.6	2.9
Write-Downs Taken through May 31		-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Incremental Write-Down Required		(0.1)	0.2	0.4	0.7	1.0	1.2	1.5	1.7	2.0	2.3

A memo written by Cyrus and Neighbor on May 16, 2008 stated that Archstone "had sold $289 million of core assets to date for a 4.77% cap rate."[1763] Cyrus and Neighbor explained that "[i]t should be noted that these assets, and more broadly the assets held for sale in general, are biased toward lower quality, lower growth assets and thus trade at a wider cap rate than the average Archstone asset. Also, the Company is marketing during unfavorable market conditions and is perceived as a distressed seller (based in part on unfair media commentary by the likes of Barron's), which is putting upward pressure on cap rates. We expect that once the initial marketing process has concluded, Archstone's short-term liquidity issues are resolved, and credit and asset sales markets improve throughout the year, cap rates will be lower on later sales."[1764] Cyrus and Neighbor also mentioned in this memo that the third party research firm

[1763] Memorandum from Keith Cyrus, Lehman, *et al.*, to Donald E. Petrow, Lehman, *et al.*, Archstone Update (May 16, 2008), at p. 3 [LBEX-DOCID 1416761].
[1764] *Id.*

Lehman referenced in the first quarter identified a 50 basis point increase in AvalonBay's capitalization rate since Lehman's May 22, 2007 analysis and an approximately 90 basis point increase over the going-in capitalization rate Lehman assigned to Archstone in its purchase price allocation.[1765] A memo written by Tishman Speyer to the other investors during this quarter noted the "very difficult" environment, stated that the plan was to only accept "slightly lower prices if necessary" and committed "to do everything we can to close deals at reasonable prices without appearing desperate."[1766] Tishman Speyer also noted that "we are in the midst of discussions with several potential buyers that appear to be promising."[1767]

(ii) Sum of the Parts

The Sum of the Parts analysis performed by the Examiner's financial advisor for the second quarter of 2008 is similar to the analysis performed for the first quarter. This analysis was updated to reflect the additional write-downs that Lehman took during the second quarter. As a result of the write-downs taken during the second quarter, and assuming the platform continued to be valued at $1 billion, Lehman's valuation as of the second quarter implied a going-in capitalization rate on the core portfolio that was closer to 4.5% than 4.25%, as shown in the table below.

[1765] *Id.*; Lehman, Discussion / Valuation Materials (May 21, 2007), at p. 8 [LBEX DOCID 1695375].

[1766] Memorandum from David Augarten, Tishman Speyer, *et al.*, to R. Scot Sellers, Archstone, *et al.*, Archstone Update (Mar. 24, 2008), at p. 1 [LBEX-DOCID 2932586].

[1767] *Id.*

Going-In Capitalization Rate Sensitivity Analysis (Q2 2008)

Core Portfolio Cap Rate	4.11%	4.25%	4.50%	4.75%	5.00%	5.25%	5.50%	5.75%	6.00%
Reduction in Total Equity Value	0	596	1,551	2,406	3,175	3,871	4,504	5,081	5,611
Reduction in Lehman's Equity (46.8%)	0	279	726	1,126	1,486	1,812	2,108	2,378	2,626
Write-Downs Taken by Lehman as of Q2 2008	637	637	637	637	637	637	637	637	637
Incremental Write-Downs	(637)	(358)	89	489	849	1,175	1,471	1,741	1,989

As discussed above, the average going-in capitalization rate for Archstone assets that were sold, under contract, or in negotiation during 2008 was approximately 5.00%. As illustrated in the table above, a going-in capitalization rate of 4.75% results in a $489 million incremental write-down, and a 5.0% going-in capitalization rate results in an $849 million incremental write-down.

A Lehman research report dated May 2008 published for publicly traded apartment REITs (which was circulated to Jonathan Cohen) noted an average going-in capitalization rate of 6.1% for the industry. AvalonBay had the lowest capitalization rate at 5.5%.[1768] Applying this 5.5% going-in capitalization to Archstone would support a $1.471 billion write-down.

(iii) DCF Model

Lehman's DCF calculation in the second quarter considered various combinations of downward adjustments to the base case analysis. Lehman disclosed a

[1768] David Harris, Lehman, *et al.*, REITs Investor Briefing Package (May 14, 2008), at p. 45 [LBEX-DOCID 4329202], attached to e-mail from Donald E. Petrow, Lehman, to Jonathan Cohen, Lehman [LBEX-DOCID 4432688].

specific scenario on its second quarter earnings call: an increase in exit capitalization rates of over 100 basis points and no other adjustments to the base case.[1769] This is also a scenario set forth in the Q2 Book.[1770] However, the Q2 Book included other combinations of sensitivity scenarios that resulted in a similar valuation.[1771] In an e-mail to Hughson, Neighbor summarized some of these combinations, which included: a 75 basis point increase in the exit capitalization rate and 25 basis point decrease in rent growth rate; a 50 basis point increase in the exit capitalization rate and 75 basis point decrease in rent growth rate; and a 25 basis point increase in the exit capitalization rate and 125 basis point decrease in rent growth.[1772]

(iv) Rent Growth

Lehman's base case rent growth assumption for assets held over the entire projection period was 5.62% per year and the resulting NOI growth rate was 7.95% per year, which is similar to Lehman's first quarter base case analysis. Therefore, the first quarter analysis performed by the Examiner's financial advisor is applicable to the second quarter as well.[1773] As was the case with the first quarter analysis, the

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[1769] Final Transcript of Lehman Brothers Holdings Inc. Second Quarter Earnings Call (June 16, 2008), at p. 14 [LBHI_FIN 00007].

[1770] Lehman, Archstone Q2 2008 Update (June 12, 2008), at p. 15 [LBEX-DOCID 2929329].

[1771] *Id.* at pp. 16-17.

[1772] E-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman (June 14, 2008) [LBEX-DOCID 1865693].

[1773] Cyrus recognized that the long-term rent growth rates were approximately 3 percentage points higher than projections made by third parties for apartments in similar markets and the NOI growth rates were significantly higher than Archstone's historical performance. E-mail from Keith Cyrus, Lehman, to Kevin Siebers, Tishman Speyer, et al. (Jan. 4, 2008) [TSREV00003176].

Examiner concludes that there is sufficient evidence to support a finding that Lehman's valuation for its Archstone bridge and permanent equity investment as of the end of the second quarter of 2008 was unreasonable. The largest rent growth decrease in Neighbor's e-mail to Hughson was 125 basis points. A sensitivity analysis prepared by Product Control that was presented to Lehman's CFO considered a decrease in the rent growth assumption of up to 200 basis points.[1774]

(v) Exit Capitalization Rate

The base case exit capitalization rate was approximately 4.9%, which is similar to the base case analysis in the first quarter of 2008.[1775] Therefore, the observations made by the Examiner's financial advisor in its analysis of the first quarter are applicable to the second quarter as well. Similar to the Examiner's first quarter analysis, a significant increase in the exit capitalization assumption was warranted. Lehman recognized an increase was warranted, as evidenced by its decision to disclose the sensitivity analysis that assigned the largest possible increase in exit capitalization rates, of over 100 basis points.[1776] A sensitivity analysis prepared by Product Control that was presented to Lehman's CFO on May 27, 2008 considered a decrease in the exit capitalization assumption by 50 basis points, which was the same decrease Lehman used in its March

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[1774] Lehman, Real Estate Product Control Update (May 27, 2008), at p. 115 [LBHI_SEC07940_2258765].

[1775] *Id.*

[1776] Final Transcript of Lehman Brothers Holdings Inc. Second Quarter Earnings Call (June 16, 2008), at p. 14 [LBHI_FIN 00007]. By stressing only one assumption (exit capitalization rates), this analysis resulted in the largest possible reduction to exit capitalization rates that would result in Lehman's valuation. The inclusion of another variable to stress would reduce the ability to reduce the exit capitalization rate and still arrive at the same value.

2008 valuation.[1777] As discussed in the Sum of the Parts subsection above, going-in capitalization rates were higher than the 4.1% used in the initial purchase price allocation, and Lehman's own valuation implied a going-in capitalization rate that was approaching 4.5%. These indications are reflected in the Examiner's sensitivity analysis below.

(vi) Quantification of Changes in Assumptions

The Examiner's financial advisor used Lehman's second quarter valuation model and created four scenarios for purposes of sensitivity analysis. The first scenario analysis estimated an overvaluation of $183 million (see "Case 1" in the table below). The assumptions in the subsequent scenarios were progressively more stringent and in the fourth scenario, estimated a potential overvaluation of $657 million.

[1777] Lehman, Real Estate Product Control Update (May 27, 2008), at p. 113 [LBHI_SEC07940_2258765]. The March valuation, which resulted in a $250 million write-down, included a 50 basis point increase in exit capitalization rates. Lehman, Global Real Estate Product Control, Real Estate Americas Potential Write-downs (May 2008), at p. 80 [LBHI_SEC07940_2258765].

DCF Method Sensitivity Analyses (Q2 2008)

Numbers in Millions unless stated otherwise

	Assumptions	Case 1	Case 2	Case 3	Case 4
Inputs	Rental Growth Rate Decrease	50 bps	100 bps	150 bps	200 bps
	Exit Cap Rate increase	100 bps	100 bps	100 bps	100 bps
	IRR	15.0%	15.0%	15.0%	15.0%
	Total Funded Amount of the Equity	$2,388	$2,388	$2,388	$2,388
	Lehman Reported Valuation for the Equity	$1,794	$1,794	$1,794	$1,794
	Weighted Average Mark of the Equity	75.1	75.1	75.1	75.1
	Write Down taken by Lehman within the Equity	$594	$594	$594	$594
Outputs	Implied Valuation	$1,611	$1,449	$1,293	$1,137
	Implied Mark	67.5	60.7	54.2	47.6
	Implied Incremental Write-Down	$183	$345	$501	$657

(vii) Examiner's Findings and Conclusions as to the Reasonableness of Lehman's Archstone Valuation as of the End of the Second Quarter of 2008

As previously noted, because there were no meaningful amounts of sales of Archstone debt or equity positions during the quarter, and no meaningful benchmarks for Archstone equity positions in a private market context, Archstone equity was a SFAS 157 Level 3 asset.

The Examiner concludes that there is sufficient evidence to support a finding that Lehman's valuation of Archstone bridge equity as of the end of the second quarter of 2008 was unreasonable, for purposes of a solvency analysis. Recognizing that the valuation of such an illiquid investment requires the application of judgment to numerous factors and criteria, the Examiner concludes that the evidence supports a finding that Lehman's valuation of $1.805 billion for its Archstone bridge and

permanent equity investment was overvalued by $200 million to $500 million.[1778] Nevertheless, the Examiner does not find sufficient evidence to support the existence of a colorable claim for a breach of fiduciary duty in connection with Lehman's valuation of its Archstone positions.

The low end of the range implies a going-in capitalization rate on Archstone's core portfolio (assuming no decrease in value for Archstone's other assets) between 4.50% and 4.75%, which is lower than the average going-in capitalization rate of about 5.0% for the approximately $2 billion of actual sales closed in 2008 or under contract or in negotiation as of May 30, 2008. The low end of the range is consistent with a 7.5% decline in enterprise value since the Commitment Date, which is lower than the 11.6% decline for the approximate $2 billion of actual sales closed in 2008 or under contract or in negotiation as of May 30, 2008. Therefore, these assumptions give some credit to Lehman's argument that these sales were not indicative of the value for the remainder of the portfolio. The Examiner's financial advisor's analysis shows a $200 million incremental write-down is generally consistent with a DCF analysis in which the exit capitalization rate increased 100 basis points and the rent growth assumption decreased 50 basis points. The 100 basis point increase in exit capitalization rate is lower than the

[1778] Conclusion on a precise valuation amount would reflect false precision as valuing assets such as real estate properties and entities such as Archstone involves substantial judgment. Accordingly, Lehman when valuing Archstone took write-downs in round numbers (250 in March 2008, 100 in May, and 125 in August). The Examiner's estimations as to whether further write-downs or write-ups were required is done in similar fashion.

assumption Lehman publicly disclosed and is generally consistent with the increase in the average going-in capitalization rate for the approximately $2 billion of actual sales closed in 2008 or under contract or in negotiation as of May 30, 2008, and the actual capitalization rate for AvalonBay noted in Lehman's contemporaneous memo. The 50 basis point decrease in the rent growth assumption still results in rent growth rates above third-party projections for Archstone's markets and NOI growth rates that are significantly higher than Archstone's historical performance.

The high end of the range implies a going-in capitalization rate on Archstone's core portfolio (assuming no decrease in value for Archstone's other assets) of approximately 4.75%, which is lower than the average going-in capitalization rate of approximately 5.0% for the approximately $2 billion of actual sales closed in 2008 or under contract or in negotiation as of May 30, 2008. The high end of the range is consistent with an approximate 11% decline in enterprise value since the Commitment Date, which is generally consistent with the 11.6% decline for the approximate $2 billion of actual sales closed in 2008 or under contract or in negotiation as of May 30, 2008. The Examiner's financial advisor's analysis shows a $500 million incremental write-down is generally consistent with a DCF analysis in which the exit capitalization rate increased 100 basis points and the rent growth assumption decreased 150 basis points. The 100 basis point increase in exit capitalization rate is lower than the assumption Lehman publicly disclosed and is generally consistent with the increase in the average going-in

capitalization rate for the approximately $2 billion of actual sales closed in 2008 or were under contract or in negotiation as of May 30, 2008 and the actual capitalization rate for AvalonBay noted in Lehman's contemporaneous memo. The 150 basis point decrease in the rent growth assumption still results in rent growth rates above third party projections for Archstone's markets and NOI growth rates that are significantly higher than Archstone's historical performance.

(d) Reasonableness as of the Third Quarter of 2008

Lehman determined that the value of its Archstone positions was $4.2 billion as of the end of the third quarter of 2008.[1779] This valuation reflected a 15.7% discount from Lehman's original Archstone investment.[1780]

The reduction in Lehman's valuation between the second and third quarters of 2008 (88.0% of funded value to 84.3% of funded value) was primarily due to $125 million of valuation-related write-downs that were taken in August.[1781] That write-down was based on a valuation model similar to that used for the second quarter

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[1779] *See* Chart titled, "Lehman's Valuation of Archstone Positions (U.S. $ million, Oct 07 - Aug 08)" in the preceding Section of this Report, with data from Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113] and Lehman, Top Global Real Estate Exposures (Aug. 31, 2008), at p. 18 [LBHI_SEC07940_ICP_002615].

[1780] *See* Chart titled "Archstone Marks by Month (Oct 07 - Aug 08)" in the preceding Section of this Report, with data from Lehman, Archstone Monthly Expenses as of July 08 (July 2008), at p. 1 [LBHI-BARFID 0013113] and Lehman, Top Global Real Estate Exposures (Aug. 31, 2008), at p. 18 [LBHI_SEC07940_ICP_002615]. The discount rate was computed by subtracting the total mark for November from 100 (*i.e.*, 100 – 84.3. = 15.7).

[1781] The total $125 million write-down comprised a permanent equity write-down of $15 million and a bridge equity write-down of $110 million.

valuation, with changes in the rent growth and exit capitalization rate assumptions resulting in a lower valuation.[1782]

The average variance between Archstone's sales prices (including sales under contract or in negotiation) and Lehman's budgeted values increased from approximately 12% in the second quarter to approximately 15% in the third quarter, as shown in the table below.[1783] The Examiner's financial advisor obtained an Excel file[1784] that held the underlying data for different bids that Archstone appeared to have been entertaining. This table had the same headers (Assets Under Contract and Deals in Negotiation) used in presentations to support the marks for Archstone's May 2008 valuation.[1785] Data in the presentation allowed the Examiner's financial advisor to deduce that it was created between June 27, 2008 and June 30, 2008.[1786]

[1782] E-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman (Sept. 12, 2008) [LBEX-DOCID 2903130].

[1783] *Compare* Lehman, Archstone August 2008 Update (Sept. 19, 2008), at p. 7 [LBEX-DOCID 2903110] *with* Lehman, Archstone July 2008 Update (July 29, 2008), at p. 10 [LBHI_SEC_07940_ICP_ 008526].

[1784] Lehman, Archstone Update (July 1, 2008), at Bids tab [LBEX-DOCID 4320349], attached to e-mail from Webster Neighbor, Lehman, to Abebual Kebede, Lehman (July 1, 2008) [LBEX-DOCID 4377703].

[1785] Lehman, Archstone Q2 2008 Update (June 12, 2008), at p. 11 [LBEX-DOCID 2929329].

[1786] Per the July presentation, there had been assets sold on June 30, 2008; however, this file lists the last asset sale as June 27, 2008. Lehman, Archstone Update (July 1, 2008), at Bids tab [LBEX-DOCID 4320349]. The Examiner's financial advisor noticed that there was an extra category titled "Evaluating Bids" listed in the spreadsheet, which implied that before deals were entered into the "Deals in Negotiation" header, they were first pruned as to be worthy of negotiations. The Examiner's financial advisor observed that the Evaluating Bids appeared to be severely off budget (19.5%) compared to the Deals in Negotiation (14.5%) and Assets under Contract (7.2%). The Examiner's financial advisor was not able to find the same spreadsheet for quarter end dates.

Assets Sale Analysis from Third Quarter 2008[1787]

	$ in millions			Cap Rates		
	Budgeted Value	Sale Value	2008 NOI	Budget	Sales	Variance
Assets Sold in 2007	1,637	1,726	66	4.0%	3.8%	5.5%
Assets Sold in 2008	1,067	941	50	4.7%	5.3%	-11.8%
Assets Sold	2,704	2,668	116	4.3%	4.4%	-1.3%
Assets Under Contract	442	404	18	4.2%	4.6%	-8.6%
ASN Walnut Creek Port.	232	210	9	4.1%	4.5%	-9.6%
Crystal City Port.	809	680	32	4.0%	4.7%	-15.9%
New York City Port.	1,569	1,275	59	3.8%	4.6%	-18.7%
Others	167	152	8	4.5%	4.9%	-8.9%
Deals in Negotiation	2,777	2,317	108	3.9%	4.7%	-16.6%
2008 Deals - Sold, Under Contract and In Negotiation	4,287	3,663	177	4.1%	4.8%	-14.5%
2008 Deals - Under Contract and In Negotiation	3,220	2,722	127	3.9%	4.7%	-15.5%
All Deals	5,924	5,389	243	4.1%	4.5%	-9.0%

As was done for the second quarter 2008, the Examiner's financial advisor performed a sensitivity analysis to demonstrate the effect of a reduction in enterprise value on the required write-down as of the third quarter of 2008. The sensitivity analysis for the third quarter was updated with new information, but otherwise performed in the same manner as in the second quarter. As discussed above, the average asset sale in 2008 occurred at 15% below budgeted value. A 15% reduction in enterprise value results in an implied write-down of $1.6 billion. Lehman's cumulative write-downs through the third quarter were approximately $800 million. Therefore, this analysis suggests a potential overvaluation of $800 million.

[1787] Lehman, Archstone August 2008 Update (Sept. 19, 2008), at p. 7 [LBEX-DOCID 2903110].

(i) Sum of the Parts

The Examiner's financial advisor's Sum of the Parts analysis for the third quarter of 2008 is similar to the analysis that was performed for the second quarter of 2008. This analysis was updated by the Examiner's financial advisor to reflect the additional write-downs that Lehman took during the third quarter. See the table below for this analysis. Assuming the platform continued to be valued at $1 billion, Lehman's valuation as of the third quarter implied a going-in capitalization rate on the core portfolio that was closer to 4.5% than 4.75%, as shown in the table below.

Going-In Capitalization Rate Sensitivity Analysis (Q3 2008)

Core Portfolio Cap Rate	4.11%	4.25%	4.50%	4.75%	5.00%	5.25%	5.50%	5.75%	6.00%
Reduction in Total Equity Value	0	596	1,551	2,406	3,175	3,871	4,504	5,081	5,611
Reduction in Lehman's Equity (46.8%)	0	279	726	1,127	1,487	1,813	2,109	2,379	2,627
Write-Downs Taken by Lehman as of Q3 2008	783	783	783	783	783	783	783	783	783
Incremental Write-Downs	(783)	(504)	(57)	344	704	1,030	1,326	1,596	1,844

As discussed above, the average going-in capitalization rate for Archstone assets that were sold, under contract, or in negotiation during 2008 was between 4.7% and 4.8%. As shown in the chart above, a going-in capitalization rate of 4.75% results in a $344 million incremental write-down and a 5.0% going-in capitalization rate results in a $704 million incremental write-down. The average sales capitalization rate declined between second and third quarter in part because a deal on a New York property was under negotiation at a 4.6% capitalization rate. Hughson told the Examiner that these

were the "good assets" that separated Archstone from AvalonBay.[1788] However it is also important to note that it was precisely this deal that increased the overall variance to budget (*i.e.*, it had a relatively low capitalization rate and a relatively high variance between sales price and Lehman's budgeted value).

Examiner's Financial Advisor's Sensitivity Analysis

		Reduction in Enterprise Value ($ in billions)						
	At Purchase	5.0%	7.5%	10.0%	12.5%	15.0%	17.5%	20.0%
Initial Enterprise Value	22.2	21.1	20.5	20.0	19.4	18.9	18.3	17.8
Face Value of Debt	17.1	17.1	17.1	17.1	17.1	17.1	17.1	17.1
Equity Value	5.1	4.0	3.4	2.9	2.3	1.8	1.2	0.7
Lehman's Equity	2.4	1.9	1.6	1.3	1.1	0.8	0.6	0.3
Implied Write-Down		(0.5)	(0.8)	(1.0)	(1.3)	(1.6)	(1.8)	(2.1)
Write-Downs Taken through Aug 31		(0.8)	(0.8)	(0.8)	(0.8)	(0.8)	(0.8)	(0.8)
Incremental Write-Down Required		0.3	0.0	(0.3)	(0.5)	(0.8)	(1.0)	(1.3)

(ii) DCF Method

The Examiner's financial advisor's DCF Method analysis for the third quarter 2008 is similar to the analysis that was performed for the second quarter 2008. As discussed above, the Examiner's analysis of the DCF Method focused on two assumptions: rent growth and exit capitalization rates. This Section addresses the Examiner's financial advisor's analysis of the assumptions used in Lehman's valuation for third quarter 2008.

[1788] Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at p. 11.

The DCF valuation for the third quarter was based on a similar valuation model Lehman used for its second quarter valuation, though during the third quarter the rent growth was reduced to 4.90% and the exit capitalization rate was increased to 5.57%.[1789] The DCF valuation for the third quarter was lower than the DCF valuation for the second quarter due to these changes in assumptions.[1790]

(iii) Rent Growth

During the third quarter 2008, Lehman recognized that Archstone's growth rates had declined, and Lehman adjusted its projections downward.[1791] However, it appears this was work was not completed by the end of the third quarter 2008.[1792] To counter this, Lehman ran the DCF model with a rental revenue CAGR of 4.90%, a more conservative assumption than previously used.[1793]

[1789] E-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman (Sept. 12, 2008) [LBEX-DOCID 2903130].

[1790] Lehman, Easy Living Corporate Q3 Model (Aug. 22, 2008) [LBEX-DOCID 3119444].

[1791] Lehman ran the model at a CAGR of 4.9%, which was a 74 basis points reduction from the base case. E-mail from Webster Neighbor, Lehman, to Paul Hughson, Lehman (Sept. 12, 2008) [LBEX-DOCID 2903130].

[1792] The projections within the third quarter model, Lehman, Easy Living Corporate Q3 Model (Aug. 22, 2008), at Full Rollup tab [LBEX-DOCID 3119444], were the same ones as those in the second quarter model, Lehman, Easy Living Q2 Model Risk (June 15, 2008), at Full Rollup tab [LBEX-DOCID 4456413]. There was difference in the cash-flows that was driven by more assets having been sold by the end of the third quarter.

[1793] E-mail from Webster Neighbor, Lehman, to Paul Hughson, Lehman, (Sept. 12, 2008) [LBEX-DOCID 2903130].

(iv) Exit Capitalization Rate

The base case exit capitalization rate was approximately 5.57%, which is 75 basis points higher than the base case analysis as of the second quarter of 2008,[1794] but over 25 basis points below what Lowitt cited as the over 100 basis points increase on the second quarter earnings call.[1795]

The observations made by the Examiner's financial advisor in its analysis of the first and second quarter (*i.e.*, that there is a correlation between going-in and exit capitalization rates, and going-in capitalization rates were increasing) apply to the third quarter as well. The Examiner's financial advisor increased the exit capitalization assumption in its third quarter analysis less than in its first and second quarter analysis since Lehman had recognized the need for an upward adjustment and increased the base case exit capitalization rate by 75 basis points.[1796] The Examiner's financial advisor made a further increase to this rate because Lehman's asset prices were increasing in their variances from the budget and it became more readily apparent that going-in capitalization rates were increasing.[1797] As discussed in the asset sales section above, third quarter going-in capitalization rates were 65-90 basis points higher than the 4.1%

[1794] Lehman, Archstone Sensitivity Analysis — 08-22-08 (Sept. 12, 2008) [LBEX-DOCID 2852318], *attached to* e-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman (Sept. 12, 2008) [LBEX-DOCID 2903130].

[1795] Final Transcript of Lehman Brothers Holdings Inc. Second Quarter Earnings Call (June 16, 2008), at p. 14 [LBHI_FIN 00007].

[1796] Lehman, Archstone Sensitivity Analysis — 08-22-08 (Sept. 12, 2008) [LBEX-DOCID 2852318], attached to e-mail from Webster Neighbor, Lehman, to Paul A. Hughson, Lehman (Sept. 12, 2008) [LBEX-DOCID 2903130].

[1797] *See* Section III.A.2.f.4.b for a discussion of the Sum of the Parts valuation method.

used in the initial purchase price allocation, and Archstone's own sales implied a going-in capitalization rate approaching 4.8%. The sensitivity analysis below accounts for these indications by flexing the exit capitalization rate assumption from 5.82% to 6.07%.

(v) Quantification of Changes in Assumptions

An e-mail exchange between Webster Neighbor and Alex Kirk details the model Lehman used to value Archstone in the third quarter.[1798] The base case in this model assumed a flexed case of 5.57% for the exit capitalization rate and 4.90% for the rent CAGR. The Examiner's financial advisor created four different cases in the model stressing each of these two assumptions. In the first case the Examiner's financial advisor assumed that the rental growth assumption was that of the base case that Lehman used (4.90%) and that the exit capitalization rate was 1.0% higher than at closing. Applying the same rental growth rate assumption Lehman used in the third quarter, the Examiner's financial advisor's stress of the exit cap rate raised it to the rate Lowitt cited in the second quarter earnings call (albeit at a lower rental growth rate). The second case maintained the same exit cap rate but further stressed the rental growth rate by 75 basis points, bringing the rental revenue CAGR to 4.15%. The third case also maintained the same exit cap rate but further stressed the rental growth rate by an additional 75 basis points, bringing the rental revenue CAGR to 3.90%. In the last case, the Examiner's financial advisor ran the model at a CAGR of 3.40%.

[1798] Lehman, Easy Living Corporate Q3 Model (Aug. 22, 2008), at Full Rollup tab [LBEX-DOCID 3119444].

DCF Method Sensitivity Analyses (Q3 2008)

Numbers in Millions unless stated otherwise

	Assumptions	Case 1	Case 2	Case 3	Case 4
Inputs	Rental Growth Rate Decrease (from 72 bps)	0 bps	75 bps	100 bps	125 bps
	Exit Cap Rate increase (from 75 bps)	25 bps	25 bps	25 bps	50 bps
	IRR	15.0%	15.0%	15.0%	15.0%
	Total Funded Amount of the Equity	$2,388	$2,388	$2,388	$2,388
	Lehman Reported Valuation for the Equity	$1,647	$1,647	$1,647	$1,647
	Weighted Average Mark of the Equity	69.0	69.0	69.0	69.0
	Write Down taken by Lehman within the Equity	$741	$741	$741	$741
Outputs	Implied Valuation	$1,507	$1,265	$1,187	$992
	Implied Mark	63.1	53.0	49.7	41.6
	Implied Incremental Write-Down	$140	$382	$460	$655

(vi) Examiner's Findings and Conclusions as to the Reasonableness of Lehman's Archstone Valuation as of the End of the Third Quarter of 2008

As noted earlier, Archstone equity was a SFAS 157 Level 3 asset whose valuation is entitled to a significant amount of judgment. For the reasons set forth above, the Examiner's financial advisor concluded that there is sufficient evidence to support a finding, for purposes of a solvency analysis, that Lehman's valuation for its Archstone bridge equity investment as of the end of the third quarter of 2008 was unreasonable. Recognizing that the valuation of such an illiquid investment requires the application of judgment to numerous factors and criteria, the Examiner concludes that the evidence supports a finding that Lehman's valuation of $1.647 billion for its Archstone bridge and permanent equity investment was overvalued by $140 million to $400 million.

The low end of the range implies a decline in enterprise value of between 7.5% and 10.0% since the acquisition. This decline is less than the decline in value of

Archstone assets under contract or in negotiation at this time; therefore the low end of the range assumes there is some merit to Lehman's argument that asset sales were not indicative of the value for the remainder of the portfolio. The Examiner's financial advisor's analysis shows a $140 million overvaluation based on a DCF analysis using the following assumptions: a 25 basis points increase in exit capitalization rate and a zero basis point decrease in rent growth (which results in rent growth that is significantly higher than third-party projections for Archstone's markets and a NOI growth rate of 7.0%, which is significantly higher than Archstone's historical average). The Examiner's financial advisor used Lehman's base case figure for the rent growth but stressed the exit capitalization rate an extra 25 basis points from Lehman's base case. The resulting exit capitalization rate is the same as the exit capitalization rate used in the second quarter analysis.

The high end of the range implies a decline in enterprise value since the acquisition of 12.5%. A 12.5% decline is still below the decline in value for Archstone assets under contract or in negotiation at this time. The Examiner's financial advisor's analysis shows a $382 million overvaluation based on a DCF analysis making the following assumptions: a 75 basis point decrease in rent growth and a 25 basis points increase in exit capitalization rate. The Examiner's financial advisor stressed the exit capitalization rate to 6.07% based on the implied going-in capitalization rate of 5.37%. This capitalization rate is below the 5.5% that was cited as the appropriate capitalization

rate for AvalonBay in the research report published by Lehman on May 14, 2008.[1799] The rental growth CAGR assumed by a 75 basis point decline is 4.15% while the implied NOI CAGR is 6.1%. The NOI CAGR is significantly higher than what Archstone was able to achieve historically while the rent CAGR is slightly higher than Archstone's 10 year historical average.

g) Examiner's Analysis of the Valuation of Lehman's Residential Whole Loans Portfolio

This Section of the Report addresses Lehman's valuation of Residential Whole Loans ("RWLs") and Residential Mortgage-Backed Securities ("RMBS") during the second and third quarters of 2008. RWLs, the valuation of which presents the greater challenge of the two, are addressed first and in greater detail. The comparatively straight-forward valuation of RMBS follows. While this Report notes several issues with Lehman's price testing of its RWL portfolio, insufficient evidence exists to support a colorable claim that Lehman's valuation of these assets was unreasonable. Likewise, there is insufficient evidence to support a colorable claim that Lehman's valuation of its RMBS portfolio was unreasonable.

(1) Residential Whole Loans Overview

RWLs are residential mortgages from around the world that can be traded and pooled as the first stage in the securitization process, the goal of which is the creation of

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[1799] David Harris, Lehman, *et al.*, REITs Investor Briefing Package (May 14, 2008), at p. 45 [LBEX-DOCID 4329202], *attached to* e-mail from Donald E. Petrow, Lehman, to Jonathan Cohen, Lehman [LBEX-DOCID 4432688].

RMBS.[1800] A sponsor of a RMBS transaction such as Lehman first acquires the underlying RWLs, which are pooled together in the securitization process. Such pools are generally homogenous in some respects (*e.g.,* in terms of quality of loans and vintage) and are geographically diversified in order to mitigate the risk of loss due to a regional decline in home prices. Once the pool size reaches its target, the sponsor prepares the legal documentation to sell the pool to a special purpose entity (the "SPE"), proposes a division of the interest and principal payment priorities into bonds that are "tranched," obtains a rating from a rating agency for the applicable bonds, and then sells the bonds, also known as RMBS, to investors. The purchase money that investors pay to the SPE enables the SPE to purchase the RWL pool from the issuer.

As a predicate to securitization, RWLs are created by loan originators that approve mortgages and lend directly to homeowners. Government entities, such as Fannie Mae and Freddie Mac, financial firms such as Lehman and other investors buy the pooled mortgages from the originators. These investors may hold whole loan pools as investments, sell them to other investors or create securities by "carving up" the pools and selling the securities. This last option is the domain of investment banks such

[1800] *See* Peter J. Elmer, *Conduits: Their Structure and Risk*, F.D.I.C. Banking Rev., Dec. 1999, at pp. 27, 32-33. The creation of RMBS is described in greater detail below.

as Lehman. Typically, investment banks securitize or sell RWLs and do not purchase RWLs for the purpose of owning them as investments for an extended period.[1801]

As of May 31, 2008, Lehman reported that it owned RWLs with an aggregate market value of approximately $8.3 billion, as consolidated across subsidiaries.[1802] For valuation purposes, Lehman assigned RWLs to one of several categories that were organized by geographic origin and the type of mortgage loan. The geographic distribution of the RWL assets held by Lehman in May and August of 2008 was as follows:

Origin/Class	**Total Value (in $ billions)**[1803]	
	May 2008	**Aug 2008**
U.S. Prime / Alt-A	2.1	1.2
U.S. Subprime / Second Lien	1.1	0.6
Other U.S.	1.0	0.9
Europe	3.6	3.1
Asia Pacific	0.5	0.5
Total	8.3	6.3

This Section of the Report examines whether Lehman's valuation of its RWL assets, as determined by Lehman in May and August of 2008, was reasonable.[1804] The

[1801] *Id.* at pp. 31-32 (stating that most loans held by conduits are newly originated and may be held for "several months" awaiting securitization).

[1802] LBHI 10-Q (filed July 10, 2008), at p. 69.

[1803] *Id.* at pp. 69-70; Lehman, Q3 Residential Template w_Elq (v83).xls [LBEX-BARFID 0011867]. August data at this level of detail was not publicly disclosed prior to bankruptcy.

[1804] The Examiner has focused on the dates May 31, 2008 and August 31, 2008 because these dates were the ends of Lehman's second and third quarter reporting periods. While Lehman did not actually file a

Examiner's investigation has revealed that Lehman's product control process for RWLs was not particularly robust and that there was some risk of misstatement in this asset class. While certain of the sources Lehman used in price testing its U.S. RWL portfolio in May and August of 2008 proved ultimately unreliable, the asset values arrived at by Lehman did not fall outside a range of reasonableness. Accordingly, the Examiner does not find evidence to support a finding that Lehman's valuation of its U.S. RWL portfolio in May or August of 2008 was unreasonable. In light of this conclusion, and given the expense to the Debtors' estates and the time that would be required for the Examiner to conduct an investigation of the reasonableness of Lehman's valuation of its non-U.S. RWLs, the Examiner determined that conducting such an investigation would not be a prudent use of the estates' resources and therefore limited the investigation to the reasonableness of the valuation of U.S. RWLs.

(2) Lehman's U.S. Residential Whole Loans in 2008

Lehman divided U.S. RWLs into 10 different categories based on the nature of the underlying mortgage loan.[1805] The table below lists these 10 categories, along with the May 2008 market value of all of Lehman's U.S. assets in that category.[1806]

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quarterly report for the third quarter of 2008, it did collect prices from its trading desk and perform price testing of its U.S. RWLs for this period.

[1805] *See* Lehman, New 05-30-08 WL Testing.xls, tab "WL Testing Summary" [LBEX-BARFID 0006698]. The categories of loans labeled "Capital Crossing" and "SBF" are not included in this analysis because they are not residential loans. The amounts reported in LBHI's Quarterly Report for the second quarter of 2008 vary slightly with the amounts in the testing files reviewed. Explanations for this variance include the possibility that the testing files included minimal amounts of non-US assets or that Lehman's 10-Q numbers included some hedge positions.

Categories of U.S. RWLs Held by Lehman as of May 31, 2008 and August, 31, 2008[1807]

Collateral Type	Market Value (in $ billions)	
	May 08	Aug 08
FHA/VA	0.27	0.12
High LTV	0.02	0.02
Home Express	0.00	0.00
Neg Am	0.24	0.19
Prime Fixed	0.49	0.33
Prime Hybrid ARMs	1.36	0.66
Reverse Mortgages	0.62	0.65
Scratch & Dent	0.39	0.23
Subprime	0.16	0.11
Subprime 2nds	0.89	0.50
Total	4.44	2.80

Lehman also divided each of the 10 categories listed above into "performing" and "non-performing" groups, distinguished by whether the loans were still producing timely interest and principal payments. Because loans in the "reverse mortgages" category cannot be non-performing,[1808] Lehman recognized 19 unique categories of U.S. RWLs for pricing purposes in May and August of 2008.

[1806] Lehman had distinct Product Control groups for its U.S. and European divisions and there was little communication and no standardization between U.S. and European entities. Examiner's Interview of Brian Sciacca, Oct. 19, 2009, at p. 4.

[1807] Lehman, New 05-30-08 WL Testing.xls, tab "WL Testing Summary" [LBEX-BARFID 0006698]; Lehman, Pricing Package Aug 08.xls (Aug. 29, 2008), tab "Whole Loans" [LBEX-BARFID 0006669].

[1808] In a reverse mortgage, a homeowner borrows against the equity in their home. Unlike in a traditional home equity loan, no repayment is required until the borrower no longer uses the home as their principal residence. Usually marketed to seniors, the loan is repaid with interest and fees when the home is sold by the borrower or the borrower's estate. *See* U.S. Dep't of Hous. and Urban Dev., Top Ten Things to Know if You're Interested in a Reverse Mortgage, Feb. 20, 2009, *available at* http://www.nls.gov/offices/hsg/sfh/hecm/rmtopten.cfm (last visited Feb. 3, 2010).

Despite the relationship between RWLs and RMBS, valuation of RWLs is more difficult than the valuation of RMBS. In comparison to RMBS, the number of identifiable trades of RWL pools establishing typical price and yield ranges is relatively small.[1809] The total value for which RMBS are sold is typically greater than the value of the RWL pool on which they are based due to the value added during the securitization process and the business model of the investment bank.[1810] Additionally, the value of RWL pools is largely dependent on the anticipated opportunity to securitize the assets in the near-term and a robust secondary market for RMBS. Without a functioning market, estimating the value of RWL pools awaiting securitization becomes more difficult. Accordingly, there is less certainty as to the market price of RWL assets held on Lehman's books during 2008 than for such assets during prior periods when the RMBS market was more robust.

In 2008, the pace of new securitizations slowed significantly.[1811] Fewer loans were being made to homeowners,[1812] there was very little trading of RWLs between

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[1809] This is a direct result of the fact that securitization improves liquidity. Since the securitization of RWL pools into RMBS transactions enhances liquidity, it follows that the number of identifiable RWL trades would be small in comparison to RMBS. *See* Peter J. Elmer, *Conduits: Their Structure and Risk*, F.D.I.C. Banking Rev., Dec. 1999, at pp. 27, 32.

[1810] When the securitization market is functioning, an investment bank will bid for a whole loan pool based on the expected sale proceeds of the securities it will create, the expenses (such as rating agency and legal fees and marketing costs) it will incur, and the desired fees (typically 1-2% of the transaction size). Accordingly, the total RMBS value will exceed the RWL value in a functioning market. Lehman Brothers Holdings Inc., Overview of Securitization [LBEX-BARFID 0012513].

[1811] Examiner's Interview of Joseph Sapia, Oct. 26, 2009, at p. 2; Securities Industry and Financial Markets Association, Mortgage-Related Issuance, (1996 - June 2009), *available at* http://www.sifma.org/research/pdf/Mortgage_Related_Issuance.pdf (last visited Feb. 3, 2010) (showing issuance of non-agency

market participants[1813] and several mortgage originators filed for bankruptcy.[1814] One result of the significant decline of securitization activity was that it made the pricing of RWL assets extremely difficult. In May of 2008, Lehman acknowledged internally that "price transparency does not exist for whole loans."[1815]

During the second quarter of 2008, the value of Lehman's U.S. RWL portfolio fell by approximately $2.5 billion — from $6.6 billion to $4.1 billion — due to a mix of write-downs and sales.[1816] Of this decline of approximately $2.5 billion, approximately $750 million was due to write-downs.[1817] During this time, the combined gross write-down of both RMBS and U.S. RWLs was $2.4 billion.[1818] During the third quarter of 2008, the value of Lehman's U.S. RWL portfolio fell by approximately $1.4 billion — from $4.1

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mortgage-backed securities fell from approximately $774 billion in 2007 to $41 billion in 2008); Luo Jun, *Credit Crisis Will Extend Into 2009, Oppenheimer Says (Update 1)*, Bloomberg.com, May 20, 2008, *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=aAMUjyxli6Lc (noting the "shut down in the securitization market").

[1812] Mortgage Bankers Association, Mortgage Origination Estimates, Oct. 16, 2009, http://www.mbaa.org/files/Research/HistoricalWAS/HistoricalMortgageOriginationEstimates101609.xls (providing estimates of quarterly mortgage originations).

[1813] W. Joseph Caton, *Will the Loan Trade Market Finally Open Up?*, National Real Estate Investor, Jun. 1, 2008, http://nreionline.com/commentary/finance/real_estate_loan_trade_market_0601 (describing a "virtual standoff in the real estate loan investment and trading marketplace").

[1814] *See* Worth Civils & Mark Gongloff, *Subprime Shakeout*, Wall St. J. Online, http://online.wsj.com/public/resources/documents/info-subprimeloans0706-sort.html (listing bankruptcy filings of mortgage originators in late 2007).

[1815] Lehman, Pricing Package May 08.xls (May 2008), at p. 1 [LBEX-BARFID 0006591].

[1816] Lehman, Q2 08 High Level Mortgage Roll Forward(v2).xls [LBEX-BARFID 0011863].

[1817] *Id.*

[1818] Lehman, Q3 2008 Financial Review (Sept. 6, 2008), at p. 22 [LBHI_SEC 07940_744701].

billion to $2.7 billion — due to a mix of write-downs and sales.[1819] Of this decline of approximately $1.4 billion, approximately $840 million was due to write-downs.[1820] The write-downs Lehman took on these assets throughout the year reflect its recognition of the changed market conditions of 2008 and an acknowledgment of the diminished value of its U.S. RWL and RMBS assets.

(3) Lehman's Valuation Process for its Residential Whole Loans

The asset values Lehman reported on its balance sheet for RWLs were the marks reported by its traders, which were subject to revision pursuant to the price testing process described below.[1821] Each Lehman trading desk had its own method for pricing assets and there was little consistency across desks as to methodology.[1822] In order to provide a check on the traders' marks, and to provide some standardization, Lehman's Product Control Group performed an independent price verification of U.S. RWL assets on a monthly basis, with special emphasis placed on price verification at the end of each fiscal quarter.[1823] While the trading desks marked individual RWL assets, meaning that RWLs within a single category could be assigned different marks, the Product Control

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[1819] *See* LBHI 10-Q (filed July 10, 2008) at p. 69; Lehman, Pricing Package Aug 08.xls (Aug. 29, 2008), tab "Whole Loans" [LBEX-BARFID 0006669]; Lehman, Q3 Residential Template w_Elq (v83).xls [LBEX-BARFID 0011867].

[1820] Lehman, Q3 Residential Template w_Elq (v83).xls [LBEX-BARFID 0011867].

[1821] Examiner's Interview of Usman Babar, October 16, 2009, at pp. 3-5.

[1822] *Id.*

[1823] Lehman, Price Verification Policy Global Capital Markets 2008 [Draft], at pp. 4, 49-54 [LBHI_SEC07940_2965994]. While the task of price verification was assigned to the Valuation Control group, Lehman documents, as well as E&Y documents, refer to the "Product Control" group and "product controllers" when describing this function. For ease of reference and consistency, the terms "Product Control" and "product controllers" are used throughout this Section.

Group's price testing assigned a single mark to each of the 19 categories of U.S. RWLs identified above.[1824] As described below, the Product Control Group relied on several different methods to value RWL assets depending on the current market conditions and data available. When the variances between the Product Control Group's price verification and the desk price for a particular asset exceeded certain tolerances,[1825] the Product Control Group would seek to resolve the variance through conversation with the appropriate trading desk and would escalate material unresolved variances to senior management.[1826] The Product Control Group also prepared summaries of its findings and procedures that were distributed to Lehman's senior management on a monthly basis.[1827]

Prior to 2008, Lehman's Product Control Group used a "mock securitization" model to value its U.S. RWL assets.[1828] The mock securitization approach is based on the

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[1824] Lehman, New 05-30-08 WL Testing.xls, tab "WL Testing Summary" [LBEX-BARFID 0006698]. When this report notes a single Lehman "desk price" for a category of RWLs, that number is the weighted average of the prices assigned by the trading desk. The range of prices reported by Lehman's traders are often extremely large. For Prime Hybrid ARMs in May of 2008, for example, traders reported a low price of 0.1 and a maximum price of 110.9. Six of the ten categories of performing RWLs as defined by Lehman showed ranges of essentially 1 to 100. *See* Appendix 16, Valuation - Residential Whole Loans, for a more detailed discussion of the range of desk prices assigned to each category of RWLs.

[1825] The tolerance level for RWLs was set at 3%, although in some unspecified instances higher variances would be deemed acceptable. Lehman, Price Verification Policy Global Capital Markets 2008 [Draft], at p. 53 [LBHI_SEC07940_2965994].

[1826] *Id.* at p. 54.

[1827] *Id.* at p. 4. *See, e.g.*, Lehman, Valuation & Control Report - Fixed Income Division (Feb. 2008), at pp. 3-5 [LBEX-WGM 002234].

[1828] Lehman, Price Verification Policy Global Capital Markets 2008 [Draft], at p. 49, [LBHI_SEC07940_2966042]. The product controllers also relied to a limited extent on sales data, but the primary source for their price testing was mock securitization. *See* Lehman Brothers Holdings Inc., "Prime Hybrid Arms.xls" [LBEX-BARFID 0011869].

theory that the value of a pool of RWLs is closely related to the price that could be realized by selling the RMBS created if the pool were to be securitized.[1829] Using this approach, a recently closed deal with similar underlying collateral — meaning the underlying loans had similar anticipated default rates, recovery rates and rates of prepayment — is selected as a point of reference. The sum total of the values of all RMBS issued in such a deal is considered to be representative of the price of the RWL pool on which it is based. As indicated previously, the RWL pool will have a somewhat lower value than the total of all the RMBS created by the pool in functioning markets and this difference is estimated in order to determine the value of RWLs by mock securitization.

The valuation of RWLs became more difficult in 2008 as securitization of residential mortgages slowed significantly.[1830] Potential buyers of a RWL pool were no longer able to rely on near-term securitization of the pool. In addition, the slowing pace of securitizations meant that there were fewer potential buyers for RWL pools in 2008, because buyers whose goal was securitization rather than investment diminished in number. Because of this change in market conditions, in May 2008 Lehman concluded that the mock securitization model was no longer a valid method for valuing its U.S.

[1829] E&Y Walkthrough Template, Residential Whole Loans, at p. 5 [EY-LE-LBHI-MC-GAMX-08-072872] (describing mock securitization methodology); Examiner's Interview of Usman Babar, October 16, 2009, at p. 4.

[1830] Examiner's Interview of Joseph Sapia, Oct. 26, 2009, at p. 2.

RWL assets.[1831] Instead, Lehman decided to rely solely on recent sales data and prices reported by third-party sources as benchmarks for price verification.[1832]

(a) Lehman's May 2008 Price Testing

Lehman's Product Control Group price tested its entire U.S. RWL portfolio for the second quarter of 2008.[1833] In price testing assets using recent trade activity, it is important that the recent transactions used as benchmarks involve the same general type of assets as the Lehman assets being valued, and that the trades be close in time to the relevant reporting date. Furthermore, a greater number of benchmark sales would allow a higher level of confidence in the estimated price of the assets being valued. However, Lehman had very little relevant trade data to provide benchmark values for its U.S. RWL assets in May and August 2008. Lehman Product Control records demonstrate that Lehman's Product Control Group identified only seven trades upon which to rely in price testing its U.S. RWL assets for its second quarter reporting.[1834]

The Examiner reviewed the May 2008 price testing records related to all 19 categories of Lehman's U.S. RWL portfolio, ten performing and 9 non-performing.[1835] For five of the 10 performing categories, Lehman's Product Control Group used only

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[1831] E&Y Walkthrough Template, Residential Whole Loans, at p. 4 [EY-LE-LBHI-MC-GAMX-08-072872].
[1832] *Id.*; Lehman, Valuation Review - 2nd Quarter 2008 (July 2008), at pp. 8-10, [LBHI_SEC07940_750105].
[1833] Lehman, Valuation Review - 2nd quarter 2008 (July 2008), at pp. 8-10, [LBHI_SEC07940_750105].
[1834] Examiner's Interview of Joseph Sapia, Oct. 26, 2009, at p. 2; Lehman, Whole Loan Closings (June 4, 2008), at pp. 1-2 [LBEX-BARFID 0006588]; Lehman, New 05-30-08 WL Testing.xls, at tab "WL Testing Summary" [LBEX-BARFID 0006698].
[1835] Lehman, New 05-30-08 WL Testing.xls, tab "WL Testing Summary" [LBEX-BARFID 0006698].

recent trade activity for price verification.[1836] Together, these five categories account for $1.7 billion of Lehman's reported U.S. RWL asset value in May 2008. One of the categories, Federal Housing Administration ("FHA") / Veterans' Administration ("VA") loans, was backed by an FHA guarantee, making its valuation relatively straightforward.[1837] Another, the Reverse Mortgage category, was priced using a recent sale to the Government National Mortgage Association ("Ginnie Mae"), a strong basis for the mark given.[1838]

However, the other three categories of performing loans valued by reference to recent sales are more problematic. Many of the trades Lehman used as benchmarks in price testing its U.S. RWL portfolio in May 2008 failed to close and eventually were cancelled, albeit after Lehman relied upon the trades as benchmarks. In hindsight, it is apparent that the failed trades did not accurately indicate the value of the assets at issue because no assets actually traded at the prices reflected by the trade data reviewed by Lehman's product controllers. Although it would be unreasonable for Lehman's Product Control Group to rely on trades they knew would be cancelled, the Examiner has not found evidence that the Product Control Group should have known, at the time it performed second quarter 2008 price testing, that the trades used would eventually be cancelled. The table below provides a list of the then-recent trades used by Lehman to

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[1836] *Id.*
[1837] *Id.*
[1838] *Id.*

price test its RWL portfolio in May 2008 and the subsequent settlement status of the trades.

Benchmark Trades Used By Lehman Product Control In May of 2008[1839]

Category	Benchmark Trade	Value of Assets Traded ($million)	Price	Settlement / Cancellation
High LTV	Fannie Mae	56.0	94.7	Undetermined
Prime Fixed	Vertical Mortgage	87.5	86.0	Cancelled on 7/1/08
Prime Hybrid ARMs	Chevy Chase Bank	37.0	96.0	Cancelled on 8/5/08
Reverse Mortgages	Ginnie Mae	33.0	100.8	Undetermined
Scratch & Dent	RLT	11.0	65.0	Securitization closed on 5/31/08
Subprime	Arch Bay	105.0	65.0	Not Entered in Trade System
Subprime Seconds	Great Western Bank	11.0	65.0	Cancelled on 6/16/08

At the time they valued Lehman's U.S. RWL assets in May 2008, Lehman's product controllers relied on the limited number of trades they were able to identify as the best available information. A review of Lehman's trade database demonstrates that of trades on which Lehman possessed information in May 2008, only 5% of December 2007 trades and no trades in January or February 2008 were cancelled.[1840] Higher rates of cancellation existed for trades in March and April 2008 — 16% and 15%

[1839] Lehman, New 05-30-08 WL Testing.xls, at tab "WL Testing Summary" [LBEX-BARFID 0006698]; APB Trade Database Report [LBEX-BARAPB 0049422].
[1840] APB Trade Database Report [LBEX-BARAPB 0049422].

respectively.[1841] While the March and April 2008 cancellation rates were high enough that Lehman's product controllers should have been aware that there was a possibility that some trades may be cancelled, the cancellation rates were not so high as to render the controllers' reliance on trade data unreasonable during the second quarter price verification process.

During interviews with the Examiner, Lehman's product controllers indicated that no one in their group subsequently checked to confirm if the trades used as valuation benchmarks in May 2008 actually settled and that the group never discussed the settling or cancelling of trades as a potential issue.[1842] However, even though greater diligence in investigating these trades would have revealed some red flags, such as the fact that at least one trade was never entered in Lehman's trade database, there was no way for the product controllers to know conclusively in May and early June 2008 — at the time the price verification process occurred — that certain trades would be cancelled in the future. Accordingly, without more reliable information at their disposal, it was reasonable for the product controllers to use the initial trade data in performing price testing. Each of the trades relied upon is discussed below.

[1841] *Id.*

[1842] Examiner's Interview of Brian Sciacca, Oct. 19, 2009, at p. 3; Examiner's Interview of Joseph Sapia, Oct. 26, 2009, at p. 3.

The subprime category of RWLs, valued at $87 million by the trading desk, was price tested based on a trade of $105 million of assets to Arch Bay (at a price of 65).[1843] While the product controllers obtained some information regarding the Arch Bay trade, the Examiner's investigation revealed that this trade never formally settled and ultimately did not occur.[1844] Had Lehman's product controllers checked to confirm that this was a proper trade, they would not have found any entry in Lehman's MTS trade system, which would have been a red flag that this trade was irregular in some way. However, there was no way for the product controllers to know conclusively, in May 2008, that this trade would not close.

Similarly, the Subprime Seconds category of RWLs, valued at $656 million by the trading desk in May 2008, was price tested on the basis of a single trade of $11 million of assets to Great Western Bank (at a price of 65).[1845] Unlike the Arch Bay trade, this trade was entered into the MTS system, but failed to close and was cancelled on June 16, 2008, after the May 2008 price verification process ended.[1846] There was no way for Lehman's product controllers to have realized at the time they performed their price testing that this trade would be cancelled the following month. Even had they further investigated this trade in May 2008, product controllers would only have seen that the

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[1843] Lehman, New 05-30-08 WL Testing.xls, tab "WL Testing Summary" [LBEX-BARFID 0006698].

[1844] This trade was never entered in Lehman's trade database; accordingly, it is unclear when the trade was scheduled to settle and when it was cancelled. See APB Trade Database Report [LBEX-BARAPB 0049422].

[1845] Lehman, New 05-30-08 WL Testing.xls, tab "WL Testing Summary" [LBEX-BARFID 0006698].

[1846] APB Trade Database Report [LBEX-BARAPB 0049422].

settlement date for this trade was "TBD."[1847] As such, their decision to rely on this trade in price verification of Lehman's Subprime Seconds RWLs was reasonable at the time.

Finally, the Scratch & Dent category, valued at $158 million by the trading desk in May 2008, was price tested on the basis of a then-recent RMBS securitization. Lehman created this securitization, entitled Residential Loan Trust ("RLT") 2008-2, in May 2008 and provided a mark of 49 that was used as the Product Control price for these assets.[1848] The underlying loans in the RLT securitization consisted of non-performing loans; the Baupost Group, a third-party hedge fund, provided approximately 60% of the funding for the SPE to purchase the underlying loans, which had already been securitized, and owned approximately 60% of the securitization. When the SPE purchased the underlying RWLs, a relevant price point was established that could be used to test RWL pools with similar characteristics to the loans underlying the RLT securitization. However, this price was not as robust an indicator of the value of the RWLs as a sale to a wider group of investors would have been.

The Product Control Group's price testing of the other five categories of performing loans, together representing $2 billion of Lehman's $4.1 billion U.S. RWL portfolio in May 2008, employed a price obtained from a Morgan Stanley research

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[1847] Lehman, Copy of WholeLoanClosings 06.04.08.xls [LBEX-BARFID 0006588].

[1848] Lehman, New 05-30-08 WL Testing.xls, tab "WL Testing Summary" [LBEX-BARFID 0006698]. While there was little securitization activity in 2008, the RLT securitization was one of the few.

report.[1849] Two categories of performing loans were valued by reference to this Morgan Stanley report alone, while another three categories used the report in conjunction with trade data.[1850] In an interview with the Examiner, Joseph Sapia, a former Vice President in Lehman's Securitized Products Valuation and Control group, stated that the trade data was the primary source of the marks given to these three categories of loans and that Lehman merely used the Morgan Stanley report to confirm the marks.[1851] However, this characterization of the methodology is inconsistent with the Product Control Group's price testing spreadsheets. As described above, the prices reflected by the trade data ranged from 86 to 96 for these three categories.[1852] However, rather than use these prices, the product controllers used 89, the price identified by the Morgan Stanley report, for each of these categories.[1853]

To value its High LTV, Home Express, Neg Am, Prime Fixed and Prime Hybrid ARM RWLs, Lehman's Product Control Group used a mark of 89, which was the

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[1849] *See* Morgan Stanley Research, Special Report: A Writedown Writeup (May 13, 2008), at p. 4 [EY-LE-LBHI-KEYPERS 2818439]. The pricing spreadsheet for these assets states that the price was "[t]ested using Merrill Lynch price for performing prime loans marked back to 93." Lehman, New 05-30-08 WL Testing.xls, tab "WL Testing Summary" [LBEX-BARFID 0006698]. However, the Examiner's investigation has produced evidence, in the form of an e-mail from Joseph Sapia, a Lehman Vice President in the Securitized Products Valuation and Control Group, that the source referred to is actually a May 13, 2008 Morgan Stanley research report. *See* e-mail from Joseph Sapia, Lehman, to Nicholas McClay, Lehman (June 14, 2008) [EY-LE-LBHI-KEYPERS 4651500]. It is unclear what the "marked back to 93" note refers to. The mark used by the Product Control Group was 89. Lehman, New 05-30-08 WL Testing.xls, tab "WL Testing Summary" [LBEX-BARFID 0006698].

[1850] Lehman, New 05-30-08 WL Testing.xls, tab "WL Testing Summary" [LBEX-BARFID 0006698].

[1851] Examiner's Interview of Joseph Sapia, Oct. 26, 2009, at p. 3.

[1852] Lehman, New 05-30-08 WL Testing.xls, tab "WL Testing Summary" [LBEX-BARFID 0006698].

[1853] *Id.*

average price identified by the Morgan Stanley research report for Alt-A loans.[1854] These categories together represented approximately $2 billion of Lehman's U.S. RWL portfolio. While the Examiner has identified several significant issues with the use of the Morgan Stanley report for May 2008 price testing, it was one of the few sources of information available to Lehman's product controllers in May 2008 and the mark identified therein was not unreasonable, as discussed below.

The Examiner identified the following issues with the Product Control Group's use of the Morgan Stanley research report as part of the May 2008 price verification process. First, and most significantly, the Morgan Stanley report offered an average of the first quarter 2008 marks for Alt-A RWLs. It appears that Lehman simply took this survey of first quarter prices and applied it to value $2 billion of its U.S. RWL portfolio in the second quarter, without any confirmation that the first quarter mark remained valid. Given the rapidly changing market conditions of this period, a three-month-old price would be of limited relevance in determining the present value of RWL assets.[1855]

Second, the Morgan Stanley report provides an average mark for "Alt-A" loans, a broader category than the specific loans Lehman's Product Control Group priced using the report. The Morgan Stanley report is unclear as to which of the specific

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[1854] *Id.*

[1855] It is possible that some first quarter numbers collected by Morgan Stanley would be for the period ended March 2008. While Lehman and most investment banks end their first quarter in February, some banks end their first quarter in March. However, even two months is an unduly long period of time to assume price stability.

categories of loans, as defined by Lehman, its average price is based upon, making it something of a blunt instrument to use for the pricing of more narrowly defined categories of RWLs. Third, the Morgan Stanley mark used, 89, is actually the weighted average of the marks given to U.S. and European Alt-A RWL assets. The Morgan Stanley mark for U.S. assets was 86. Even if the report was otherwise reliable, Lehman's Product Control Group should have used the U.S. mark, 86, not the weighted average, 89, for pricing Lehman's U.S. RWL assets.[1856]

Despite the problems with the manner in which the Product Control Group used the Morgan Stanley report, the group had very few options for price testing U.S. RWL assets in 2008. The Morgan Stanley report provided a survey of sales prices, compiled and reported by a credible source. Furthermore, given the wide uncertainty in the valuation of this asset class in May of 2008, and the fact that the limited trade data Lehman possessed revealed marks between 86 and 96, the mark Lehman's Product Control Group used, 89, was not unreasonable.

It should be noted, however, that two of the three trades the Product Control Group used to conduct price testing in conjunction with the Morgan Stanley report were cancelled and never closed. Lehman's Prime Hybrid ARMs category, valued at $1.2 billion by the trading desk, was price tested using a combination of the Morgan

[1856] When asked about Lehman's use of international data, Joseph Sapia had no explanation for why the weighted average was used and acknowledged that this was simply a mistake. Examiner's Interview of Joseph Sapia, Oct. 26, 2009, at pp. 3-4.

Stanley report and a sale of $37 million of assets to Chevy Chase Bank at a price of 96.[1857] This sale to Chevy Chase never settled and was cancelled on August 5, 2008.[1858]

Similarly, Lehman's Prime Fixed category of RWLs, valued at $456 million, was price tested using both the Morgan Stanley report and a sale of $87 million of assets to Vertical Mortgage at a price of 86.[1859] The trade to Vertical Mortgage also never settled and was cancelled on July 1, 2008.[1860] As with the cancelled trades discussed above, however, there was no way for Lehman's product controllers to know in May 2008 that these trades would be cancelled. Thus, their decision to rely on these trades for testing was reasonable at the time.

The pricing of the final category, High LTV loans, was based on a sale of $56 million of assets to Fannie Mae, at a price of 95, a trade that did actually settle.[1861] Accordingly, the price testing of this category was based on a more reliable source.

The nine categories of Lehman's non-performing U.S. RWL assets, valued at roughly $829 million, were price verified in May 2008 using the same RLT securitization discussed earlier.[1862] The loans underlying the RLT securitization are sufficiently comparable to Lehman's non-performing loans to use the RLT securitization price as a

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[1857] Lehman, New 05-30-08 WL Testing.xls, at tab "WL Testing Summary" [LBEX-BARFID 0006698].
[1858] APB Trade Database Report [LBEX-BARAPB 0049422].
[1859] Lehman, New 05-30-08 WL Testing.xls, tab "WL Testing Summary" [LBEX-BARFID 0006698].
[1860] APB Trade Database Report [LBEX-BARAPB 0049422].
[1861] Lehman, New 05-30-08 WL Testing.xls, tab "WL Testing Summary" [LBEX-BARFID 0006698].
[1862] *Id.*

price check for Lehman's non-performing U.S. RWL assets. Accordingly, the Examiner finds the valuation of these assets to have been reasonable.

Overall, the valuations reached by Lehman's Product Control Group in May 2008 were fairly close to the marks applied by the desk. Taken together, there was a net variance of $123 million between Lehman's desk prices for its U.S. RWL assets as of May 31, 2008 and the values calculated by the Product Control Group, about 3% of the total value of the U.S. RWL portfolio reported by Lehman at this time.[1863] In the course of resolving variances there was a net reduction of $78 million in the desk prices of Lehman's U.S. RWL assets, demonstrating that the Product Control Group was able to influence the desk in the valuation of RWLs at this time.[1864]

E&Y conducted a review of Lehman's Product Control processes for price testing of U.S. RWLs in the second quarter of 2008.[1865] In the course of this review, E&Y noted Lehman's decision to switch to a price verification model based on recent sale prices rather than mock securitization and found this decision to be consistent with the lack of

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[1863] Lehman, New 05-30-08 WL Testing.xls, tab "WL Testing Summary" [LBEX-BARFID 0006698].

[1864] *Id.* The $78 million reduction is the aggregate adjustment taken on all whole loans in the testing file, including the non-residential whole loan categories SBF and Capital Crossing that are not included in this analysis. However, the desk and Product Control prices for these two categories are very close, and for the larger SBF category the Product Control price is actually higher than the desk price. Therefore, the Examiner concludes that that the $78 million reduction was related primarily to RWLs addressed by this Report.

[1865] E&Y Walkthrough Template, Residential Whole Loans (Nov. 30, 2008), at p. 1 [EY-SEC-LBHI-MC-GAMX-08-072875]. The E&Y document is dated November 30, 2008, but discusses second quarter 2008 price testing.

securitization activity in the second quarter of 2008.[1866] However, the scope of E&Y's review was limited. E&Y did not conduct an independent valuation of U.S. RWL assets to verify the marks reported by Lehman. Rather, its review was qualitative in nature, focusing on whether Lehman's Product Control procedures were adequate as designed, whether Lehman followed its own procedures and whether there was a risk of management override of controls.[1867] Thus, E&Y's report approves of Lehman's decision to use a methodology based on comparison to recent sales data to value its U.S. RWL assets; it does not address the specific valuations reached by Lehman.

(b) Lehman's August 2008 Price Testing

The Examiner's investigation has revealed similar problems with Lehman's August 2008 price verification process for U.S. RWLs, but also finds that there is not sufficient evidence to support a finding that the U.S. RWL values determined for August of 2008 were unreasonable. As noted above, Lehman wrote down the value of its U.S. RWL portfolio by approximately $750 million during the second quarter of 2008 and by $840 million during the third quarter of 2008.[1868] The Examiner reviewed the August 2008 price testing records related to all U.S. RWL performing and non-performing categories. As in May, recent sales were used to value many of Lehman's

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[1866] *Id.* at p. 4.

[1867] *Id.* at p. 16.

[1868] Lehman, Q2 08 High Level Mortgage Roll Forward(v2) [LBEX-BARFID 0011863]; Lehman, Q3 Residential Template w_Elq (v83).xls [LBEX-BARFID 0011867].

U.S. RWL positions in August of 2008.[1869] Also as in May, the data the Product Control Group relied upon for third quarter price verification was somewhat thin for the purpose of testing the entirety of Lehman's U.S. RWL portfolio.

For its August 2008 U.S. RWL price verification process, Lehman Product Control used the average of four Prime Whole Loan sales to test five categories of performing U.S. RWLs — High LTV, Home Express, Neg Am, Prime Fixed and Prime Hybrid ARMs.[1870] However, three out of the four benchmark trades were later cancelled and never closed, and one of the trades was never entered into Lehman's trading system.[1871]

Lehman's product controllers' reliance in August 2008 on trades that were ultimately cancelled is more problematic in third quarter price testing than in second quarter testing. By August of 2008, the product controllers would have been able to discover that most of the trades they relied upon in performing their second quarter price testing were cancelled. Furthermore, most of the trades used for third quarter price testing were cancelled before the end of that quarter. Of the four trades averaged

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[1869] Lehman, Pricing Package Aug 08.xls (Aug. 2008) [LBEX-BARFID 0006669].

[1870] *See* Lehman, Pricing Package Aug 08.xls (Aug. 2008) [LBEX-BARFID 0006669]; Lehman, Whole Loan Sales Q3.xls [LBEX-BARFID 0006667]. The four trades averaged were RWPO 2008-1, Bayview Fund Acquisitions 2008-3, Fortress 2008-1 and Pennymac 2008-1.

[1871] The Fortress 2008-1 trade does not appear in Lehman's transaction databases. The RWPO 2008-1 and Pennymac 2008-1 trades appear as cancelled. *See* APB Trade Database Report [LBEX-BARAPB 0049422].

to provide a mark for the five categories of U.S. RWLs, three were cancelled between August 27, 2008 and August 29, 2008.[1872]

Use of canceled trades in performing price testing conducted after the cancellation dates would have been unreasonable. However, despite this methodological problem, the mark applied to these five categories, 66.31, is ultimately reasonable given the fact that the one trade that did actually close had a price of 66.0.[1873]

The Examiner observed that Lehman's product controllers employed a different methodology in price testing three other performing U.S. RWL categories in their third quarter 2008 price verification process. The test prices for the Scratch & Dent, Subprime and Subprime Seconds asset categories were not calculated in the same way as those for the other performing loan categories. Lehman had data on three sales of Scratch & Dent RWL pools during or proximate in time to the third quarter of 2008.[1874] However, instead of taking the average of these prices, as was done with other categories of performing loans during the August 2008 price verification process, Lehman's Product Control Group used 50.25, the highest mark among the three sales, to value these categories of RWLs.[1875] In addition, the single trade used by the Product Control Group to provide the mark for these RWLs was not the largest trade; another trade existed,

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[1872] *Id.*

[1873] This was the Bayview Fund Acquisitions 2008-3. Lehman, Pricing Package Aug 08.xls (Aug. 2008) [LBEX-BARFID 0006669]; Lehman, Whole Loan Sales Q3.xls [LBEX-BARFID 0006667].

[1874] Lehman, Whole Loan Sales Q3.xls [LBEX -BARFID 0006667].

[1875] This mark was based on the sale of a Fasthold 2008-1 whole loan pool. Lehman, Pricing Package Aug 08.xls (Aug. 2008), tab "Whole Loans" [LBEX-BARFID 0006669].

involving three times the value of RWLs, at a mark of 30.55, 40% less than the mark used by the product controllers.[1876] The weighted-average mark of the three Scratch & Dent RWL sales was 37.4. However, these three categories of performing loans, and an additional nine categories of non-performing loans,[1877] together representing a $1.2 billion value as determined by the trading desk, were price tested using the 50.25 mark.

Had the Product Control Group used the average of the three marks, as it did with other asset categories, the third quarter value of these assets would have been approximately $890 million ($1.2 billion * 37.4/50.25), or approximately $310 million less than the value calculated by the product controllers in August of 2008. When asked about this inconsistency, Joseph Sapia could not recall why the highest price was used instead of the average.[1878] He speculated that it may have had something to do with the underlying collateral, but could not be certain.[1879]

The decision by the Product Control Group not to use an average of the prices available is also problematic because the single trade relied upon was cancelled on August 8, 2008, well before the end of the third quarter.[1880] While the methodology used to price these categories of RWLs raises serious issues, both because of the failure to use the average price reflected by the trade data and because the single trade used was

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[1876] This was a trade of Archbay 2008-2. Lehman, Whole Loan Sales Q3.xls [LBEX -BARFID 0006667].

[1877] In addition to the issues discussed above, the use of this sale of a pool of performing loans to value non-performing loans is also methodologically questionable.

[1878] Examiner's Interview of Joseph Sapia, Oct. 26, 2009, at p. 5.

[1879] *Id.*

[1880] APB Trade Database Report [LBEX-BARAPB 0049422].

cancelled well before quarter end, the U.S. RWL values arrived at do not themselves appear unreasonable. The reasonableness of this valuation is discussed in the following Section.

Despite the issues identified above, the Examiner concludes that the U.S. RWL values determined by Lehman in August 2008 were not unreasonable. The marks calculated by the Product Control Group presented a variance with the prices noted by the trading desk of only approximately $28 million, or 1.0% of the total value of Lehman's U.S. RWL portfolio at the time.[1881] As noted, Lehman took approximately $750 million in write-downs on its U.S. RWL portfolio during the second quarter of 2008 and an $840 million write-down during the third quarter of 2008,[1882] demonstrating a responsiveness to changing market conditions. As in May, the product controllers had very little information to rely upon in price testing U.S. RWL assets and had no option but to use information that would have been unreliable, due to its nature and limited scope, in ideal market conditions. Moreover, in August 2008, the market for RWLs was anything but ideal and Lehman's product controllers were forced to make do with the information available. The marks they determined for price testing were not unreasonable under the circumstances.

[1881] Lehman, Pricing Package Aug 08.xls (Aug. 2008), tab "Whole Loans" [LBEX-BARFID 0006669].

[1882] Lehman, Q2 08 High Level Mortgage Roll Forward(v2) [LBEX-BARFID 0011863]; Lehman, Q3 Residential Template w_Elq (v83).xls [LBEX-BARFID 0011867].

(4) Examiner's Independent Valuation of Lehman's Residential Whole Loans Portfolio

Because of the limited sales data available to Lehman to price its U.S. RWL assets in the second and third quarters of 2008, this asset class was at some risk of misstatement. In order to further assess the reasonableness of the values determined by Lehman, the Examiner requested that an independent estimate of the value of these assets be performed. This valuation does not represent the Examiner's opinion of the true value of these assets in May or August 2008, but is simply an alternate method to estimate prices of these assets, providing context in which to assess the reasonableness of Lehman's valuations. For each of four major loan types, Prime Hybrid ARM, Prime - Fixed, Subprime and Alt-A, two representative securitized deals among Lehman's recent securitizations were chosen. The deals chosen are representative of Lehman's U.S. RWL assets in May 2008 as a whole.

The representative deals identified were:

Loan Type	Representative Deals
Prime Hybrid ARMs	SARM 2008 – 02 , SARM 2007-09
Prime Fixed	LMT 2006-03, LMT 2006-04
Subprime	SASCO 2007-BC4, SASCO 2007-BNC1
Alt-A	Lehman XS Trust 07-10H, Lehman XS Trust 2007 – 17H

The Examiner chose these bonds by either looking at the Securitization Shelf Name used by Lehman's Product Control Group for each category of Whole Loans for

purposes of mock securitization,[1883] or by finding a recent vintage deal originated by Lehman with similar underlying collateral, if available.

The price of all the notes in the selected deals was then estimated using Intex, a data source provider capable of performing calculations based on user-defined inputs.[1884] For inputs, the model relied on estimates as to default rate, loss severity and prepayment rate of the underlying assets, as well as the discount yield demanded by investors. These inputs were based only on information that would have been available to Lehman's product controllers in May and August 2008. The value of all of Lehman's U.S. RWL assets as of May and August 2008 was then estimated by using the weighted average of the estimated note prices, with weights taken as the proportion of the different notes in the capital structure of the securitization.

However, the assumptions required by the analysis were made more uncertain by the distressed market conditions of 2008. While it could be assumed that the default rate, loss severity and prepayment rate of the underlying loans would be the same whether in an unsecuritized RWL or in an RMBS transaction,[1885] the yield demanded by investors for RWLs would be higher for several reasons. There are fewer potential buyers of whole loan pools than for RMBS since the latter has credit ratings, CUSIP identifiers and publicly available data from sources such as Intex. This available data

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[1883] E&Y Walkthrough Template, Residential Whole Loans, at p. 6 [EY-LE-LBHI-MC-GAMX-08-072872].

[1884] *See* Appendix 16, Valuation - Residential Whole Loans.

[1885] These inputs, which are used in pricing both RMBS and RWLs, are characteristics of the underlying mortgage loans and, by definition, are unaffected by their presence in a securitization.

provides investors significantly more information than is typically available for RWL pools. Primarily for these reasons, RWLs are less liquid than RMBS and an investor would normally demand a higher yield for RWLs than for the corresponding RMBS.[1886] However, reliable expected market yields for RWLs were not available as of mid to late 2008. Therefore, the Examiner used RMBS yields to test RWL assets. The RMBS yields used were the same ones used to test Lehman's RMBS securities, as discussed in the following Section. It is worth noting that because the Examiner's model uses RMBS yields, the resulting values effectively establish an upper limit of value based on the notion that an investor would normally require a higher yield for RWLs than for corresponding RMBS securities.

Using this approach, the Examiner estimated values for the U.S. RWL assets tested that were close to Lehman's values. Having reviewed all of Lehman's U.S. RWL assets, comprising $4.4 billion of Lehman's reported $8.3 billion in worldwide RWL assets as of May 31, 2008, the Examiner's estimated prices result in a valuation $375 million below that of Lehman.[1887]

In contrast, the Examiner's analysis suggests that the third quarter value of Lehman's U.S. RWL assets as determined by the trading desk, $2.8 billion of $6.3 billion worldwide, may have been *under*stated. Applying the same analysis to Lehman's third

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[1886] *See* Yakov Amihud *et al.*, Liquidity and Asset Prices, 1 Found. and Trends in Fin. 269, 269-364 (2005) (providing a detailed study on the relationship between liquidity and asset prices).
[1887] *See* Appendix 16, Valuation - Residential Whole Loans.

quarter U.S. RWL assets, and using August 31, 2008 RMBS yields demanded, the Examiner estimates an understatement of the value of Lehman's U.S. RWL assets of $276 million.[1888]

Because the analysis operates by estimating the average price of all RMBS bonds in a securitization to determine the value of the RWLs underlying the securitization, the accuracy of the Examiner's valuation can be gauged by looking to sales prices of securities from the very securitizations it used for price testing RWLs. There were few trades of RMBS in 2008, but the Examiner identified a few trades of RMBS from the representative securitizations he used to provide estimated prices for Lehman's U.S. RWL portfolio. The trade data identified does not provide prices for every tranche of any one securitization, as would be required to directly estimate the prices of the underlying RWLs. However, the data can be used to check the accuracy of the Examiner's estimated prices for individual tranches that were calculated as an interim step in providing a model price for RWLs. The table below provides sales prices for those tranches for which sales were identified, along with the Examiner's model price.[1889]

[1888] *Id.*

[1889] ABP Trade Database [LBEX-BARAPB 0049422].

Deal	Tranche	Examiner's Model Price	Transaction Price	Buy/ Sell	Date	Third Party
SARM 2008-2 (Prime)	A1	87.4	100	Sell	5/30/08	FHLB Seattle
	A2	87.8	88.9	Sell	5/30/08	Mutual of Omaha and United of Omaha Ins.
SARM 2007-9 (Prime)	2A1	87.3	60.25	Buy	6/24/08	Smith Breeden Assoc.
			60	Sell	6/25/08	Smith Breeden Assoc.
SASCO 2007-BC4 (Subprime)	A3	82.3	93.25	Buy	4/9/08	Morgan Stanley & Co.
			93.75	Sell	4/9/08	Merrill Lynch
			93.625	Sell	4/9/08	Merrill Lynch
			94	Sell	5/28/08	R3 Capital Management
	M1	31.8	29	Sell	6/30/08	Harbert Fund Advisors
	M2	24.6	14.5	Sell	6/30/08	Harbert Fund Advisors

As the table shows, the trades indicate prices both higher and lower than the Examiner's model prices. For example, on June 30, 2008, there was a sale of the M1 and M2 classes of the SASCO 2007-BC4 subprime securitization to Harbert Fund Advisors at prices of 29 and 14.5, respectively. The prices calculated by the Examiner for these tranches were 31.8 and 24.6, respectively, suggesting that the Examiner's prices may have been overstated. In the Prime Hybrid ARMs category, there were trades, both buy and sell, of the 2A1 class of the SARM 2007-9 securitization between Lehman and Smith

Breeden Associates on June 24 and 25, 2008. These trades were expected at prices of 60 and 60.25. The Examiner's mark for this tranche was 87.3, again suggesting that the Examiner's calculations may have been overstated.

Other trades suggest that the Examiner's model prices may have been understated. For example, some of the A1 class of the SARM 2008-2 prime securitization was sold at a price of 100 on May 30, 2008, which compares to the Examiner's price of 87.4. Similarly, some of the A3 tranche of the SASCO 2007-BC4 subprime securitization was sold on May 30, 2008, at a price of 94 to R3 Capital Management, which exceeds the Examiner's model price of 82.3.

In summary, while the trade results generally support the Examiner's estimated marks, the results also support the notion that estimating prices for these assets was difficult, and there was likely a wide range of reasonableness around the value of these assets in May and August 2008. Importantly, the fact that the Examiner's model provides a total value of Lehman's U.S. RWL portfolio less than that reported by Lehman in May 2008 but greater than that determined by Lehman in August 2008 indicates that Lehman's valuations were not uniformly aggressive.

(5) Examiner's Findings and Conclusions With Respect to the Reasonableness of Lehman's Valuation of Its Residential Whole Loans Portfolio

As noted, Lehman stopped using its own mock securitization model in May 2008 because of the declining rate of mortgage securitizations occurring at approximately

this time.[1890] For the reasons described above, this decision and the switch to a method based on comparison to recent sales prices were reasonable. The sales data that Lehman used to price test its U.S. RWL assets in May and August 2008 was thin; however, Lehman's Product Control Group had few options available for price verification at this time. Even though several of the trades used for price verification in May 2008 were later cancelled, Lehman's product controllers had no way to know this at the time they undertook the price verification process. While the August 2008 price testing process presents more serious issues, the ultimate valuations determined for the third quarter of 2008 by both the Product Control Group and the trading desk were within the range of reasonableness, and, when compared to the Examiner's model prices described above, appear understated.

The Examiner has identified evident errors and questionable judgments by the Product Control Group in connection with its price testing process for U.S. RWLs in the second and third quarters of 2008. However, evaluated in the light of the information available in May and August 2008, the Examiner concludes that there are not sufficient facts to support a finding that Lehman's valuations of its U.S. RWL assets as reported in its financial statement for the period ending May 31, 2008, and as determined by its trading desk and Product Control Group as of August 31, 2008, were unreasonable.

[1890] *See* Lehman, Valuation Review - 2nd quarter 2008 (July 2008), at pp. 8-10 [LBHI_SEC07940_750105].

h) Examiner's Analysis of the Valuation of Lehman's RMBS Portfolio

In reporting the value of its residential mortgage-related assets, Lehman distinguished between RWLs and the RMBS formed by securitization.[1891] While the valuation of RWLs during 2008 was difficult in light of the issues described above, the valuation of RMBS was more straightforward. Throughout 2008, there was a greater degree of price transparency for Lehman's RMBS assets than existed for its RWL assets. Consistent with this observation, the Examiner has not identified problems with Lehman's price testing of RMBS during this period like those which existed for RWLs. Having investigated the valuation of Lehman's RMBS portfolio during the second and third quarters of 2008, the Examiner concludes that there is insufficient evidence to support a finding that the valuation of these assets was unreasonable.

As described above, RMBS are a form of bond backed by loans to residential property owners. To create RMBS, the sponsor of an RMBS transaction, often an investment bank such as Lehman, will set up a SPE, identify a group of RWLs and sell the RWLs owned by the bank to the SPE. The SPE, in turn, receives its funds for the purchase of the RWLs from the investors' purchases of the RMBS. These RWLs produce the cash flow to pay interest and principal under the RMBS issued by the SPE. RMBS are generally formed as tranches with claims on the interest and principal payments of varying seniority; thus, investors holding securities from senior tranches

[1891] LBHI 10-Q (filed July 10, 2008), at pp. 69-70.

are repaid before those holding the junior tranches. In this manner, the senior tranches are designed to be the least risky while junior tranches carry the most risk. To compensate for the higher level of risk borne by the junior tranches, these securities offer higher coupon payments and/or lower prices.

As noted, the pace of securitization of RWLs into RMBS slowed significantly in 2008.[1892] However, throughout 2008, Lehman still held many RMBS previously securitized by itself and other investment banks. Lehman held $18.2 billion in RMBS on February 29, 2008, $12.4 billion of which consisted of U.S. RMBS.[1893] On May 31, 2008, Lehman's RMBS portfolio had declined to $14.4 billion, $8.5 billion of which consisted of U.S. RMBS.[1894] By August 31, 2008, the value of Lehman's RMBS portfolio had further declined to approximately $8.3 billion, $4.1 billion of which consisted of U.S. RMBS.[1895] These values represent Lehman's entire portfolio of non-CDO securities related to

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[1892] Examiner's Interview of Joseph Sapia, Oct. 26, 2009, at p. 2; Securities Industry and Financial Markets Association, Mortgage-Related Issuance (1996 - June 2009), *available at* http://www.sifma.org/research/pdf/Mortgage_Related_Issuance.pdf (last visited Feb. 3, 2010) (showing issuance of non-agency mortgage-backed securities fell from approximately $774 billion in 2007 to $41 billion in 2008); Luo Jun, *Credit Crisis Will Extend Into 2009, Oppenheimer Says (Update 1)*, Bloomberg.com, May 20, 2008, *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=aAMUjyxli6Lc (last visited Feb. 3, 2010) (noting the "shut down in the securitization market").

[1893] LBHI 10-Q (filed July 10, 2008) at pp. 69-70. As with other asset classes, information regarding the valuation and price testing of European and Asian RMBS assets is not available. Accordingly, the Examiner draws no conclusions regarding the reasonableness of the marks applied to these assets by Lehman in 2008.

[1894] *Id.*

[1895] Lehman, Q3 Residential Template w_Elq (v83).xls, tab "Q3 Trade Data" [LBEX-BARFID 0011867].

residential mortgage loans, as reported in its quarterly Form 10-Q statements and reflected in its third quarter Product Control price testing spreadsheets.[1896]

Thus, during the second quarter of 2008, the value of Lehman's U.S. RMBS portfolio fell by approximately $3.9 billion due to a mix of write-downs and sales. Of this decline, approximately $1.0 billion was due to write-downs.[1897] Similarly, during the third quarter of 2008, the value of Lehman's U.S. RMBS portfolio fell by approximately $4.4 billion, of which $2.3 billion was due to write-downs.[1898] The write-downs Lehman took on these assets throughout the year reflect its recognition of the changed market conditions of 2008 and an acknowledgment of the diminishing value of its U.S. RMBS assets.

As with RWLs, the asset values Lehman reported on its balance sheet for its RMBS portfolio were those reported by its trading desks.[1899] These marks were subject to revision pursuant to the price testing process described below.[1900] Unlike with RWLs, the pricing of which was done manually, the pricing of RMBS was an automated

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[1896] Lehman did not file a quarterly report for the third quarter of 2008 before filing for bankruptcy. Accordingly, information regarding this period is obtained from data compiled by the Product Control group for price testing purposes.

[1897] Lehman, Q2 08 High Level Mortgage Roll Forward (v2).xls.pdf [LBEX-BARFID 0011863].

[1898] Lehman, Q3 Residential Template w_Elq (v83).xls, tab "Q3 Trade Data" [LBEX-BARFID 0011867].

[1899] Examiner's Interview of Usman Babar, Oct. 16, 2009, at pp. 3-4.

[1900] Lehman, Price Verification Policy Global Capital Markets 2008 [Draft], at p. 4 [LBHI_SEC07940_2965994].

process, meaning that the prices provided by the trading desks were standardized across desks.[1901]

As with any asset, the preferred strategy for performing valuation of RMBS is to look to recent trade prices to determine the market value. If recent trade data is not available, models are used to price RMBS; most models function in a similar manner. Though different RMBS bonds vary considerably in level of risk and remaining average life, the common structure of RMBS allows for a relatively standardized valuation process. The key feature of RMBS for valuation purposes is the tranche structure and the associated cash flow waterfall. Once this information, which is available from vendors, is obtained, the only remaining step is for the price tester to apply assumptions regarding the underlying RWL collateral. These assumptions include: (i) the expected default rate, (ii) loss severity expectations, and (iii) expected rates of prepayment. These inputs, along with information about the tranche structure of the RMBS, provide estimates of the cash flow produced by the RMBS. After these cash flows are calculated, the party performing valuation need only take into account the yield demanded by investors in the market to determine the price at which the RMBS could be sold.

Analysts reach different conclusions regarding the value of a given RMBS bond only if they apply different assumptions regarding these variables. Accordingly, the major issue in price testing RMBS is the selection of proper assumptions to use as inputs

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[1901] Examiner's Interview of Joseph Sapia, Oct. 26, 2009, at p. 4.

in the price testing process. In price testing RMBS, Lehman's Product Control Group confirmed the reasonableness of the assumptions applied by the trading desks.[1902]

The primary model used by Lehman to value RMBS in 2008 was the Intex waterfall engine, the same model used for the mock securitization model described above. Intex is a software tool, publicly available for a subscription fee, which can be used to analyze structured finance transactions. This tool incorporates underlying collateral information and information regarding the tranche structure of many publicly traded RMBS, and projects the cash expected to flow to different tranches under different assumptions applied to the RWL collateral. In performing mock securitization valuation of RWL assets, the value of all RMBS in a securitization is estimated and then, by estimating the costs associated with securitization and profits expected by the originator, the relationship of this value to the value of the underlying RWL can be determined. Because the valuation of RMBS does not require this additional step, and because it does not assume a functioning securitization market, this asset class presents a less complicated valuation exercise than do RWLs.

Price testing for RMBS can also be performed through comparison to recent trade data and third-party prices. Unlike RWLs, where each pool of loans is inevitably unique even within broad categories (*e.g.*, Prime, Alt-A and Sub-prime), bonds from the same tranche of the same RMBS securitization are identical. Therefore, when available,

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[1902] *Id.*

the prices at which these bonds trade on the secondary market provide a readily observable indicator of the value of RMBS. Additionally, compared to RWLs, there are more identifiable trades of RMBS providing pricing information.[1903] Accordingly, since the secondary market for RMBS is more robust than the market for RWLs, the pricing of RMBS is more straightforward, and a greater degree of price transparency exists, than for RWLs. The stated policy of Lehman's Product Control Group was to price test approximately 60% of Lehman's Prime and non-Prime RMBS using recent trade prices or using Intex.[1904] The other 40% of RMBS, for which there was no trade or Intex data available, were to be price tested by means of third-party prices.[1905]

As with other asset classes, Lehman identified certain tolerances within which variances between the desk prices and Product Control prices would be deemed acceptable for RMBS. The acceptable tolerances were defined by a "tolerance matrix" that took into account whether the collateral backing the RMBS were agency, prime or non-prime loans, and which of several tranche categories the bonds fell into.[1906] The

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[1903] This is a direct result of the fact that securitization improves liquidity. Since the securitization of RWL pools into RMBS transactions enhances liquidity, it follows that the number of identifiable RWL trades would be small in comparison to RMBS. *See* Peter J. Elmer, *Conduits: Their Structure and Risk*, F.D.I.C. Banking Rev., Dec. 1999, at pp. 27, 32.

[1904] Lehman, Price Verification Policy Global Capital Markets 2008 [Draft], at pp. 62, 64 [LBHI_SEC07940_2965994].

[1905] *Id.*

[1906] *Id.* at p. 61.

categories of bonds included: Interest Only, Principal Only, Inverse, Zero-Coupon, Subordinate, Mezzanine and Supplemental.[1907]

The pace of trading RMBS on the secondary market also slowed considerably in 2008.[1908] This meant that it was difficult for Lehman's trading desks and Product Control Group to gather the information necessary to price RMBS by means of recent trade data. Additionally, while there were still third-party sources providing prices for RMBS, these sources were not as readily available or as reliable as they would be in a normally functioning market. Lehman's Product Control Group did use third-party sources in performing its price testing of RMBS in 2008, but it also relied heavily on Intex to model RMBS cash flows to determine the value of the bonds.[1909] Additionally, the Product Control Group simply noted the valuations of many RMBS bonds — mainly from the IO and subordinate tranches — as "ok," because the trading desks had marked them down so significantly that their market value was immaterial.[1910] Among RMBS bonds backed by sub-prime RWL collateral, the trading desks marked the

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[1907] *Id.*

[1908] Examiner's Interview of Joseph Sapia, Oct. 26, 2009, at p. 2.

[1909] Lehman, 5-30-08 PRICING.xls [LBEX-BARFID 0002548]; Lehman, 08-29-08 PRICING.xls [LBEX-BARFID 0004120].

[1910] Lehman, 5-30-08 PRICING.xls [LBEX-BARFID 0002548]; Lehman, 08-29-08 PRICING.xls [LBEX-BARFID 0004120].

majority down to prices less than 10% of their notional value, and in many cases to prices of just a few cents on the dollar.[1911]

Of Lehman's 80 largest RMBS positions by exposure amount on May 31, 2008, 54 were also held by Lehman on August 31, 2008.[1912] Lehman's Product Control Group price tested these positions using a variety of methods as summarized in the table below.[1913]

Product Control Group Testing Method	May 2008 positions tested (#)	May 2008 positions tested ($million)	Aug 2008 positions tested (#)	Aug 2008 positions tested ($million)
Intex	41	768.5	44	650.5
Third-party quote	8	71.6	4	21.8
Trade data	2	154.4	0	0
Intex/Third-party quote mix	1	49.5	0	0
Immaterial	1	0.2	2	1.0
Other	1	149.8	4	290.1
Total	**54**	**1,194.0**	**54**	**963.4**

As this table shows, the primary method used by the Product Control Group for price testing in May and August 2008 was the Intex model. Third-party quotes and trade data were also used but to a much lesser extent.

[1911] Lehman, 5-30-08 PRICING.xls [LBEX-BARFID 0002548]; Lehman, 08-29-08 PRICING.xls [LBEX-BARFID 0004120].

[1912] This information was obtained from Lehman's GFS and GQuest systems.

[1913] Lehman, 5-30-08 PRICING.xls [LBEX-BARFID 0002548]; Lehman, 08-29-08 PRICING.xls [LBEX-BARFID 0004120]. The market values of the positions were obtained from the GFS system. The Other methods included using average prices from other securities, was using a method called "1x multiple," and two marks in August were assigned a value of 0 with a note to follow up with the trade desk.

In order to further assess the reasonableness of the values determined by Lehman, the Examiner performed a valuation of a sample of Lehman's RMBS positions. This valuation does not represent the Examiner's opinion of the value of these assets during May and August 2008, but rather is intended only to provide context in which to evaluate the reasonableness of Lehman's valuations of its RMBS portfolio. The Examiner valued each of the 54 positions noted above, those of the 80 largest RMBS positions that Lehman held on both May 31, 2008 and August 31, 2008, using the Intex model. As previously noted, in determining inputs for the Intex model the reported historical rates of prepayment, default and loss severity serve as a starting point. In order to calculate the present value of RMBS, a user must make assumptions regarding future prepayment rates, default rates and loss severity. For the Examiner's valuation, these assumptions were determined by considering the observed performance of residential mortgages in May and August 2008 as reported by industry research at the time.[1914] Using the actual rates and loss severity as a basis, the Examiner estimated what rates and loss severity market participants would have expected going forward from May and August 2008. The Examiner also estimated the yield that investors would have required for RMBS bonds.

The following tables present the inputs applied by the Examiner in valuing the 54 Lehman RMBS positions identified.

[1914] *See* J.P. Morgan, SOS - Summary of Subprime, Alt-A, Prime Jumbo (May 22, 2009), at pp. 1-3.

The Examiner's Assumptions for Valuation as of May 2008

Product Type	Prepayment Rate	Default Rate	Loss Severity (1st/2nd Lien)	Resulting Losses	Yield
Prime	15%	5%	50% / 100%	High single digits	10%
Alt-A	10%	10%	50% / 100%	High teens – Low 20s	15%
Subprime	5%	15%	50% / 100%	Mid 30s	20%

The Examiner's Assumptions for Valuation as of August 2008

Product Type	Prepayment Rate	Default Rate	Loss Severity (1st/2nd Lien)	Resulting Losses	Yield
Prime	15%	5%	50% / 100%	High single digits	10%
Alt-A	10%	10%	50% / 100%	High teens – Low 20s	15%
Subprime	4%	17%	50% / 100%	Mid - High 30s	20%

Applying these assumptions to the 54 Lehman RMBS positions identified, and using Intex to perform a valuation, the Examiner calculated a total value for these bonds close to that determined by Lehman. The table below provides a comparison of the valuations for these assets in May and August 2008.

	Lehman Total Market Value ($ billion)	Examiner's Estimated Total Market Value ($ billion)
May 2008	1.19	1.14
Aug 2008	0.97	1.04

In aggregate, the Examiner's estimated valuation was 4.1% lower than that of Lehman in May 2008 and 7.1% higher than that of Lehman in August 2008. However, the range of results with respect to any particular RMBS was, in some cases,

significantly wider. For individual RMBS bonds, the Examiner's estimated values in May 2008 ranged from 58% less than Lehman's value at the low extreme to 129% more at the high extreme. In August 2008, the Examiner's values ranged from 80% less at the low extreme to 70% more at the high extreme. However, these differences in valuation are not inconsistent with reasonable differences in estimates of prepayment rate, default rate, loss severity and yield. Furthermore, the fact that the Examiner's valuations fall both above and below those of Lehman suggests that Lehman's valuations were not uniformly aggressive or uniformly conservative. Despite these wide ranges, because the Examiner's estimates were not consistently above or below the Lehman marks, in aggregate the differences in valuation were not significant.

As described, RMBS do not present the same valuation challenges that arise in attempting to value RWLs. Even without bond-specific trade data or third-party pricing information, the Intex model provided a reasonable method for estimating the value of these assets in the unprecedented market conditions of 2008. Of course, the model remains sensitive to the assumptions used as inputs, but industry reports provide some guidance regarding conventional wisdom in the industry as to these inputs throughout 2008. Although these assumptions may not have accurately predicted ultimate residential mortgage loan performance, it would be reasonable for one to have relied on them for valuation purposes at the time. Furthermore, Lehman acknowledged the falling value of these assets throughout 2008, as reflected by the

write-down of $1.0 billion it took on its RMBS portfolio in the second quarter of 2008 and the $2.3 billion write-down it took in the third quarter of 2008. In light of the foregoing, the Examiner has not found evidence sufficient to support a finding that Lehman's valuation of its RMBS portfolio in 2008 was unreasonable.

i) Examiner's Analysis of the Valuation of Lehman's CDOs

Collateralized debt obligations ("CDOs") are a form of asset-backed security ("ABS") backed by a portfolio of fixed-income securities such as RMBS, commercial mortgage-backed securities ("CMBS") or corporate bonds and loans.[1915] CDOs backed by RMBS are typically referred to as "ABS CDOs", while CDOs backed by CMBS are typically referred to as "CRE CDOs." To create CDOs, an originator, often an investment bank such as Lehman, will set up a special purpose entity ("SPE"), identify a group of debt obligations sharing certain characteristics, such as debt rating, and either transfer to the SPE conforming debt obligations owned by the bank or use investors' funds to purchase such obligations. Those debt obligations produce the cash flow to pay interest and principal under the CDOs issued by the SPE. CDOs are divided into tranches and interest and principal payments are made in order of seniority; thus,

[1915] Broadly defined, the term CDO includes Collateralized Loan Obligations ("CLO") and Collateralized Bond Obligations ("CBO"), which are also considered in this Section, but are not treated as distinct asset classes. As a general matter, CLOs and CBOs have the same basic structure as CDOs, the difference being that CLOs are backed by corporate loans and CBOs by corporate bonds. For the purposes of this Section, the term "CDO" includes CLOs and CBOs unless otherwise noted. For financial reporting purposes, Lehman grouped CDOs with other asset backed securities in a category it termed "Other Asset Backed." For valuation purposes, Lehman tested each ABS position (including CDO positions) separately, but the overall methods were similar across ABS classes.

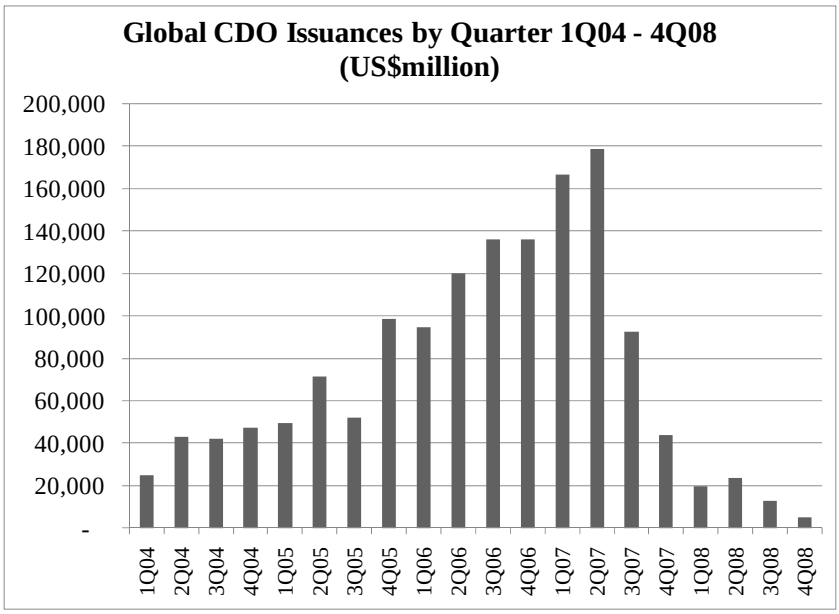
investors holding securities from senior tranches are repaid before those holding the junior tranches. In this manner, the senior tranches are designed to be the least risky and junior tranches are designed to carry the most risk. To compensate for the higher level of risk borne by the junior tranches, these securities offer higher coupon payments and/or lower prices.

The assets underlying the CDOs issued by Lehman were primarily RMBS, CMBS and other asset-backed securities.[1916] Lehman originated $16.2 billion of CDOs in fiscal year 2006, $25.0 billion in fiscal year 2007, and $17.0 billion in fiscal year 2008.[1917] This 2008 decline is generally consistent with, but not as drastic as, the decline in the global CDO market, as the following chart indicates.[1918]

[1916] Lehman Brothers Holdings Inc., "05-30-08 PRICING.xls" [LBEX-BARFID 0002548].

[1917] The data for this chart was compiled by the Examiner's financial adviser from commercially available sources.

[1918] Securities Industry and Financial Markets Association, Global CDO Market Issuance Data (fourth quarter 2008), *available at* http://www.sifma.org/research/pdf/CDO_Data2008-Q4.pdf (last visited Feb. 3, 2010) .



Notwithstanding the billions of dollars worth of CDOs that Lehman originated, from 2006 to 2007 Lehman accounted for only 3% of the total value of new CDO issuances.[1919] Lehman identified its key operating tenet regarding CDOs as "distribute not retain," meaning that it would "move - not warehouse - risk," and minimize its own CDO holdings.[1920] Lehman reported holding CDOs with a value of approximately $1.2 billion as of May 31, 2008, and $0.9 billion as of August 31, 2008.[1921] Because the positions held in Lehman's CDO portfolio were primarily ABS/CRE CDOs, backed by

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[1919] Lehman, Lehman Brothers ABS CDO Exposure (Nov. 1, 2007), at pp. 5-6 [LBEX-BARFID 0011553].

[1920] *Id.* at p. 5.

[1921] These figures represent the CDO positions identified by Lehman's Product Control group for price verification purposes. *See* Lehman, 05-30-08 PRICING.xls [LBEX-BARFID 0002548]; Lehman, 08-29-08 PRICING.xls [LBEX-BARFID 0004120]. Some Lehman securitizations, such as Pine, Spruce and Verano, would qualify as CDOs or CLOs, but are represented for balance sheet and valuation purposes by the underlying collateral (mostly non-investment-grade bank loans) rather than by CDO/CLO tranches. *See* Lehman, Loans PxTesting_053108–final.xls [LBEX-BARVAL 0061231]. The Examiner located supporting documentation for the U.S. CDO balances noted, but estimates that another $400 million in Non-U.S. CDO assets are on Lehman's balance sheet based on a review of CUSIPs, though no supporting documents have been located to support this estimate.

RMBS and CMBS, they were subject to the disruptions in the credit markets and deteriorating value of mortgages and mortgage-linked securities that occurred in 2007 and 2008.[1922] As the market deteriorated, Lehman was unable to sell subordinate pieces of securitizations, and many of Lehman's CDO positions were such pieces.[1923] However, much of Lehman's CDO portfolio was made up of senior tranches of securitizations that it created in 2007 and 2008 and was unable to sell.[1924]

Between the first and second quarters of 2008, Lehman wrote down the value of its ABS/CRE CDO portfolio by $168 million on a gross basis ($97 million net), leaving $834 million on the balance sheet excluding hedges.[1925] Between the second and third quarters, Lehman further wrote down the value of its ABS/CRE CDO portfolio by another $178 million gross ($99 million net) leaving $489 million on the balance sheet

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[1922] The term "position" is used to refer to a pool of like securities from the same tranche of a securitization. Additionally, the term is sometimes used to refer to the market value of the pool.

[1923] Diane Hinton, S&P, Liquidity Management In Times Of Stress: How The Major U.S. Broker-Dealers Fare, Nov. 2007, S&P RatingsDirect, at pp. 2-3 [LBHI_SEC07940_439424] ("Recent disruptions in the subprime market and its contagion effects into the leveraged finance, asset-backed commercial paper (ABCP), and CDO spaces have substantially curtailed market liquidity."); Timothy Geithner, FRBNY President, Transcript of Remarks to The Economic Club, Reducing Systemic Risk In A Dynamic Financial System (June 9, 2008), http://www.newyorkfed.org/newsevents/speeches/2008/tfg080609.html ("The funding and balance sheet pressures on banks were intensified by the rapid breakdown of securitization and structured finance markets. Banks lost the capacity to move riskier assets off their balance sheets, at the same time they had to fund, or to prepare to fund, a range of contingent commitments over an uncertain time horizon.").

[1924] Over one-third of the total value of Lehman's May 2008 CDO portfolio was comprised of Ceago, a 2007 securitization that Lehman was unable to sell. *See* Lehman, 05-30-08 PRICING.xls, tab "ABS Secondary," [LBEX-BARFID 0002548].

[1925] Lehman, Write downs, Key Exposures & Level 3 Assets – 2Q 2008 (July 15, 2008), at p. 1 [LBHI_SEC07940_167791]. Note that this number includes both U.S. and European assets.

excluding hedges.[1926] These write-downs are generally consistent with what was occurring in the market as ABS/CRE CDOs were experiencing increasing numbers of events of default.[1927] For example, of the $431 billion of ABS/CRE CDOs originated in 2006-2007, more than half had experienced events of default by November 2008, with increasing numbers of defaults over time.[1928]

The Examiner's analysis of the reasonableness of Lehman's valuation of its CDO positions begins by describing Lehman's process for valuing CDO assets, with particular attention to the price verification procedure of Lehman's Product Control Group, and the E&Y review of that process. Next, Lehman's largest CDO position, Ceago, is addressed. While the super-senior Ceago tranche was appropriately valued, the most junior of the Ceago subordinate tranches, together a relatively small portion of the whole, were not accurately valued. In order to provide further context in which to assess the reasonableness of Lehman's CDO valuations, a sample of Lehman's CDO portfolio is valued by means of an alternate method, with particular attention paid to the most junior Ceago subordinate tranches. While the Examiner's investigation has

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[1926] Lehman, Write downs, Key Exposures & Level 3 Assets – Q3 FINAL (Sept. 11, 2008), at p. 6 [LBHI_SEC07940_828711]. Note that this number includes both U.S. and European assets.

[1927] An event of default typically occurs in an ABS CDO due to ratings downgrades of the underlying collateral. When an event of default occurs, a CDO may either accelerate all cash payments to the AAA controlling investor, liquidate the CDO, or remain in default with cash flows per the waterfall priority. In all cases, the impact is a large reduction in cash flow and value for tranches beneath the most senior tranche of the CDO. Additionally, the most senior tranche may not recover its par amount if the collateral values have fallen significantly.

[1928] J.P. Morgan, US Fixed Income Markets 2009 Outlook, Collateralized Debt Obligations (Nov. 28, 2008), at p. 1.

produced evidence that Lehman's price verification process for CDOs was not particularly robust, given the lack of information available and the condition of the CDO market during second and third quarters of fiscal year 2008, the Examiner does not find evidence to support a finding that Lehman's valuations of CDOs as of these dates were unreasonable.

(1) Lehman's Price Testing Process for CDOs

The asset values Lehman reported on its balance sheet for CDOs were the marks reported by its traders.[1929] Each trader used his or her own method for pricing assets and there was no uniformity across trading desks as to methodology.[1930] In order to provide a check on the marks reported by the traders for each position (commonly referred to as "desk marks"), Lehman's Valuation Control group, a part of the Product Control Group, performed an independent price verification of CDO assets.[1931] The Product Control Group performed price verification procedures on a monthly basis, and particular attention was paid to testing the marks at quarter-end.[1932] In doing so, the Product Control Group relied on several different methods for price testing CDOs. The preferred method was to use executed trade activity to provide a basis for

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[1929] Examiner's Interview of Usman Babar, Oct. 16, 2009, at pp. 3-4.
[1930] Examiner's Interview of Brian Sciacca, Oct. 19, 2009, at pp. 2-5.
[1931] Lehman, Valuation Review - 2nd Quarter 2008, at p. 3 (July 2008) [LBHI_SEC07940_750107] (listing "Product Control Core Functions").
[1932] *Id.*

valuation.[1933] Typically, prices from trades that occurred four to six weeks prior to the month end were considered reasonable to use for this purpose. However, if markets were so volatile that these trades would be considered stale by month end, trades closer to the valuation date were used to provide a more accurate basis for valuation.[1934] If there was no recent trade activity with which prices could be verified, the Product Control Group looked to external prices obtained from third-party providers such as Bloomberg, Markit Group Limited ("Markit") and other sources.[1935]

Illiquid products for which recent trade activity or third-party prices are not available are classified as Level 3 assets pursuant to SFAS 157.[1936] For these assets, the Product Control Group performed an independent valuation of the position's mark by using a model. The group's Policy & Procedures document identifies the primary tool used for this modeling as the Intex cash flow engine, a program widely used for modeling CDO cash flows.[1937] However, the Examiner's interviews with product controllers indicated that those controllers responsible for price testing CDOs regarded Intex as unreliable and did not typically use it to price CDOs.[1938] Instead, some positions were price tested by using interest-only models or by estimating the value of the

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[1933] Lehman, CDO Price Verification Policy & Procedure (Jan. 24 2008), at p. 3 [LBHI_SEC07940_4228808].
[1934] *Id.*
[1935] *Id.* at pp. 2-4. Additionally, where Lehman hedged a position and the marks on the two positions were the same, the product controllers considered the price to be val*Id.*
[1936] *See* SFAS No. 157, Fair Value Measurements, at SFAS 157-6.
[1937] Lehman, CDO Price Verification Policy & Procedure (Jan. 24, 2008), at p. 4 [LBHI_SEC07940_4228808].
[1938] Examiner's Interview of Brian Sciacca, Oct. 19, 2009, at p. 4.

underlying assets held by the SPE that issued the CDOs.[1939] Product controllers used various inputs, such as spreads based on collateral type, that were published by JPMorgan, along with prepayment, default and recovery assumptions obtained from other providers, to calculate the mark for each asset tested.[1940] Additionally, the LehmanLive CDO calculator, which received an Intex feed and a pricing feed to determine the net asset value of a given tranche, was used in some cases. Finally, interest-only analysis or pricing from ABX indices were used as last options to value CDOs.[1941]

After Product Control determined its estimated mark for a CDO position, it would compare its mark to that of the desk. Where a variance exceeded the applicable threshold, Product Control would discuss the variance with the appropriate trader.[1942] The product controller and the trader would discuss how each derived their respective marks and would attempt to resolve the variance by agreeing on either the desk mark or the Product Control mark. In attempting to resolve the variance, the parties would consider market conditions, the quality of the vendors from whom pricing information

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[1939] *See* Lehman, Ceago & Ballyrock Subs 5-30-08.xls, at tab "IO Analysis," [LBEX-BARFID 0010998]. Because of the relatively small size of Lehman's CDO portfolio, the Examiner did not investigate each of the models used, but focused on those used for the largest positions held by Lehman.

[1940] Lehman, CDO Price Verification Policy & Procedure (Jan. 2008), at p. 4 [LBHI_SEC07940_4228809].

[1941] *Id.*

[1942] The applicable variance threshold for CDOs was $400,000 for SFAS 157 Level 1 and 2 securities, and $300,000 for SFAS 157 Level 3 securities. *Id.*

was received, traders' track records and the size of the position and the variance.[1943] If the product controller and the trader could not resolve the variance, the issue would be escalated by Product Control to senior finance management, who would discuss the variance with their counterparts on the trading desk.[1944] Brian Sciacca, a former Vice President and Head of the Credit Valuation group, stated in an interview that some traders were more open to discussing variances with product controllers than others.[1945] Sciacca recalled one instance in which an issue regarding unresolved variances for bank loan marks was escalated to senior management. He described the outcome as a "rude awakening" for the trader and an education on the necessity of write-downs.[1946] However, Sciacca also stated that no one trader stood out in his memory as being particularly recalcitrant in conversations with product controllers about variances.

At the conclusion of each monthly price verification process, assets for which there were variances were either remarked by the desk or the Product Control Group determined that the desk price was reasonable. The Product Control Group then prepared monthly price verification variance reports setting forth the largest variances by asset class and noting whether the desk remarked the asset. If a material variance

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[1943] Lehman, CDO Price Verification Policy & Procedure (Jan. 24, 2008), at p. 4 [LBHI_SEC07940_4228809]; Examiner's Interview of Brian Sciacca, Oct. 19, 2009, at p. 4.

[1944] Lehman, CDO Price Verification Policy & Procedure (Jan. 24, 2008), at p. 4 [LBHI_SEC07940_4228809]; Brian Sciacca also described escalating variances to Clement Bernard, former CFO, Fixed Income Division. Examiner's Interview of Brian Sciacca, Oct. 19, 2009, at p. 4.

[1945] Examiner's Interview of Brian Sciacca, Oct. 19, 2009, at p. 4.

[1946] *Id.*

did not result in a write-down of the asset, the report included an explanation as to why the desk price was acceptable. These reports were distributed to Product Control management and the trading desk.[1947]

While the function of the Product Control Group was to serve as a check on the desk marks set by Lehman's traders, the CDO product controllers were hampered in two respects. First, the Product Control Group did not appear to have sufficient resources to price test Lehman's CDO positions comprehensively. Second, while the CDO product controllers were able to effectively verify the prices of many positions using trade data and third-party prices, they did not have the same level of quantitative sophistication as many of the desk personnel who developed models to price CDOs.

Regarding its limited resources, in its May 2008 Valuation and Control Report, the Product Control Group noted that CDOs were an asset class at high risk of misstatement because of a large review backlog of 250 trades and inefficient data preparation.[1948] These issues would have limited the ability of the product controllers to use recent trade data for price verification. However, it is unclear whether these issues had much impact by May 2008, at which time there was very little trade activity upon which to rely. This report also states that the Product Control Group deemed super-senior tranches of CDOs and CLOs to be at a medium risk of misstatement because they

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[1947] *Id.*

[1948] Lehman, Valuation & Control Report - Fixed Income Division (May 2008), at p. 27 [LBHI_SEC07940_2962709].

were not fully tested and residuals to be at a medium risk of misstatement due to poor coverage.[1949] These problems were not resolved by August 2008, as the same issues are indicated in the August Valuation & Control report.[1950] In May 2008, the Product Control Group noted that it was able to price test 78% of Lehman's CDO positions.[1951] However, it appears that the actual percentage of positions tested may have been much lower.

A review of the Product Control spreadsheets used for May 2008 price testing reveals that approximately half of Lehman's CDO positions were price tested using one of the preferred methods described in the Product Control Group's Policy & Procedures document. A pricing spreadsheet for CDOs shows that the group used prices from third-party providers to verify the prices of approximately 10% of CDO positions and used a "model price" for approximately 37%.[1952] However, approximately a quarter of Lehman's CDO positions were not affirmatively priced by the Product Control Group, but simply noted as "OK" because the desk had already written down the position significantly.[1953] For these positions, the Product Control Group noted that the desk

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[1949] *Id.* at p. 28.

[1950] Lehman, Valuation & Control Report - Fixed Income Division (Aug. 2008), at pp. 28-29, [LBEX-BARFID 0000257].

[1951] Lehman, 05-30-08 PRICING.xls, tab "ABS Secondary Control Tab" [LBEX-BARFID 0002548]. Note that this is the number of distinct positions, unweighted by position size.

[1952] *Id.* at tab "ABS Secondary." The spreadsheet also shows certain positions for which product controllers had a third-party price but elected not to use it in favor of a higher model price or noted only that the desk had already marked down the position significantly.

[1953] *Id.* On this spreadsheet, these positions are not assigned any model price or third-party price, but are simply noted as being: "OK, distressed market bond has been written down."

price fell below a certain threshold and thus concluded that it required no further review. With only two exceptions, the desk marks given to these positions were less than 10% of par, and in many cases were essentially zero.[1954] The total value of the 35 positions marked in this fashion was approximately $9 million.[1955] Accordingly, it was reasonable for the Product Control Group to have concluded that these positions were so small as to be immaterial and thus not worth expending limited resources to price test. The Product Control Group considered these positions reviewed and they are included in calculating that 78% of CDO positions were reviewed in May 2008. If they are counted as not reviewed, then approximately half of Lehman's CDO portfolio was unreviewed in May 2008.

The effectiveness of the Product Control Group was also limited because it did not have the technical sophistication to develop complex models for pricing CDOs, as did certain of the desk personnel (commonly referred to as "quants") they were charged with monitoring.[1956] Sciacca, a former Vice President and Head of the Credit Valuation group, described their respective roles by explaining that the desk developed models for pricing CDOs, which were checked and approved by the Model Validation group.[1957] The Product Control Group did not have their own models, and did not have the ability to develop or evaluate the type of models being used by Lehman's desk traders.

[1954] Lehman, 05-30-08 PRICING.xls, tab "ABS Secondary" [LBEX-BARFID 0002548].
[1955] *Id.*
[1956] Examiner's Interview of Brian Sciacca, Oct. 19, 2009, at p. 6.
[1957] *Id.*

Instead, the CDO Product Control Group limited itself to checking the inputs used by the desk to determine whether they were reasonable and using the other price verification methods described above. Sciacca explained his deference to the models developed by the desks by simply stating: "[W]e're not quants."[1958]

The Examiner also reviewed work papers from E&Y's 2007 annual audit and 2008 quarterly reviews. In its 2007 annual review, E&Y examined Lehman's Product Control modeling process for CDOs as well as model inputs.[1959] E&Y noted that "there was much illiquidity in the CDO market during the latter half of 2007" and stated that neither Lehman nor it were able to obtain market prices for CDOs from vendors.[1960] E&Y observed that Lehman's Product Control Group relied on two methods for price testing CDOs: comparison to recent trade activity and Intex modeling.[1961] Reviewing CDO positions comprising between 75% and 80% of Lehman's total CDO population, E&Y concluded that the control was operating as designed and that the value of Lehman's CDO portfolio was fairly stated as of November 30, 2007.[1962] In preparing its second quarter 2008 Summary Review Memorandum, E&Y observed and interviewed

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[1958] *Id.*

[1959] Stephanie L. Weed, *et al.*, E&Y, Memorandum to Files: CDO Valuation Approach (Jan. 21, 2008), at p. 1 [EY-SEC-LBHI-ABS 000063].

[1960] *Id.* at p. 7.

[1961] *Id.* The observation that the Product Control group used Intex is consistent with Lehman's CDO Price Testing Policy and Procedure document, but is contradicted by statements made in an interview with a CDO product controller. Examiner's Interview of Brian Sciacca, Oct. 19, 2009, at p. 4; *see* Lehman, CDO Price Verification Policy & Procedure (Jan. 24, 2008), at p. 4 [LBHI_SEC07940_4228809].

[1962] Lehman, CDO Price Verification Policy & Procedure (Jan. 24, 2008), at pp. 7-8 [LBHI_SEC07940_4228809]

Lehman product controllers, focusing on the reasonableness of the product control process and not the specific valuations produced.[1963] The stated purpose of the quarterly review was to "provide [E&Y] with a basis for communicating whether [they were] aware of any material modifications that should be made to the Company's interim financial information for it to conform with generally accepted accounting principles."[1964] After observing Lehman's Product Control process for CDOs and noting the write-downs Lehman had taken on its CDO portfolio, which included the super-senior tranche of the Ceago securitization, described below, E&Y did not identify any necessary material modifications.[1965] While this did not constitute approval of the particular valuations reported, it did reflect the reasonableness of Lehman's Product Control process as a whole.[1966]

(2) Price Testing Results for the Second and Third Quarters 2008

The following table summarizes the results of the Product Control Process for CDOs, CLOs and CBOs for the second quarter of 2008.

[1963] E&Y's quarterly reviews were of a more limited scope than a full audit and consisted of "applying analytical review procedures and making inquiries of persons responsible for financial and accounting matters." E&Y, Lehman Brother's Holdings Inc. Summary Review Memorandum, Consolidated Financial Statements, Quarter-ended May 31, 2008 (Aug. 8, 2008), at p. 2 [EY_SEC_LBHI-WP-2Q08 000119].

[1964] *Id.*

[1965] *Id.* at pp. 7-8, 17.

[1966] *Id.*

U.S. Positions as of May 31, 2008[1967]

	Market Value ($000)	Number of Positions	Number of Positions Tested[1968]	Variance between PC and Desk ($000)	% Variance
CDOs	679,362	93	73	(21,867)	-3.22%
CLOs	447,610	23	18	(32)	-0.01%
CBOs	53,764	11	5	(4)	-0.01%
Total	1,180,735	127	96	(21,903)	-1.86%

As the table shows, the desk valuation of the CDOs tested was approximately 3% higher than the Product Control valuation for the positions tested, and there was virtually no variance in the pricing of CLOs and CBOs.[1969]

The following table summarizes the results of the Product Control Process for CDOs, CLOs and CBOs for the third quarter of 2008.

U.S. Positions as of August 31, 2008[1970]

	Market Value (US$000)	Number of Positions	Number of Positions Tested	Variance between PC and Desk ($000)	% Variance
CDOs	510,837	67	64	(40,284)	-7.89%
CLOs	329,932	16	4	(796)	-0.24%
CBOs	50,103	9	5	(993)	-1.98%
Total	890,872	92	73	(42,073)	-4.72%

The variances between Lehman's desk and Product Control prices increased from May 2008 to August 2008. The variance in ABS/CRE CDOs was nearly 8% and the

[1967] Lehman, 05-30-08 PRICING.xls [LBEX-BARFID 0002548-0004119].

[1968] The reported number of positions tested includes those positions which the Product Control group did not affirmatively test, but deemed acceptable because they had been heavily written-down by the desk.

[1969] Lehman, 05-30-08 PRICING.xls [LBEX-BARFID 0002548-0004119] .

[1970] Lehman, 08-29-08 PRICING.xls, at tab "ABS Secondary" [LBEX-BARFID 0004120].

variance for CDOs, CLOs and CBOs was approximately 4.7%. However, the Product Control spreadsheets showing third quarter 2008 price testing are missing some data found in the second quarter spreadsheets.[1971] Accordingly, although August 2008 marks are calculated for many Lehman positions, it is unclear whether the Product Control Group completed its third quarter price testing process before LBHI filed its chapter 11 petition.

(a) Lehman's Price Testing of its Ceago CDOs

Ceago securities were by far the largest CDO position held by Lehman as of May and August 2008. Of the $1.2 billion market value of CDOs Lehman reported it held in May 2008, several tranches of Ceago securities accounted for over $520 million.[1972] This is due to the fact that Lehman was unable to sell, and still held, many of the senior positions of this 2007 securitization. The table below shows how much of each tranche of the Ceago securitization Lehman still held and what it considered the market value of each tranche as of May 31, 2008.

[1971] *Id.*

[1972] Lehman, 05-30-08 PRICING.xls, tab "ABS Secondary" [LBEX-BARFID 0002548].

Retained Ceago Positions as of May 31, 2008

Tranche	Balance as of May 31, 2008 ($000)[1973]	Notional Value of Lehman Position ($000)[1974]	Percentage Retained by Lehman	Market Value of Lehman Position ($000)[1975]
Ceago 2007-1A A1	837,385	837,385	100%	480,241
Ceago 2007-1A A2	104,854	76,167	73%	25,897
Ceago 2007-1A B	20,773	20,773	100%	5,816
Ceago 2007-1A C	11,376	11,376	100%	3,185
Ceago 2007-1A D	2,473	2,473	100%	742
Ceago 2007-1A S	5,782	5,782	100%	5,320
Ceago 2007-1A Preferred[1976]	***	***	***	***
Total	982,643	953,957	97%	521,201

Lehman sold virtually none of the Ceago securities and, as of May 30, 2008, retained approximately 97% of the securitization. Alone, the securities held by Lehman from the super-senior tranche of Ceago were valued at approximately $480 million,

[1973] The balance of each tranche is the value at offering minus principal payments made since offering. This information is obtained from Intex.

[1974] Lehman, 05-30-08 PRICING.xls, tab "ABS Secondary" [LBEX-BARFID 0002548]. The term "notional" refers to the face value of the securities.

[1975] *Id.*

[1976] The price testing spreadsheet shows inconsistent values for this position. While it shows that the notional value of the position is only $4,000, it shows a mark of 515.00 and a market value of approximately $2 million. *Id.* Not only is the mark inexplicably high, but, even accepting that mark, the market value is incorrectly calculated. The position is small enough that these issues do not materially affect the analysis.

over one-third of the total value of Lehman's May 2008 CDO portfolio.[1977] The size of this position merited closer review of Lehman's valuation.

The product controllers price tested the super-senior tranche of Ceago securities by taking the market value of the underlying collateral and subtracting the value of the other tranches in the deal.[1978] The S and "Preferred" tranches of Ceago, together valued at $10 million, were price tested using Intex,[1979] and the subordinate tranches, valued at $35 million, were price tested using the interest-only method described below. In its Second Quarter 2008 Summary Review Memorandum, E&Y reviewed this process and noted that Lehman's Product Control Group price verified each of the underlying collateral in the super-senior tranche of the Ceago CDO through third-party quotes.[1980] E&Y found that this process was methodologically sound and observed that it resulted in no significant variances between the desk and Product Control prices.[1981]

However, E&Y did not review Lehman's price testing of the subordinate Ceago tranches, reasoning that they were immaterial to Lehman's product control process as a whole for purposes of a quarterly, non-audit review.[1982] Lehman's Product Control Group price tested the subordinate tranches of Ceago as if the tranches were interest-

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[1977] *Id.*

[1978] Lehman, Ceago 5-30-08.xls, at tab "SS Value," "Portfolio" and "ESM" [LBEX-BARFID 0011033].

[1979] Lehman, Ceago & Ballyrock Subs 5-30-08.xls, at tabs "Ceago 07-1 S," and "Price-Yield PREF" [LBEX-BARFID 0010998].

[1980] *See* E&Y, Lehman Brothers Holdings Inc. Summary Review Memorandum Consolidated Financial Statements Quarter-ended May 31, 2008 (Aug. 8, 2008), at pp. 7-8 [EY-SEC-LBHI-WP-2Q08 000125].

[1981] *Id.*

[1982] Examiner's Interview of Jennifer Jackson, Nov. 3, 2009.

only ("IO") bonds, meaning that although the holder of the tranche was legally entitled to repayment of principal, Lehman determined that the likelihood of such repayment was so remote that the securities should be viewed as paying interest only for a certain period.[1983] Using this analysis, the Product Control Group discounted coupon cash flows obtained from reports prepared by the Ceago trustee at the swap rate corresponding to the projected tenor of the bonds.[1984] However, such a method would be sensitive to the discount rate and tenor assumptions used and it appears that the Product Control Group was overly optimistic in both respects.

The discount rates used by Lehman's Product Controllers were significantly understated. As stated, swap rates were used for the discount rate on the Ceago subordinate tranches. However, the resulting rates (approximately 3% to 4%) were significantly lower than the approximately 9% discount rate used to value the more senior S tranche. It is inappropriate to use a discount rate on a subordinate tranche that is lower than the rate used on a senior tranche.[1985] Doing so would suggest that the subordinate tranche is less risky than the senior tranche. Further, it is understood in the financial industry that applying the prevailing swap rate as the discount yield is

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[1983] Lehman, Ceago & Ballyrock Subs 5-30-08.xls, at tab "IO Analysis" [LBEX-BARFID 0010998]; Examiner's Interview of Usman Babar, Oct. 16, 2009, at p. 4.

[1984] Based on the offering memorandum for the preferred shares in the Ceago securitization, the trustee was LaSalle Bank National Association. Preferred Shares Offering Memorandum: Ceago ABS CDO 2007-1, Ltd., (Aug.16, 2007) [LBEX-LL 1006113].

[1985] *See* JPMorgan, US Fixed Income Markets 2009 Outlook, Collateralized Debt Obligations (Nov. 28, 2008), at p. 1 (providing CDO spreads showing this relationship).

reasonable when the projected cash flows have minimal uncertainty. For the reasons described above, the cash flows from the subordinate Ceago tranches, and even the senior S tranche, were subject to great uncertainty in May 2008. Thus, there are significant doubts as to the discount rates used to value the subordinate Ceago tranches and as to the ultimate reasonableness of the Product Control Group's marks.

In addition to this overly optimistic discount rate, the periods during which the securities were expected to pay interest, known as the "tenor" assumptions, used for the IO model were also overstated. The Product Control Group assumed a four-year tenor for the C and D Ceago tranches, a six-year tenor for the B tranche, and an eight-year tenor for the A2 tranche.[1986] These tenors assume that the underlying securities will pay interest for longer periods of time than would be estimated by a waterfall cash flow model.[1987] As a contemporaneous Intex calculation would have demonstrated, the Product Control Group's assumptions are unreasonably optimistic given the securities comprising these tranches. 85% of the collateral debt securities underlying the Ceago CDOs were residential mortgage-backed securities.[1988] As stated in the Ceago Offering Memorandum, many of these were comprised of sub-prime mortgage loans posing a heightened risk of default.[1989] As of May 2008, the delinquency rate of U.S. subprime mortgages originated in 2006 was as high as 37%, and that of loans originated in 2007

[1986] Lehman, Ceago & Ballyrock Subs 5-30-08.xls, at tab "IO Analysis" [LBEX-BARFID 0010998].
[1987] *See* Appendix 14, Valuation - CDO.
[1988] Ceago ABS CDO 2007-1 Offering Memorandum (Aug. 16, 2007), at p. 32 .
[1989] *Id.* at pp. 35-39.

was almost 26%.[1990] By August 2008, banks around the world had written off more than $500 billion of value in securities tied to subprime-related assets.[1991] It was unlikely in May 2008 that RMBS, comprised in large part of sub-prime and Alt-A loans, would continue to provide cash flows for as long as Lehman's Product Control Group assumed in the IO price verification model for the Ceago subordinate tranches. Had the Product Control Group used an Intex model for the Ceago subordinate tranches they would have discovered that the estimated cash flows following from their tenor assumptions, and thus the valuations of the Ceago subordinate tranches, were overstated.[1992]

It is unclear why the Product Control Group chose the tenor assumptions and discount rate assumptions that it did or why it failed to use an Intex model to price test the subordinate Ceago tranches as instructed by its own Policy & Procedures document. Usman Babar, a former Vice President and product controller in Securitized Products, told the Examiner that he could not explain why the Product Control Group used the tenor assumptions that it did for the Ceago subordinate tranches or why it failed to do a waterfall cash flow analysis.[1993] He noted only that the subordinate tranches were a relatively small part of the entire Ceago deal, approximately $100 million notional

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[1990] Walen Slew, *Subprime, Alt-A Mortgage Delinquencies Rising: S&P*, Reuters, May 22, 2008, http://www.reuters.com/article/gc03/idUSN2249493920080522.

[1991] Yalman Onaran, *Banks' Subprime Losses Top $500 Billion on Writedowns*, Bloomberg.com, Aug. 12, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=a8sW0n1Cs1tY&refer=home#.

[1992] *See* Appendix 14, Valuation - CDO.

[1993] Examiner's Interview of Usman Babar, Oct 16, 2009, at p. 4.

value, as compared to the $800 million super-senior tranche.[1994] As stated above, Sciacca, a Vice President in Credit Valuation group responsible for price testing CDOs, stated that he deemed Intex generally unreliable in modeling CDO cash flows,[1995] but this does not explain the particular tenor and discount rate assumptions used for the IO model.

By using the IO model with the tenor assumptions and discount rates it adopted, the Product Control Group valued the subordinate tranches of the Ceago securitization at prices very close to the desk marks, thus avoiding large variances. But, because of the use of unreasonably optimistic tenor and discount rate assumptions, there is a finding that the May 2008 values calculated by the Product Control Group for the most junior of the subordinate Ceago tranches was overstated.

The potential extent of this overvaluation is demonstrated by an alternate valuation method employed by the Examiner to test the reasonableness of Lehman's reported CDO asset values. This alternate valuation does not represent the Examiner's opinion of what the actual value of these assets was at the time, but is rather intended to provide context in which to judge the reasonableness of Lehman's valuations. As is described below, this alternate valuation method provides a price for the B tranche of Ceago securities that is approximately one-half of the price reported by Lehman. Furthermore, the prices estimated for the C and D tranches of Ceago securities are

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[1994] *Id.*

[1995] Examiner's Interview of Brian Sciacca, Oct. 19, 2009, at p. 4.

approximately one-thirtieth of the price reported by Lehman. The table below provides the May 31, 2008 desk prices, Product Control prices, and prices estimated by an alternative method applied by the Examiner's financial advisor,[1996] for each tranche of the Ceago securitization.

May 31, 2008 Valuations of Tranches of Ceago Securitization

Position	CUSIP	Notional Value of the Position ($000)[1997]	Desk Price[1998]	PC Price[1999]	Examiner's Model Price[2000]
CEAGO 2007-1A A1	14984XAA6	837,385	57.35	52.65	65.13
CEAGO 2007-1A A2	14984XAC2	76,167	34.00	30.83	26.33
CEAGO 2007-1A B	14984XAD0	20,773	28.00	29.39	16.63
CEAGO 2007-1A C	14984XAE8	11,376	28.00	29.68	0.91
CEAGO 2007-1A D	14984XAF5	2,473	30.00	35.78	1.10
CEAGO 2007-1A S	14984XAB4	5,782	92.00	88	84.17

As noted, the table shows large variances between the Lehman prices and the Examiner's Model price for the B, C, and D Ceago tranches. While the variances between the prices estimated for the other tranches are not insubstantial, the variances seen for these three tranches are large enough to challenge the reasonableness of Lehman's valuations. The valuations for these three tranches also appear less reasonable in light of the methodological problems described above.

[1996] This alternative method is described in detail in the following Section and is applied to Ceago and several other Lehman securitizations.

[1997] Lehman, 05-30-08 PRICING.xls, at tab "ABS Secondary" [LBEX-BARFID 0002548].

[1998] *Id.*

[1999] *Id.*

[2000] *See* Appendix 14, Valuation - CDO.

As is described above, the lack of relevant information in May 2008 made the process of determining the appropriate valuations of Lehman's CDO assets very difficult. Accordingly, the Examiner acknowledges a wide range of reasonable valuations for any given class of CDOs. As the table above shows, the alternate valuation performed by the Examiner provides a price that is materially higher than both Lehman's desk and Product Control prices for the large super-senior A1 tranche of Ceago securities. The Examiner used the same model, with different inputs, to value each tranche of the Ceago securitization. The fact that this model produced prices that were for some tranches lower, but for the super-senior tranche higher, than the prices reported by Lehman reflects the wide range of reasonable valuations for CDOs in May 2008. Only those valuations presenting variances that are too large to explain by differing reasonable methodologies and assumptions, such as the 30-1 difference in the Ceago C and D tranches, fall outside of this zone of reasonableness.

Despite the issue identified with the most junior Ceago subordinate tranches,[2001] the problems with Lehman's price verification processes occurred only in testing very small portions of Lehman's CDO portfolio. It should be noted that the most junior of the Ceago subordinate tranches, tranches B, C, and D, accounted for only about 3.6% of the notional value of the securitization and about 1.9% of the market value, as reported

[2001] One other instance was identified in which it appears that an IO method with similarly unrealistically optimistic tenor assumptions was used to price the much smaller Ballyrock ABS CDO 2007-1 subordinate tranches. *See* Lehman, Ceago & Ballyrock Subs 5-30-08.xls, at tab "IO Analysis" [LBEX-BARFID 0010998].

by Lehman.[2002] The much larger super-senior A1 tranche, accounting for almost 88% of the notional value of the securitization and about 92% of the market value,[2003] had a reasonable value.[2004] Thus, the Product Control Group used a recognized and reliable method for pricing the much larger super-senior tranche of this securitization. While it used a reasonable methodology in pricing the subordinate tranches, the assumptions used as inputs were unreasonable. However, given the relatively small size of these subordinate positions, the decisions made in price testing these assets would not support a finding that the valuation of Lehman's entire CDO portfolio in May 2008 was unreasonable.

(3) Examiner's Review of Lehman's Largest U.S. ABS/CRE CDO Positions

To provide a second check on the reasonableness of Lehman's valuation of its U.S. ABS/CRE CDO assets, a sample of Lehman's ABS/CRE CDO positions were chosen for review using the Intex cash flow engine.[2005] This review does not represent the Examiner's opinion of the actual 2008 value of these CDOs, but rather is intended to provide context in which to assess the reasonableness of Lehman's valuations. Those

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[2002] Lehman, 05-30-08 PRICING.xls, tab "ABS Secondary" [LBEX-BARFID 0002548].

[2003] *Id.*

[2004] *See* E&Y, Lehman Brothers Holdings Inc. Summary Review Memorandum Consolidated Financial Statements Quarter-ended May 31, 2008 (Aug. 8, 2008), at p. 8 [EY-SEC-LBHI-WP-2Q08 000125].

[2005] The Examiner did not independently review Lehman's valuation of CLOs. An interview with Usman Babar confirmed that Lehman's product controllers used Intex to value CLOs and had confidence in the market yields used. While Babar noted that Lehman did not check the Intex model against deal documents, which would typically be best practice, the valuation of CLOs by this method is less likely to result in misstatement. Examiner's Interview of Usman Babar, Oct. 16, 2009, at p. 3.

positions chosen for valuation were the largest Lehman positions held in May and August of 2008 for which Intex was able to compute cash flows. The ABS/CRE CDOs chosen were CEAGO 2007-1A, the valuation of which is briefly described above, CBRE 2007-1A, ACCDO 5A, and NEWCA 2005-7A. Two of these securities, CEAGO and ACCDO are primarily backed by residential mortgage-backed securities. CBRE and NEWCA are primarily backed by commercial mortgage-backed securities. Taken together, these four CDO positions represent 80% of the total value of the U.S. ABS/CRE CDO positions identified on the Lehman balance sheet as of May 31, 2008.[2006]

Only information available to Lehman's product controllers in May and August 2008 was used in calculating estimated prices for these CDOs. The principal sources of information used were the contractual terms of the securities, along with market interest rate data and credit index data from JPMorgan, Intex Solutions, Markit, and Bloomberg. The prices of the securities were estimated using a waterfall approach. The future cash flows of each CDO were estimated through time according to the terms outlined in the prospectus, including periodic examination of over-collateralization and interest coverage tests. The Examiner estimated the liquidation price and default rate for each security underlying the CDO by looking at rating agency reports for structured products or using representative indices. Prepayment assumptions were calibrated using the historical information available over the last five months for each of the

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[2006] *Id.*

underlying securities where available. Recovery assumptions for the underlying securities were calibrated from data in the trustee reports, as provided through Intex. The future cash flows of the assets were applied according to the waterfall and incorporating these default and prepayment assumptions. The coupon and principal payments of each tranche were discounted at the rate of return required by investors, based on the characteristics of the security as calculated from the indices described above in order to determine the price of the security.

The results of this independent valuation were mixed, as would be expected given the extremely illiquid CDO market in May 2008. The following table shows Lehman's desk price, the price calculated by its Product Control Group, and the price estimated by the Examiner's model for tranches of each of the four securitizations selected as of May 31, 2008.

CDO Positions, Desk Price, PC Price, and Examiner's Model Price as of May 31, 2008

Position	CUSIP	Notional Value of the Position ($000)[2007]	Desk Price[2008]	PC Price[2009]	Examiner's Model Price[2010]
CEAGO 2007-1A A1	14984XAA6	837,385	57.35	52.65	65.13
CEAGO 2007-1A A2	14984XAC2	76,167	34.00	30.83	26.33
CEAGO 2007-1A B	14984XAD0	20,773	28.00	29.39	16.63
CEAGO 2007-1A C	14984XAE8	11,376	28.00	29.68	0.91
CEAGO 2007-1A D	14984XAF5	2,473	30.00	35.78	1.10
CEAGO 2007-1A S	14984XAB4	5,782	92.00	88	84.17
CBRE 2007-1A D	1248MLAL7	10,000	80.00	NCF	50.43
CBRE 2007-1A E	1248MLAN3	7,000	80.00	NCF	50.70
ACCDO 5A B	00388EAB7	8,250	69.24	NCF	40.31
NEWCA 2005-7A 3	651065AE4	5,000	79.23	NCF	50.72

By differing amounts, the model price calculated by the Examiner was lower than the desk and Product Control prices reported by Lehman in almost every instance. As discussed above, the valuation of the most junior of the Ceago subordinate tranches provides significantly lower valuations than those reported by Lehman. However, the one exception to this rule was the super-senior Ceago A1 tranche, which was the largest position of those tested by a factor of 10. For the Ceago A1 tranche, the Examiner's estimate provided a price higher than that reported by Lehman. Applying the prices

[2007] Lehman, 05-30-08 PRICING.xls, at tab "ABS Secondary" [LBEX-BARFID 0002548].

[2008] *Id.*

[2009] *Id.*

[2010] *See* Appendix 14, Valuation - CDO.

calculated to the notional values of the positions, the Examiner's estimate of the value of these CDO positions is $44 million higher than the value reported by Lehman.

For August 2008, the same group of CDOs accounted for approximately 81% of the total value of the U.S. ABS CDOs reported on Lehman's balance sheet.

CDO Positions, Desk Price, PC Price and Examiner's Model Price as of August 31, 2008

Position	CUSIP	Notional Value of the Position (US$000)[2011]	Desk Price[2012]	PC Price[2013]	Examiner's Model Price[2014]
CEAGO 2007-1A A1	14984XAA6	834,033	43.50	37.09	59.94
CEAGO 2007-1A A2	14984XAC2	76,167	30.00	30.21	21.04
CEAGO 2007-1A B	14984XAD0	20,773	25.00	23.02	12.34
CEAGO 2007-1A C	14984XAE8	11,376	10.00	9.34	0.96
CEAGO 2007-1A D	14984XAF5	2,473	10.00	11.26	1.16
CEAGO 2007-1A S	14984XAB4	5,560	92.00	85.00	80.11
CBRE 2007-1A D	1248MLAL7	10,000	50.00	20.76	42.48
CBRE 2007-1A E	1248MLAN3	7,000	50.00	20.76	42.69
ACCDO 5A B	00388EAB7	8,250	69.24	31.23	31.61
NEWCA 2005-7A 3	651065AE4	5,000	79.23	34.21	39.02

While there are some large differences between the desk and Product Control prices in August 2008, these differences appear largely with Lehman's smaller positions. Furthermore, as in May, the model prices calculated by the Examiner are lower than the

[2011] Lehman, 08-29-08 PRICING.xls, at tab "ABS Secondary" [LBEX-BARFID 0004120].

[2012] *Id.*

[2013] *Id.*

[2014] *See* Appendix 14, Valuation - CDO.

desk and Product Control prices reported by Lehman in almost every instance. However, the higher price calculated by the Examiner for the Ceago A1 tranche once again brings the Examiner's total valuation of these CDO positions above that of Lehman by $119 million.

Ultimately, this exercise in valuation confirms only that pricing ABS/CRE CDO assets in the 2008 market was extremely difficult and results were sensitive to small deviations in input assumptions and methodology. However, the fact that this model provides a total valuation that is close to, and slightly higher than, the total valuations reported by Lehman in both May and August 2008, supports the reasonableness of Lehman's valuations by demonstrating the range of possible valuations.

(4) Examiner's Findings and Conclusions With Respect to the Reasonableness of Lehman's Valuation of its CDOs

The lack of regular transactions in 2007 and 2008 reduced the quality and availability of the basic market information necessary to reliably value many types of securities, including CDOs. This lack of price transparency meant that the exercise of judgment was a large part of the process of providing a valuation of Lehman's CDO portfolio in 2008. The inherent difficulty of pricing Lehman's CDO portfolio in the unprecedented market conditions of 2008 makes it difficult to support a finding that Lehman's valuation of its CDO portfolio was unreasonable. Lehman's own Product Control process, which was reviewed by E&Y, provided May 2008 valuations that varied from the desk prices by only 3%. Furthermore, a review of Lehman's largest

CDO positions using an Intex model provided prices close to those reported by Lehman and actually suggests that the value of Lehman's CDO portfolio may have been slightly understated. As noted, the Examiner identified problems with several aspects of Lehman's price control process for certain CDOs and it does not appear that the Product Control Group was a robust check on desk prices. However, the valuations reported by Lehman were reasonable in the context of 2008 market conditions and the information available. As noted above, the Examiner has identified problems with the valuation of certain portions of Lehman's CDO portfolio during 2008; however, the size of the positions at issue renders these problems immaterial. Accordingly, the Examiner does not find evidence to support a finding that Lehman's CDO valuations were unreasonable.

j) Examiner's Analysis of the Valuation of Lehman's Derivatives Positions

(1) Overview of Lehman's Derivatives Positions

Derivatives are a broad category of financial instruments whose value is derived from some other asset or index.[2015] The derivative itself is a contract between two or more parties and is sometimes referred to as a "financial contract."[2016] Its value is determined by fluctuations in the underlying asset, typically stocks, bonds,

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[2015] John C. Hull, *Options, Futures, and Other Derivatives* 1 (6th ed. 2006); *see also* International Swaps and Derivatives Association, Product Descriptions and Frequently Asked Questions, http://www.isda.org/educat/faqs.html#1 (last visited Jan. 13, 2010).

[2016] *See, e.g.*, U.S. Dep't of the Treasury, Cross-Border Derivatives Reporting System Becomes Operational (Apr. 27, 2007), *available at* http://www.treas.gov/tic/dqanda.html.

commodities, currencies, interest rates or market indices. Common types of derivatives include futures contracts, in which an agreement is made to buy or sell a particular commodity or financial instrument at a pre-determined price in the future; forward contracts, transactions in which delivery of the commodity is delayed until after the contract is made and the price determined; options, in which a party purchases the right to buy or sell a commodity or financial instrument at a predetermined price at some point in the future; and swaps, the exchange of one security or rate for another.[2017] Derivatives can be used to hedge risk, or for speculative purposes.

Lehman entered into derivative transactions on behalf of its clients and itself to take advantage of speculative opportunities, and to manage its exposure to market and credit risks resulting from its trading activities.[2018] As of May and August of 2008, Lehman held over 900,000 derivatives positions worldwide.[2019] The net value of Lehman's derivatives positions was approximately $21 billion as of May 31, 2008.[2020] At that time, the net value of these positions made up a relatively small percentage of Lehman's total assets, approximately 3.3%. Approximately 90% of Lehman's derivatives assets were classified as Level 2 assets under SFAS 157.[2021] The following

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[2017] John C. Hull, *Options, Futures, and Other Derivatives* 1-8 (6th ed. 2006); U.S. Commodity Futures Trading Comm'n, Glossary, http://www.cftc.gov/educationcenter/glossary/index.htm (last visited Jan. 13, 2010).

[2018] LBHI 10-Q (filed July 10, 2008) at pp. 91-92.

[2019] FRBNY, External Trade Count [FRBNY to Exam 014654].

[2020] LBHI 10-Q (filed July 10, 2008) at p. 26.

[2021] *Id.* at p. 29.

table shows the value and type of Lehman's various derivatives positions from November 30, 2006 to May 31, 2008. Derivative contracts with positive values were booked as assets, while those with negative values were booked as liabilities. As per the Financial Accounting Standards Board, derivative assets are defined as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."[2022] Derivative liabilities are defined as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."[2023]

[2022] Fin. Accounting Standards Bd., Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements 6 (December 1985).

[2023] *Id.*

Fair Value of Derivatives and Other Contractual Agreements - Assets and Liabilities[2024]

Note: All values are in $ million

	November 30, 2006			November 30, 2007			May 31, 2008	
	Assets	Liabilities		Assets	Liabilities		Assets	Liabilities
Over-the-Counter								
Interest rate, currency and credit default swaps and options	$ 8,634	$ 5,691		$ 22,028	$ 10,915		$ 25,648	$ 9,733
Foreign exchange forward contracts and options	$ 1,792	$ 2,145		$ 2,479	$ 2,888		$ 2,383	$ 2,270
Other fixed income securities contracts (including TBAs and forwards)	$ 4,308	$ 2,604		$ 8,450	$ 6,024		$ 10,341	$ 5,692
Equity contracts (including equity swaps, warrants and options)	$ 4,739	$ 4,744		$ 8,357	$ 9,279		$ 6,022	$ 6,391
Exchange traded								
Equity contracts (including equity swaps, warrants and options)	$ 3,223	$ 2,833		$ 3,281	$ 2,515		$ 2,597	$ 1,799
Total	$ 22,696	$ 18,017		$ 44,595	$ 31,621		$ 46,991	$ 25,885

[2024] Lehman, Annual Report for 2006 as of November 30, 2006 (Form 10-K) (filed on Feb. 13, 2007), at p. 91 ("LBHI 2006 10-K"); LBHI 2007 10-K at p. 106; LBHI 10-Q (filed July 10, 2008) at p. 26.

The following table shows the net value of Lehman's derivatives positions between November 2006 and May 2008.

Fair Value of Derivatives and Other Contractual Agreements - Net[2025]

Note: All values are in $ million

	November 30, 2006	November 30, 2007	May 31, 2008
Over-the-Counter			
Interest rate, currency and credit default swaps and options	$ 2,943	$ 11,113	$ 15,915
Foreign exchange forward contracts and options	$ (353)	$ (409)	$ 113
Other fixed income securities contracts (including TBAs and forwards)	$ 1,704	$ 2,426	$ 4,649
Equity contracts (including equity swaps, warrants and options)	$ (5)	$ (922)	$ (369)
Exchange traded			
Equity contracts (including equity swaps, warrants and options)	$ 390	$ 766	$ 798
Total	$ 4,679	$ 12,974	$ 21,106

While Lehman did not file public financial statements for the third quarter of 2008 before its bankruptcy filing, documents from its Product Control Group show that, as of August 31, 2008, it determined its derivative assets to be $46.3 billion and its derivative liabilities to be $24.2 billion, for a net value of $22.2 billion.[2026] This represents an almost 100% increase over the net value stated nine months earlier.

The largest holder of Lehman's derivatives positions was Lehman Brothers Special Financing ("LBSF"), an LBHI Affiliate.[2027] According to a presentation prepared by the New York Federal Reserve Bank in May of 2008, the three most common types of

[2025] LBHI 2006 10-K at p. 91; LBHI 2007 10-K, at p. 106; LBHI 10-Q (filed July 10, 2008) at p. 26.
[2026] Lehman, REC August 08 as of 17-September Ext Rep.xls [LBEX-LL 1104812].
[2027] FRBNY, External Trade Count [FRBNY to Exam 014654].

transactions to which Lehman was a party were credit default swaps, interest rate swaps, and foreign exchange derivatives.[2028] Of the top 25 counterparties in terms of number of transactions, all are commercial banks and financial broker-dealers with the exception of American Insurance Group, which, with 5,400 trades, is nineteenth on this list.[2029] The same New York Federal Reserve Bank report shows that Lehman's top three counterparties as of May 2008 were Deutsche Bank, JPMorgan, and UBS, with approximately 59,000, 53,000 and 45,000 trades, respectively.[2030]

The valuation method applied to derivatives differs depending on the assets on which the derivative contract is based. Because derivatives are a large and heterogeneous asset class, there exists no single method to price all derivatives. Rather, depending on the underlying assets, traders develop and apply different valuation methods. Accordingly, the Examiner draws no conclusions regarding the pricing methodology used for any subset of Lehman's more than 900,000 derivatives positions. Rather, the Examiner's analysis has focused on Lehman's ultimate valuations for the derivatives positions reported on the respective LBHI Affiliates' balance sheets.

The Examiner has found insufficient evidence to support a finding that Lehman's valuation of its derivatives portfolio in 2008 was unreasonable. This conclusion is based on two factors. First, the nature of derivative transactions with sophisticated

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[2028] *Id.*

[2029] FRBNY, Derivatives: Top 25 Counterparties by Deal Count [FRBNY to Exam 014653].

[2030] *Id.*

counterparties, who, through credit support annexes, will agree with or dispute marks in their own self-interest, limits the possibility of misstatement. Second, a review of the internal price verification performed by Lehman's Product Control Group provides a further level of assurance that the derivative values reported by Lehman in 2008 were reasonable.

(2) Lehman's Use of Credit Support Annexes to Mitigate Derivatives Risk

To reduce counterparty credit exposure in its derivative transactions, Lehman, like most other financial institutions, executed binding credit support annexes ("CSAs") with its financial institution counterparties. CSAs establish the rules and procedures under which a party that is "out of the money" on a derivatives transaction provides collateral to its counterparty based on its mark-to-market liability under the transaction. In this manner, CSAs operate to mitigate the risk that a party would hold an unsecured claim against its counterparty in respect of this liability in the event of early termination of the derivative transaction, such as due to the counterparty's filing for bankruptcy protection.[2031]

A party to a CSA is generally permitted to request, on a daily, weekly, or other defined basis, depending on the terms of the CSA, that its counterparty post

[2031] *See* International Swaps and Derivatives Association, 2002 Master Agreement, § 5(a)(vii) (listing bankruptcy as an event of default).

collateral.[2032] Typically, CSAs provide for a "threshold amount" of risk exposure, below which a counterparty need not post collateral.[2033] Accordingly, if Lehman determined that a derivatives contract had a present value of $20 million, and the CSA provided for a $5 million threshold amount, Lehman would ask that its counterparty post $15 million in collateral. CSAs also typically contain a dispute resolution clause, providing a mechanism for parties to resolve disputes about the mark-to-market value of a derivatives contract.[2034]

CSAs are thus constructed to require the parties to come to agreement, or otherwise resolve their differences, regarding the price of a derivatives contract at any given point in time.[2035] Even though any two parties may have many derivatives transactions between them, a single CSA may cover all of these transactions. Lehman executed CSAs with the majority of the counterparties with which it entered into derivatives transactions. Among the top 25 counterparties by number of derivatives transactions, Lehman executed 24 CSAs.[2036] Of the top 25 counterparties by exposure,

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[2032] *See* Int'l Swaps and Derivatives Ass'n, Guidelines for Collateral Practitioners (1996), at p. 24, *available at* http://www.isda.org/press/pdf/colguide.pdf.

[2033] Lehman, CSA - Collateral Agreement Screen [LBEX-LL 3150609].

[2034] *Id.*

[2035] The great majority of trades (such as credit default swaps on the majority of reference entities, interest rate swaps, and foreign exchange swaps) have well accepted valuation techniques as defined in the FASB's Accounting Standards Codification 820-10-55 and 815-10. However, differences of opinions are possible given the role that judgment necessarily plays in valuing financial assets that do not have a readily observable market price.

[2036] FRBNY, Derivatives: Top 25 Counterparties by Deal Count [FRBNY to Exam 014653]; CSAs pulled from "Entity Master," a Barclays system.

Lehman executed 15 CSAs.[2037] Typical industry practice was that only investment-grade sovereign and non-financial corporate entities might not be bound by these agreements, and transactions with such entities were likely to be limited to "vanilla," *i.e.*, standard and not exotic, products.

Derivative counterparties seek to avoid pledging collateral when possible for the reason that doing so diminishes liquidity and imposes an opportunity cost. In other words, if a party did not pledge an asset as collateral under a CSA, it could otherwise finance or sell such asset at its discretion. Hence, a sophisticated party would not accept its counterparty's claim of a derivative's value without performing its own analysis. Just as Lehman would not agree to send $15 million to a counterparty, for example, upon that party's request for collateral without verifying the derivatives marks itself, neither would Lehman's sophisticated counterparties accept Lehman's marks absent their own scrutiny.

As part of the investigation, the Examiner reviewed the values that one of Lehman's counterparties, Citigroup, determined for approximately 700 of its derivative trades with Lehman as of April 18, 2008.[2038] While these marks cover only a small portion of the derivatives positions held by Lehman, they provide an example of how sophisticated counterparties provide a check on the other's marks for derivatives.

[2037] *Id.*

[2038] Citigroup, untitled spreadsheet [CITI-LBHI-EXAM 00030489].

The derivative contracts between Lehman and Citigroup included credit default swaps on corporate entities, credit default swaps on ABS and derivatives based on the CDX, LCDX and CMBX indices.[2039] The Citigroup marks indicate an aggregate value of the positions of approximately $426 million in favor of Lehman.[2040] Lehman's marks for the same positions suggest an aggregate value of approximately $460 million in its favor, about 8% higher than the Citigroup valuation as of April 18, 2008.[2041] While this variance is not insignificant, it is not unreasonable for two market participants to have aggregate prices that vary by this much, particularly in light of the adverse market conditions of April 2008. The comparison of marks revealed in this Citigroup document demonstrates how sophisticated counterparties tracked one another's valuations of derivatives contracts, a process necessitated by CSAs.

In this manner, CSAs operated in the normal course of business to effectively limit the latitude Lehman had in marking its derivatives positions and, relative to other

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[2039] CDX family of indices is the standard North American and Emerging Markets tradable credit default swap family of indices worldwide. These indices are administered by Markit. The indices provide credit default swaps on a basket of reference entities. The main indices are: Markit CDX North American Investment Grade (125 names), Markit CDX North American Investment Grade High Volatility (30 names from CDX IG), Markit CDX North American High Yield (100 names), Markit CDX North American High Yield High Beta (30 names), North American Emerging Markets (15 names), and North American Emerging Markets Diversified (40 names). LCDX (loan-only credit default swap) consists of 100 reference entities, referencing 1st lien loans listed on the Markit Syndicated Secured List. These indices are administered by Markit. CMBX index is a synthetic tradable index referencing a basket of 25 commercial mortgage-backed securities. Markit owns and administers the CMBX, which is a liquid, tradable tool allowing investors to take positions on commercial mortgage-backed securities via CDS contracts.

[2040] Citigroup, untitled spreadsheet [CITI-LBHI-EXAM 00030489].

[2041] *Id.*

asset classes, provided an additional level of protection against a material misstatement.[2042]

(3) Lehman's Price Testing of its Derivatives Positions

As with other asset classes, the marks Lehman reported for its derivatives assets were determined by its trading desks, and these marks were subject to price testing by Lehman's Product Control Group.[2043] Because of the large number of derivatives positions held by Lehman and the different methods used by the trading desks to mark these positions, the Examiner's analysis has focused on Lehman's Product Control Group and its price verification process for derivatives.[2044]

The Examiner's review of Lehman's product control process for derivatives revealed that Lehman's price testing of these assets was more robust than that for other asset classes. There were four groups at Lehman primarily responsible for valuation,

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[2042] The Examiner has identified a spreadsheet in which Lehman tracked disputes with its counterparties over the mark-to-market value of derivatives. This spreadsheet also shows which disputes have been resolved, although it does not specify the outcome of each dispute. *See* Lehman, DERIVATIVES_MTM_DISPUTE_LOG.xls [LBEX-LL 3638800]; *see also* e-Mail from Tyler Peters, Lehman, to Ross Shapiro, Lehman, *et al.* (Jun. 25, 2008) [LBEX-LL3638822].

[2043] E&Y, Walkthrough – Global Trading Strategies Walkthrough [EY-SEC-LBHI-EED-GAMX-07-007515]; Lehman, Price Verification Policy Global Capital Markets 2008 [Draft], at pp. 4, 49-54 [LBHI_SEC07940_2965994].

[2044] The Examiner also notes that E&Y performed yearly audits and quarterly reviews of Lehman's Product Control process. After performing quarterly walkthroughs in 2008, E&Y concluded that appropriate controls had been effectively designed and placed in operation for the price verification of Lehman's derivatives. *See, e.g.*, E&Y, Walkthrough Template, Derivative Margin / Collateral Management [EY-SEC-LBHI-EED-GAMX-08-014919]; E&Y, Walkthrough Template, High Grade and High Yield Credit Default Swap Process [EY-SEC-LBHI-FID-GAMX-08-060341]; E&Y, CRE Derivative Price Verification Process [EY-SEC-LBHI-MC-GAMX-08-085788].

price testing and model approval regarding derivatives.[2045] The Capital Markets Finance group was responsible for daily revenue analysis and reporting, validation of inventory valuations and interfacing with internal and external auditors and regulators.[2046] The Product Control Group performed price verification procedures for derivatives on a monthly basis.[2047] The Complex Derivatives Review Committee reviewed complex transactions to ensure that they were modeled, valued and booked appropriately.[2048] Finally, the Model Control Committee reviewed and approved the models used to mark derivatives positions.[2049]

As noted above, the valuation of derivatives follows no set methodology, but varies according to the nature of the derivative contract at issue.[2050] Price verification procedures used by the Product Control Group included the use of independent market quotes from vendors, benchmarking against similar assets, recent trading activity and collateral marks.[2051] In the case of illiquid positions, the Product Control Group could use internally developed analytical procedures or external pricing services. Variances above certain thresholds were considered for adjustment and variances were resolved

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[2045] *See* Lehman, Price Verification Presentation (Aug. 10, 2006), at pp. 4, 8, 12 & 15 [LBEX-WGM 747129].
[2046] *Id.* at p. 4.
[2047] *Id.* at pp. 8-9.
[2048] *Id.* at pp. 12-14.
[2049] *Id.* at pp. 15-16.
[2050] Lehman, Price Verification Policy Global Capital Markets 2008 [Draft], at pp. 13-17 [LBHI_SEC07940_2965994] (noting different price verification methodologies for different kinds of derivatives).
[2051] *Id.*

through conversations between the Product Control Group and the appropriate trading desk.[2052]

The Examiner obtained detailed information regarding Lehman's Product Control process for its portfolio of credit default swaps ("CDS") written on asset-backed securities ("ABS") and collateralized debt obligations ("CDOs"). As of May 31, 2008, the total market value of these positions, as reported by Lehman, was approximately $5.4 billion, or 25% of the aggregate market value of Lehman's entire derivatives portfolio.[2053]

To perform price verification of these assets, Lehman's Product Control Group obtained third-party marks for individual CUSIPs[2054] from data providers Fitch Ratings ("Fitch") and Markit. Where the Product Control Group had only one Fitch or Markit price for a particular security, it adopted that price as its mark. Where both Fitch and Markit prices were available, the average of the two was used.[2055]

While there was some variance at the individual security level between the desk marks and the Product Control valuations, there does not appear to be a bias toward

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[2052] The established variance thresholds also differed depending on the type of derivative in question. *See* Lehman, Price Verification Policy Global Capital Markets 2008 [Draft], at pp. 13-17 [LBHI_SEC07940_2965994] (noting different price verification methodologies for different kinds of derivatives).

[2053] *See* Lehman, 5-30-08 CDS on CDO.xls [LBEX-BARFID 0015341]; Lehman, 5-30-08 CDS on ABS.xls [LBEX-BARFID 0013231].

[2054] CUSIP refers to the 9-character alphanumeric security identifier established by the Committee on Uniform Security Identification Procedures.

[2055] *See* Lehman, 5-30-08 CDS on CDO.xls [LBEX-BARFID 0015341]; Lehman, 5-30-08 CDS on ABS.xls [LBEX-BARFID 0013231].

either under- or over-statement. As a result, the aggregate difference in valuation between the desk and Product Control valuations was not significant relative to the value of the positions. The tables below provide the trading desk and Product Control valuations for each of CDS on ABS and CDS on CDO as of May 31, 2008, and August 31, 2008.[2056] Because multiple Lehman entities may have held positions in a single derivatives transaction, the number of positions held as of May 31, 2008, was much greater than the number of unique transaction CUSIPs.

Valuations of Credit Default Swaps as of May 31, 2008[2057]

	# Positions	# CUSIPs	Notional ($ billion)	Desk Value ($ billion)	Product Control / Third-Party Value	Variance ($ billion)
CDS on ABS	12998	1474	6.25	4.26	4.34	0.08
CDS on CDO	1910	349	3.38	1.18	1.20	(0.02)

[2056] LBSF was likely the primary LBHI Affiliate holding these positions, *see* FRBNY, External Trade Count [FRBNY to Exam 014654], although information confirming this fact was not available.

[2057] 5-30-08 CDS on CDO.xls [LBEX-BARFID 0015341]; "5-30-08 CDS on ABS.xls" [LBEX-BARFID 0013231].

Valuations of Credit Default Swaps as of August 31, 2008[2058]

	# Positions	# CUSIPs	Notional ($ billion)	Desk Value ($ billion)	Product Control / Third-Party Value ($ billion)	Variance ($ billion)
CDS on ABS	12938	1584	4.90	3.60	3.68	0.08
CDS on CDO	572	347	3.40	1.02	1.03	(0.01)

As the tables above demonstrate, the variance between Lehman's Desk valuation of CDS, which was the valuation reported by Lehman in its public financial statements, and the Product Control valuation was immaterial relative to the size of Lehman's CDS portfolio in both May and August of 2008. Because the Product Control Group based its valuations on third-party pricing sources, its estimated marks represent market opinion and not simply the view of Lehman's product controllers.[2059]

For the reasons described above, including the role played by CSAs, the review provided by the Product Control Group and the lack of material variances with third-

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[2058] Lehman, 12.32.6 08-29-08 CDS on CDO[1].xls [LBEX-LL 3642034]; Lehman, 12.32.5 08-29-08 CDS on ABS[1].xls [LBEX-LL 3638826].

[2059] Lehman's Product Control group produced monthly Valuation & Control Reports. *See, e.g.*, Lehman, Valuation & Control Report - Fixed Income Division (July 2008) [LBEX-WGM 790236]; Lehman Brothers Holdings Inc., Valuation & Control Report - Fixed Income Division (June 2008) [LBEX-WGM 763320]. Among other things, these reports note the challenges product controllers faced in performing their price verification duties. Such issues included the fact that the CDS price testing database was inefficient and sometimes created false variances and the fact that some classes of derivatives were not price tested at all. Lehman, Valuation & Control Report - Fixed Income Division (May 2008), at p. 27 [LBHI_SEC07940_2962709]. As these issues related only to the Product Control review process, and not to the trading desks' valuation of derivatives, they did not directly suggest that any marks were misstated. As described with respect to the valuation of residential whole loans, the Examiner has determined that weaknesses in the price verification process did not impact the reasonableness of the marks determined by Lehman.

party pricing sources, the Examiner has found insufficient evidence to support a finding that Lehman's valuation of its derivatives portfolio in 2008 was unreasonable.

k) Examiner's Analysis of the Valuation of Lehman's Corporate Debt Positions

(1) Overview of Lehman's Corporate Debt Positions

Lehman actively invested in the debt of both public and private companies around the world. In 2008, Lehman's corporate debt portfolio included both high grade and high yield bonds and loans.[2060] As of May 31 and August 31, 2008, the number of corporate debt positions listed in Lehman's Global Finance System ("GFS"), Lehman's tracking system for financial inventory, was 10,629 and 10,374 respectively.[2061] As of May 31, 2008, Lehman reported that it held approximately $50.0 billion in corporate debt assets, 89% of which Lehman determined were Level 2 assets.[2062] As of August 31, 2008, Lehman determined that the value of its corporate debt portfolio was approximately $41.7 billion, all of which it determined were Level 2 assets.[2063]

The valuation of corporate debt positions for which external quotes or recent trade information do not exist involves an analysis of the financial condition and

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[2060] Lehman, REC May-08 13-June-08 FINAL.xls [LBEX-LL 1104843]; Lehman, REC August 08 as of 17-September Ext Rep.xls [LBEX-LL 1104812].

[2061] Lehman, REC May-08 13-June-08 FINAL.xls [LBEX-LL 1104843]; Lehman, REC August 08 as of 17-September Ext Rep.xls [LBEX-LL 1104812]. These thousands of positions approximate the number of unique corporate debt positions held by Lehman, though the actual number of unique positions differed because (1) GFS reports the same investment held by two different legal entities as two different positions, and (2) adjustments to positions made by system users appear in GFS as a unique position when in fact these entries are adjustments to an existing position.

[2062] LBHI 10-Q (filed July 10, 2008) at p. 29.

[2063] Lehman, REC August 08 as of 17-September Ext Rep.xls [LBEX-LL 1104812]. Lehman did not file a quarterly report for the third quarter of 2008 before its bankruptcy filing.

prospects of the company that issued the debt.[2064] In order to determine whether there is a finding that Lehman's valuation of its entire portfolio of corporate debt positions was unreasonable, the Examiner would have needed to collect and analyze such contemporaneous information with respect to each of Lehman's corporate debt positions. The Examiner also considered what impact the valuation of these assets would have on the solvency analysis for LBHI Affiliates. According to Lehman's GFS database, LCPI was the only LBHI Affiliate holding significant corporate debt assets in May and August 2008.[2065] Because the Examiner has determined that LCPI was either borderline solvent or insolvent during the relevant period, the valuation of corporate debt assets does not materially enhance the solvency analysis of any LBHI Affiliate. In light of this fact, and the time and expense of such an exercise, the Examiner determined that extensive investigation of Lehman's valuation of corporate debt assets would be an imprudent use of Estate resources.

However, the Examiner did review a sample of Lehman's largest U.S. corporate debt positions and has identified a number of issues with respect to the price

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[2064] The information required includes financial and operational metrics such as the debt issuer's balance sheet leverage ratios, profitability ratios, and return on investment. *See* Shannon P. Pratt *et al.*, *Valuing a Business* 522-25 (4th ed. 2000).

[2065] The Examiner reviewed the largest 15 corporate debt positions held by Lehman in May and August of 2008. Of these, LBSF held an immaterial amount of assets and LCPI was the only other LBHI Affiliate holding corporate debt assets. *See* Lehman, GFS Reconciliation Files REC Feb-08.03.08 FINAL.xls [LBEX-LL 1104828]; Lehman, REC May-08 13-June-80 FINAL.xls [LBEX-LL 1104843]; Lehman, REC August 08 as of 17-September Ext Rep.xls [LBEX-LL 1104812]. While the position-level data in Lehman's GFS system was understood to contain some inaccuracies, it was relied on as a management reporting tool and is the only comprehensive source showing ownership of individual positions. Examiner's Interview of Kristie Wong, Dec. 2, 2009, at p. 4.

verification process performed by the Product Control Group for these positions. In aggregate, the issues and errors found by the Examiner are not biased toward either under- or overvaluation and do not, by themselves, suggest that there exists a finding that the value of any corporate debt position was unreasonable. Should sufficient time and resources be available these issues may be investigated further.

(2) Lehman's Price Testing of its Corporate Debt Positions

The marks Lehman reported in its public financial statements for its corporate debt assets were those determined by its trading desks, and, as with other asset classes, these marks were subject to price testing by Lehman's Product Control Group.[2066] The Product Control Group used a number of methodologies to perform price verification of corporate debt positions, ranging from use of external quotes and trade prices to modeling techniques. The method used for price verification was determined according to the SFAS Fair Value level of the position, as well as its liquidity and the availability of information.[2067]

The methods preferred by Lehman's product controllers for price testing corporate debt positions were the use of external quotes and recent trade prices.[2068] If

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[2066] Lehman, Price Verification Policy Global Capital Markets 2008 [Draft] [LBHI_SEC07940_2965994]; Lehman, HG, HY, & EMG Cash Price Testing Policy & Procedure (Jan. 2008), at p. 2 [LBEX-BARVAL 0000001].

[2067] *Id.*

[2068] *See* Lehman, HG, HY, & EMG Cash Price Testing Policy & Procedure (Jan. 2008), at p. 3 [LBEX-BARVAL 0000001]; Lehman, Valuation Review – 2nd Quarter 2008 (July 2008), at p. 15 [LBHI_SEC07940_1184255]. In using external quotes, the product controllers would test desk prices based on bid prices for the asset reported by the Loan Syndications and Trading Association ("LTSA") or

external quotes did not exist and there was no relevant trading activity for a particular position, Lehman's Product Control Group used models to determine a test price for a particular position.[2069] In addition, product controllers also occasionally used

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Mark-it Partners. *See* Lehman, Valuation Review – 2nd Quarter 2008 (July 2008), at p. 15 [LBHI_SEC07940_1184255]. A more generalized price verification policy document also mentions EJV (EJV Partners L.P.), Interactive Data Corporation (IDC), Asset Backed Securities Group (ABSG), IDSI (Interactive Data's securities pricing service), and Bloomberg as pricing sources. *See* Lehman, HG, HY, & EMG Cash Price Testing Policy & Procedure (Jan. 2008), at p. 3 [LBEX-BARVAL 0000001]. Prices that were more than a month old and prices that were otherwise deemed incorrect were disregarded. *Id.*

[2069] The models used were known as the Credit Default Swap ("CDS") and Credit Rating ("CR") Matrices. There are three primary drivers or inputs in valuing a debt security: (1) the payments to be received on the debt (*i.e.* the income Lehman would receive from holding the security), (2) the timing of the payments, including how long until maturity, and (3) the appropriate yield to apply to the future payments to estimate the present value. *See* Shannon P. Pratt *et al.*, *Valuing a Business* 521 (4th ed. 2000). The first input, also called the coupon rate, was determined by looking at the debt instrument itself. The coupon rate is the stated interest rate paid by the borrower. The second input, the timing of the payments, was assumed by Lehman to be semi-annual, and, until 2008, was assumed to last until expected maturity. *See* Lehman, Loans PxTesting_033108.xls [LBEX-BARVAL 0054040-0061041]. Through April 2008, the stated maturity was used as a proxy for expected maturity, with some adjustment for situation-specific information. *See* Lehman, Loans_PxTesting-022908.xls [LBEX-BARVAL 0000005]. In May 2008, the Product Control group changed its practice so that the expected maturity was assumed to be 60 percent of stated maturity. *See* Lehman, Loans PxTesting_053108–final.xls [LBEX-BARVAL 0061231]. The third and final value driver in valuation of a debt security is the yield, or discount rate, used to determine the present value of the payments received. This is an assumption that requires some analysis in order to estimate properly, and a CDS Matrix is a tool that can be used to estimate this rate. *See* Lehman, Valuation Review – 2nd Quarter 2008 (July 2008), at p. 15 [LBHI_SEC07940_1184255]. When using a CDS Matrix methodology the discount rate is estimated using matrices of yields based on CDS prices reported for the same issuer or a comparable issuer. Lehman, Loans PxTesting_053108–final.xls [LBEX-BARVAL 0061231]. These yields or spreads are market-based indications of what investors would expect to receive on similar debt, and therefore are appropriate discount rates to use to value the specific debt instrument. If appropriate CDS yields are not available, perhaps because there is no CDS market for the company's debt or a comparable company's debt, an alternative approach known as a Credit Rating ("CR") Matrix may be used to determine an estimated yield. Lehman, Valuation Review – 2nd Quarter 2008 (July 2008), at p. 15 [LBHI_SEC07940_1184255]. The difference between the CDS Matrix and CR Matrix approaches is in the estimation of the discount rate. In the CR Matrix methodology, the discount rate is determined based on spreads for debt issued by a benchmark company with a similar business model and capital structure as the subject issuing company. For this process, Product Controllers developed a credit rating matrix using rating/yield information from Loan Connector, an internal Lehman system, and generic spreads based on loan credit ratings as provided by Reuters Loan Pricing Corporation.

"alternative procedures," which included determining test prices for certain instruments based on typical relationships between the types of loans.[2070]

On a monthly basis, Lehman would populate a Microsoft Excel file, which it called the "price testing workbook," with all of its U.S. bank loans, and perform one of the testing methodologies identified above. In May 2008, the price testing workbook contained positions accounting for $32.7 billion, or 65% of Lehman's corporate debt portfolio.[2071] In August 2008, the price testing workbook contained positions accounting for $29.0 billion, or 70% of the corporate debt portfolio.[2072] Following is a table of the methods used to test Lehman's U.S. positions.

[2070] For example, if the price of a Term Loan was assumed to be Fair Market Value, a Delayed Draw Term Loan was priced at 0.5 points above the Term Loan. *See* Ernst & Young, Contingent Acquisition Facility Audit Approach [EY-SEC-LBHI-FID-GAMx-07 025076]. For example, in the May price testing file, the testing mark for the First Data "Sr. Cash Pay Bridge" position was determined based on the test price for the Term Loan (based on a third-party sale) less 4.75 basis points. *See* Loans PxTesting_053108 –final.xls, Tab PV, lines 533-549 [LBEX-BARVAL 0061231]. Similarly, Term Loans were priced at 2 points above Revolving Facilities; Senior Subordinate Notes were priced at 4 points above Senior PIK Bridge Loans; and Senior Bridges were priced at 1 point above Subordinate Bridges. *Id.* The reasonableness of these ranges depends on the particular circumstances of the position in question.

[2071] Lehman, Loans PxTesting_05310–final.xls [LBEX-BARVAL 0061231].

[2072] Lehman, Loans PxTesting_083108 v3.xls [LBEX-BARVAL 0048917]. Testing files for non-U.S. positions were not available and the Examiner expresses no view of the reasonableness of the valuation methodology or ultimate marks reported for Lehman's non-U.S. corporate debt positions.

Methods Used to Price Test Lehman's Corporate Debt Portfolio in May and August 2008[2073]

Method	Percentage of assets tested (by value of positions)	
	May-08	Aug-08
External Quote	13.8%	16.3%
Trading Activity	9.6%	2.3%
CDS matrix	64.2%	60.3%
CR matrix	11.9%	15.5%
Alternative Process	0.4%	5.6%
Total	**100.0%**	**100.0%**

As the table above indicates, in May and August of 2008, Lehman's product controllers were unable to use external quotes or trading activity to perform price testing for most corporate debt positions and relied on the modeling techniques described above.

After the product controllers determined their test marks for a position, variances were calculated. Variances are defined as the difference between the trading desk's mark and the mark calculated by the product controller. The thresholds for variances requiring further action were higher for high grade and high yield instruments as compared to debt positions held by the Emerging Markets Group. Variances in excess of $500,000 for high grade and high yield Level 2 and Level 3 positions were considered "significant" and were investigated further.[2074] Variances in

[2073] Lehman, Loans PxTesting_053108_final.xls [LBEX-BARVAL 0061231].

[2074] Lehman, HG, HY, & EMG Cash Price Testing Policy & Procedure (January 2008), at p. 3 [LBEX-BARVAL 0000001]. Variances were resolved using the same procedures described above for other asset classes.

excess of $300,000 for Level 1 high grade and high yield assets were treated similarly.[2075] Variances for emerging markets securities were considered significant above $400,000 for Level 2 and 3 assets and $300,000 for Level 1 assets.[2076]

(3) Examiner's Findings and Conclusions With Respect to the Valuation of Lehman's Corporate Debt Positions

While the Examiner determined that it was not a prudent use of Estate resources to perform an extensive investigation of the valuation of Lehman's entire U.S. corporate debt portfolio, the Examiner did review Lehman's price testing of its largest corporate debt positions. The review of Lehman's Product Control price testing materials was revealing in two respects. First, the price testing materials were not well organized, creating opportunities for errors on the part of the product controllers. Second, the work required to populate the price testing workbooks was manual and labor intensive, and certain relevant assumptions did not appear to have any testing process at all. The Examiner, in the course of reviewing Lehman's price testing process for its largest U.S. corporate debt positions, identified three weaknesses in the Product Control Group's price testing of corporate debt: reliance on trades that did not occur, quality control errors, and no testing of internally-determined credit ratings for debt instruments.

[2075] *Id.*

[2076] *Id.*

(a) Reliance on Non-Trades

As described above, one source of information for price verification is recent trade activity showing the price that a third party paid to acquire the debt instrument in an arms-length transaction. Transactions such as these are a useful source of information because they reflect the value as determined between a willing purchaser and a willing seller. In the price testing workbooks, the product controllers had a column that recorded the counterparty to each transaction that was used as a source for price testing.[2077] In May 2008, there were 57 instances where the listed counterparty was "INVENTORY ADJUSTMENT TMS."[2078] However, this denoted an internal transfer, such as a transfer of a position between Lehman entities, and not a true third-party transaction.[2079] Debt investments marked in May 2008 by internal trades included American Airlines, Aramark Corp., Community Health Systems, DAE Aviation Holdings, Daimler Chrysler, Dana Corp, Dollar General, First Data, HCA Inc., Supervalu Inc., Tribune Company and TXU Energy.[2080]

An error of this nature would not have been captured by the review process, which was designed to identify situations where the price testing generated variances.[2081] The price testing workbook, which was typically completed by a Product

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[2077] Lehman, Loans PxTesting_053108 –final.xls, Tab "PV" Column BL [LBEX-BARVAL 0061231].
[2078] *Id.*
[2079] Lehman, CATS.XLXS [LBEX-BAR 0001102].
[2080] Lehman, Loans PxTesting_053108 –final.xls, Tab "PV," Column BL [LBEX-BARVAL 0061231].
[2081] Examiner's Interview of Brian Sciacca, Oct. 19, 2009, at pp. 2-5.

Control Group staff member, was not reviewed by senior managers, and was never checked for errors.[2082] If the marks for the internal transfers were close to the marks obtained from third-party transactions, this error would be unlikely to be significant. However, even if the marks were identical, this error would make it appear that there was a greater number of trades upon which to base price testing of corporate debt assets, lending a greater sense of confidence to the marks than would be warranted.

(b) Quality Control Errors – Mismatched Companies

For one of the positions examined, Lehman's product controllers used the wrong asset to verify the trading desk's mark. CLP Holdings is a private equity firm. In May 2008, Lehman owned a $250 million position in a term loan to this firm, which was reduced to a $100 million position by August 2008.[2083] The price of this asset was verified in February and May 2008 using CDS Matrix pricing based on the CLP ticker.[2084] However, CLP is the ticker for Colonial Realty, a publicly traded entity entirely unrelated to CLP Holdings. The price estimated for the security using a discount rate based on Colonial Realty's debt profile was 100.00 in May 2008, slightly above the Lehman mark.[2085] The error persisted through July 2008.[2086] This error would not have

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[2082] *Id.*

[2083] Lehman, Loans PxTesting_053108 –final.xls, Tab "PV" Cells AA270 and AA271 [LBEX-BARVAL 0061231]; Lehman, Loans PxTesting_083108 v3.xls, Tab "PV", Cell AB261 and AB262 [LBEX-BARVAL 0048917].

[2084] Lehman, Loans PxTesting_053108 –final.xls, Tab "CDS Matrix", Cell E200 [LBEX-BARVAL 0061231].

[2085] Lehman, Loans PxTesting_053108 –final.xls, Tab "PV," Lines 270 and 271 [LBEX-BARVAL 0061231]. The product control group incorrectly relied on the CLP ticker in February 2008 as well. *See* Lehman, Loans PxTesting_022908.xls Tab "PV" [LBEX-BARVAL 0000005].

generated further scrutiny because the pricing did not generate a significant variance. By August 2008, product controllers were able to obtain external quotes for the security.[2087]

(c) No Testing of Internal Credit Rating

For closely-held debt instruments that were not rated by a ratings agency, Lehman generated an internal credit rating.[2088] The credit rating is a necessary element in assessing the value of a security, and is particularly important when using the CDS Matrix or CR Matrix methodology since these methodologies rely on the credit rating of the security to determine a benchmark discount rate. In general, a higher rating will translate into a lower spread and yield, which are used to discount the future principal and interest payments. Therefore, higher ratings will lead to a higher price. The price testing workbooks included a credit rating for each debt security being price tested, though external and internally generated ratings were indistinguishable.[2089] An interview with a product controller revealed that the Product Control Group did not have any established procedures to test these internal ratings.[2090]

The Examiner did not test each credit rating assumption. However, the Examiner did identify one instance that called into question the credit rating

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[2086] Lehman, Loans PxTesting_073108 –v1.xls [LBEX-BARVAL0037526].
[2087] Lehman, Loans PxTesting_083108 v3.xls, Tab "PV" Cell BJ262 [LBEX-BARVAL 0048917].
[2088] *See* Lehman, Internal Ratings: Scorecard Framework and User Guide (May 1, 2007), at p. 1 [LBEX-BARFID 0019865].
[2089] Lehman, Loans PxTesting_053108 –final.xls, Tab "CDX MTRX Mapping" [LBEX-BARVAL 0061231].
[2090] Examiner's Interview of Brian Sciacca, Oct. 19, 2008, at pp. 2-5.

assumptions used by product controllers. OZ Management, LLC ("OZ Management") is a subsidiary of Och-Ziff Capital Management Group, LLC, and Lehman held a term loan to OZ Management with a principal amount of $250 million, maturing in 2013. The Product Control Group price tested this security using a credit rating of AA.[2091] However, according to a Commitment Committee memo dated less than one year prior, the OZ Management investment was given an implied BBB- rating as of June 2007.[2092]

Under the terms of the loan agreement, OZ Management was obliged to use its "best efforts" to obtain a rating for the loan in early 2008.[2093] In addition, Lehman indicated that the terms of this investment were "below market."[2094] It does not appear, however, that a rating was ever obtained for this loan. The Examiner was unable to locate any evidence that OZ Management was rated by any rating agency during this time frame. In this particular instance, if the correct rating were BBB- instead of AA, the result would have been an overstatement of value of the investment.

As noted, the Examiner is not able to quantify the potential impact of these issues without performing an independent valuation of each of the more than 10,000 corporate debt positions held by Lehman. Because of the time and expense required by such an exercise, the Examiner did not deem this to be a prudent use of Estate resources.

[2091] Lehman, Loans PxTesting_053108 –final.xls, Tab "CDS MTRX," Line 656 [LBEX-BARVAL 0061231].
[2092] Lehman, Request to participate as a Joint Bookrunner in Och-Ziff's IPO (June 1, 2007), at p. 10 [LBEX-AM 112872].
[2093] *See* e-mail from Greg L. Smith, Lehman, to Steven Berkenfeld, Lehman (Oct. 25, 2007) [LBEX-DOCID 821562].
[2094] *Id.*

However, the Examiner notes that the issues identified relate exclusively to the price verification process performed by the Product Control Group and do not directly suggest that the valuation of Lehman's corporate debt positions, as determined by the trading desks, was unreasonable. For the reasons stated above, the Examiner draws no conclusion as to the reasonableness of Lehman's valuation of any particular corporate debt position or the valuation of its corporate debt portfolio as a whole.

l) Examiner's Analysis of the Valuation of Lehman's Corporate Equities Positions

(1) Overview of Lehman's Corporate Equities Positions

Lehman actively invested in the equity of both public and private companies around the world. Corporate equities, as defined by Lehman, include common and preferred securities in both public and private companies, as well as equity options, investments in general partnerships and limited partner positions in private equity or hedge funds.[2095] This Section of the Report addresses Lehman's valuation of common and preferred securities in public and private companies, and the term "corporate equities" as used herein refers only to these types of investments.[2096] As of May 31, 2008, the number of worldwide corporate equity positions listed in GFS, Lehman's tracking

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[2095] *See* Lehman, REC May-08 13-June-08 FINAL.xls [LBEX-LL 1104843].

[2096] Options are addressed within the Derivatives Section of this Report, assets related to commercial real estate are addressed in the CRE and Commercial Book sections, and limited partnership funds are not addressed because they are marked based on Net Asset Value ("NAV") statements provided by the respective fund, and effectively unreviewable since none of the underlying assets are disclosed. *See* Lehman, Private Investment Valuation, at p. 1 [EY-SEC-LBHI-PE-GAMx-07 000995]. Lehman's marking of fund investments is consistent with how other market participants would have marked fund investments assuming that they were subject to the same accounting rules as was Lehman.

system for financial inventory, was 33,174.[2097] On August 31, 2008, the total number of positions was 39,205.[2098] As of May 31, 2008, Lehman reported that it held $47.5 billion in corporate equity assets, approximately 56% of which were Level 1 assets.[2099] As of August 31, 2008, Lehman determined that the value of its corporate equity portfolio was $43.2 billion, approximately 60% of which were Level 1 assets.[2100]

As is discussed below, the valuation of equity positions in publicly-held companies is more straightforward than the marking and valuation of equities in privately-held companies. In reviewing Lehman's publicly traded corporate equities, the Examiner has found that Lehman's marks for these positions closely tracked publicly-quoted prices. The Examiner has found insufficient evidence to support a finding that Lehman's marks for these assets were unreasonable. With respect to Lehman's equity positions in privately-held companies, evaluating the reasonableness of Lehman's valuations of these assets would require an investigation of the financial circumstances and prospects of each privately-held company. Furthermore, the Examiner has considered what impact the valuation of these assets would have on the

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[2097] *Id.*; Examiner's Interview of Kristie Wong, Dec. 2, 2009, at p. 4 (describing function of GFS system). These thousands of positions approximate the number of unique corporate equity positions held by Lehman. However, the actual number of unique positions held differed because (1) GFS reports the same investment held by two different legal entities as two different positions, (2) multiple option positions are grouped together into one position for GFS purposes, and (3) system users enter "Adjustments" directly into the system that appear as a position but are more accurately described as adjustments to existing positions. Lehman., REC May-08 13-June-08 FINAL.xls [LBEX-LL 1104843]

[2098] Lehman, REC August 08 as of 17-September Ext Rep.xls [LBEX-LL 1104812].

[2099] LBHI 10-Q (filed July 10, 2008) at p. 29.

[2100] Lehman, REC August 08 as of 17-September Ext Rep.xls [LBEX-LL 1104812]. Lehman did not file a Form 10-Q statement for the third quarter of 2008 before its bankruptcy filing.

solvency analysis for LBHI Affiliates. According to Lehman's GFS database, LCPI was the only LBHI Affiliate to hold significant corporate equity assets.[2101] Because the Examiner has determined that LCPI was either borderline solvent or insolvent during the relevant period, an analysis of Lehman's valuation of corporate equity assets would not materially enhance the solvency analysis of any LBHI Affiliate. For this reason, and because of the time and expense required by such an exercise, the Examiner did not deem an extensive investigation of these assets to be a prudent use of Estate resources. However, the Examiner has investigated a number of individual equity positions in publicly-held companies and other non-publicly traded equities and identified issues that may be relevant to the valuation of these assets generally.

(2) Lehman's Valuation Process for its Corporate Equities Positions

As with other classes of assets, the marks reported by Lehman in its public financial statements for corporate equities were the values determined by its trading desks, and these values were subject to price testing performed by Lehman's Product Control Group.[2102] Within the Equity Division, the global Equity Valuation Group ("EVG") was responsible for testing equity investments in public companies and some

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[2101] The Examiner reviewed the largest 15 corporate equity positions held by Lehman in May and August 2008. No LBHI Affiliate held any of these in May 2008, and only LCPI held any in August 2008. *See* Lehman, REC Feb-08.03.08 FINAL.xls [LBEX-LL 1104828]; Lehman, REC May-08 13-June-08 FINAL.xls [LBEX-LL 1104843]; Lehman, REC August 08 as of 17-September Ext Rep.xls [LBEX-LL 1104812]. While the position-level data in Lehman's GFS system was understood to contain some inaccuracies, it was relied on as a management reporting tool and is the only comprehensive source showing ownership of individual positions. Examiner's Interview of Kristie Wong, Dec. 2, 2009, at p. 4.

[2102] Lehman, Price Verification Policy Global Capital Markets 2008 [Draft] [LBHI_SEC07940_2965994].

private companies.[2103] Equity positions in most privately-held companies were price tested by the Private Equity Valuation Committee.[2104] Each group is discussed below.

The EVG gathered information on listed equity positions held by Lehman from the GQuest system, while information on over-the-counter equities positions was gathered from its GEDS system.[2105] The preferred method for price testing publicly traded equities was to look to the market price of these assets.[2106] In order to avoid circular reliance on its own prices, the Product Control Group considered Bloomberg quotes derived from Lehman's own traders' marks to be unreliable.[2107] Similarly, if the product controllers only had a quote from a single broker, and could not corroborate that quote with information from another source, they would deem that quote to be unreliable.[2108]

For price testing of positions for which they did not have either visible market prices or information from third-party sources, Lehman's product controllers relied on methods they termed "input" pricing.[2109] In performing input pricing, the Product Control Group used models to determine the appropriate marks for corporate equity

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[2103] *Id.* at p. 103.

[2104] EVG would test equity investments in certain positions in private companies that were held exclusively in Equities Group within the Capital Markets business line. This separation of testing was a function of which internal business line held the equity position.

[2105] Lehman, Price Verification Policy Global Capital Markets 2008 [Draft], at p. 104 [LBHI_SEC07940_2965994].

[2106] *Id.*

[2107] *Id.* at p. 105.

[2108] *Id.*

[2109] *Id.* at p. 104.

positions and relied on interpolation and extrapolation from observable indicators.[2110] In addition, product controllers sometimes performed statistical analyses, relying on regression analysis and volatility estimation.[2111]

After the EVG determined a benchmark, the price testing variance between EVG's and the traders' mark was calculated. Product controllers and traders would attempt to resolve variances through conversation and unresolved variances were escalated to senior management as with other asset classes.[2112] A summary of the price testing results was subsequently submitted for inclusion in the Valuation and Control Reports presented to senior management.[2113]

As noted above, the price testing of most private equity positions was a more difficult process than the testing of positions in publicly-held corporations. Lehman's private equity holdings were not price tested as were other asset classes, but rather values were established based on a committee review. A committee, informally titled the Private Equity Valuation Committee ("PEVC"), would meet quarterly to discuss the valuation of private equity assets.[2114] Each private equity investment typically had a

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[2110] *Id.* at p. 105.

[2111] *Id.*

[2112] *Id.* at p. 107; Lehman, Equities Finance Org Chart [BCI-EX-(S)-00109843].

[2113] Lehman, Price Verification Policy Global Capital Markets 2008 [Draft], at p. 107 [LBHI_SEC07940_2965994].

[2114] Examiner's Interview of James Emmert, October 9, 2009, at pp. 3-4; Lehman, Private Equity Valuation Committee, May 2008, Final Version (June 3, 2008) [LBHI_SEC07940_889460].

trader that would be considered the "owner" of that investment.[2115] After analysis of a privately-held corporation, each trader would determine what mark he or she thought appropriate for Lehman's position in that corporation. In doing so, the trader would develop a set of documents to support the mark. These documents included financial statements and other documents describing the financial and operational circumstances of the company in question. In the course of its quarterly review, these supporting documents would be presented to the PEVC for its consideration. The PEVC would review the supporting documents, the subject corporation's most recent financial metrics, and any significant events or transactions that would impact the value of Lehman's investment.[2116] Based on all the facts available, the PEVC would settle on a mark for the investment. Following each quarterly meeting, the PEVC would assemble a presentation summarizing its findings.[2117]

(3) Examiner's Findings and Conclusions With Respect to the Valuation of Lehman's Corporate Equities Positions

The Examiner reviewed a number of Lehman's May and August 2008 publicly traded Level 1 corporate equity positions and confirmed that the mark used by Lehman matched the publicly traded price. This was to be expected given the price

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[2115] Examiner's Interview of James Emmert, October 9, 2009, at pp. 3-4.

[2116] *Id.*

[2117] *See, e.g.*, Lehman, Private Equity Valuation Committee, May 2008 (June 3, 2008), at p. 2 [LBHI_SEC07940_889460].

transparency for this asset class. These Level 1 assets made up approximately 56% of Lehman's total corporate equity positions in May 2008, and 60% in August 2008.[2118]

Because visible market prices are not available for Level 2 and 3 corporate equity assets, which are generally equity positions in privately-held corporations, a similar approach is not possible for these assets. Rather, the valuation of Level 2 and 3 corporate equity positions typically requires a host of supporting information and a number of assumptions on the part of the party performing the valuation. Typical documents and information that would be required to determine the value of these equity positions included historical financial statements, projections for the business, business plans, capital structure tables, customer lists, discussions with executive officers or others addressing operations and sales, competitor analyses, articles of incorporation, marketing plans and other similar information.[2119]

In order for the Examiner to evaluate the reasonableness of Lehman's valuation of its Level 2 and 3 corporate equity positions, all of this supporting documentation and information would have to be reviewed and analyzed for each privately-held corporation in which Lehman held an equity position. Additionally, interviews with individuals who attended PEVC meetings revealed that this type of background information was sometimes not disclosed in hard copy, but was reported orally by the

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[2118] LBHI 10-Q (filed July 10, 2008) at p. 29; Lehman, REC August 08 as of 17-September Ext Rep.xls [LBEX-LL 1104812].

[2119] Shannon P. Pratt et al.,. Valuing a Business: The Analysis and Appraisal of Closely Held Companies 77 (5TH ED. 2007).

trader responsible for the position.[2120] As noted, the Examiner determined that the time and expense required to assemble and then analyze this information was not a prudent use of the Estate resources. Accordingly, the Examiner has not evaluated the reasonableness of each of Lehman's valuations of its equity positions in privately-held corporations.

However, the Examiner did review a limited selection of Lehman's corporate equity positions in order to understand the type of issues that may arise in the valuation of these assets. The positions reviewed were the 15 largest Level 2 and 15 largest Level 3 positions on May 31, 2008, and August 31, 2008.[2121] The issues identified in the course of reviewing these positions do not, by themselves, suggest that there exists a finding that the value of any particular corporate equity position held by Lehman was unreasonable. However, they do indicate that further review of Lehman's corporate equity positions may be warranted if supporting documents and sufficient time and resources are available.

(a) Impaired Debt with No Equity Mark Down

The capital structure of any given company is comprised of various types of equity and/or debt. It is axiomatic that, within a capital structure, debt is senior to equity. Accordingly, if there is impairment of the value of debt at a particular company

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[2120] Examiner's Interview of James Emmert, October 9, 2009, at pp. 3-4.

[2121] *See* Lehman, REC May-08 13-June-08 FINAL.xls [LBEX-LL 1104843] and Lehman, REC August 08 as of 17-September Ext Rep.xls [LBEX-LL 1104812].

due to increased riskiness, it would strongly suggest that the value of the company's equity must also be reduced due to the same risk.

The Examiner identified an example where Lehman had marked down the debt but not the equity of the same company. This company was Bawag PSK ("Bawag"). Bawag is a privately held company that provides financial services, principally in Austria.[2122] In an August 29, 2008 e-mail, there was discussion about the possibility of a 10% write-down of Bawag's equity.[2123] However, by September 1, 2008, it was determined internally that Bawag's equity no longer needed to be written down, even though the debt component, represented by a position held by the Investment Management Division ("IMD"), had already been written down.[2124] It is highly irregular for an equity position to remain unchanged when a debt security sitting higher in the capital structure is written down since both securities would likely be impacted by the same risk factors that cause a decrease in the value of the debt instrument. In the same September 1, 2008 e-mail, it is mentioned that the write-down on equity is still being discussed "due to the impact on IMD," suggesting that the write-down on equity may

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[2122] Data available from CapitalIQ.

[2123] E-mail from Gilles Aublin, Lehman, to James Emmert, Lehman, *et al.* (Aug. 29, 2008) [LBHI_SEC07940_2492814].

[2124] E-mail from Tony Ellis, Lehman, to Gilles Aublin, Lehman, *et al.* (Sept. 1, 2008) [LBHI_SEC07940_2499269].

not have been evaluated based on fundamentals, but rather how it would affect other businesses within Lehman.[2125]

(b) Static Marks

The Examiner identified several instances in which the valuations of some of Lehman's corporate equity positions remained unchanged for up to 15 months.[2126] Given day-to-day fluctuations in the market, economic variables, and the circumstances of any particular company and its business operations, it is highly improbable that the value of a company, and therefore the value of Lehman's equity position in it, would remain constant over an extended period of time.

One example of Lehman keeping its mark on an investment unchanged for an extended period of time is Lehman's Bawag investment, mentioned above. In May and August of 2008 Lehman valued its equity position in Bawag at approximately $170 million with a mark of 100 cents on the dollar, implying that $170 million was the amount of its initial investment.[2127] Based on the fact that the initial investment in Bawag was in May 2007, this implies that Lehman marked its position in Bawag at 100

[2125] *Id.*

[2126] Examples include First Data Corporation, BATS Holding, Greenbrier Minerals, and Floatel International. *See* Lehman, REC Feb-08.03.08 FINAL.xls [LBEX-LL 1104828]; Lehman, REC May-08 13-June-08 FINAL.xls [LBEX-LL 1104843]; Lehman, REC August 08 as of 17-September Ext Rep.xls [LBEX-LL 1104812]; Lehman, GFS Export [LBEX-LL 1174708]; Lehman, GFS Export [LBEX-LL 2236006]; Lehman GFS Export [3280239].

[2127] Lehman, REC May-08 13-June-08 FINAL.xls [LBEX-LL 1104843] and Lehman, REC August 08 as of 17-September Ext Rep.xls [LBEX-LL 1104812].

cents on the dollar for a 15-month period before bankruptcy.[2128] Comparing Lehman's valuations of corporate equity positions in February, May and August of 2008, the Examiner identified 343 examples, totaling $455 million in investments, where the mark for a corporate equity position did not change over this 6 month time period.[2129] For lack of detailed information regarding the companies in question, the Examiner draws no conclusion about the reasonableness of the valuation of any particular one of these positions. However, Lehman's static marks for these positions may warrant further investigation.

In addition to these issues, the Examiner identified other, less significant, issues with Lehman's valuation of corporate equity assets. These include the performance of corporate equity positions as compared to an index of similar companies,[2130] and the application of a discount for lack of marketability.[2131]

[2128] BAWAG Revised Terms and Underwriting Amount, High Yield Commitment Committee, Memorandum (Feb. 7, 2007) [LBEX-DOCID 511627]; *Austrian BAWAG's $4.3 bln sale to Cerberus closed*, Reuters, May 15, 2007

[2129] [2129] Lehman Brothers Holdings Inc., "REC Feb-08.03.08 FINAL.xls [LBEX-LL 1104828 – 1104842]; Lehman Brothers Holdings Inc., "REC May-08 13-June-08 FINAL.xls" [LBEX-LL 1104843 - 1104857]; Lehman Brothers Holdings Inc., "REC August 08 as of 17-September Ext Rep.xls" [LBEX-LL 1104812 – 1104827].

[2130] The Examiner identified several cases in which Lehman's valuation of a private equity position implied that the company in question significantly diverged from, and usually outperformed, a comparable set of publicly-traded corporations. These include investments in Wilton Re Holdings ("Wilton"), First Data Corporation, ECL Finance, BATS Trading, Castex, and Greenbrier Minerals. In one such case, that of Wilton, a provider of risk and capital management solutions for the life insurance industry, outperformed an index of comparable companies' equities by 12.6% as of May 31, 2008, and 19.4% as of August 31, 2008, according to Lehman's estimates. During the first three quarters of 2008, Lehman's marks for Wilton increased slightly while a comparable index showed a significant decrease in value. *Id.* It would be inappropriate to blindly conclude that Lehman should have adjusted its valuation of its position in Wilton to match the performance of a set of comparable companies. The performance of

As noted, none of the issues identified provide evidence that the value of any particular Lehman corporate equity position is misstated. A thorough investigation of the subject company's financial and operational circumstances would be necessary to reach such a conclusion. In fact, without reviewing every one of Lehman's corporate equity positions, it is impossible to know what portion of Lehman's corporate equity

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comparable companies is but one indicator of the value of a private equity position, to be considered in the context of the financial information and particular circumstances of the company in question. However, comparable companies provide insight into the valuation trends to which a company in a particular industry may be subject. Instances in which Lehman's valuation of a particular private corporate equity position seem inconsistent with the performance of comparable companies suggest further review may be warranted.

For Wilton, the comparable companies were: AFLAC; The Hartford; Allstate; Everest Re; and Reinsurance Group of America. For First Data Corporation, the comparable companies were: Alliance Data Systems; Global Payments, Inc.; Fidelity National; and Fiserv, Inc. For ECL Finance, the performance was compared to Edelweiss Capital, the publicly traded parent company. For BATS Trading, the comparable companies were: Interactive Brokers; MarketAxess Holdings; Intercontinental Exchange; and BGC Partners. For Castex, the performance was compared to the U.S. Oil Fund ETF, as well as major oil companies. For Greenbrier, the comparable companies were: James River Coal Co.; Alliance Holdings GP, LP; International Coal Group, Inc.; Patriot Coal Corporation; and Arch Coal, Inc. Lehman, GFS Export [LBEX-LL 1174708]; Lehman, GFS Export [LBEX-LL 2236006]; Lehman GFS Export [3280239].

[2131] Of the positions reviewed by the Examiner, a number had a restriction on the sale of the underlying security, sometimes referred to as a lock-up provision. A lock-up provision is a restriction that limits the ability to sell a particular security, even if the security is publicly-traded, for a certain period of time. Lehman's accounting for these restrictions, while consistent with GAAP, resulted in reported values that may have deviated from fair market value for purposes of solvency analysis.

When Lehman held a publicly-traded security that had a restriction, the policy was to apply a discount to the publicly-traded price for valuation purposes, based on the period of restriction. Lehman, Global Consolidated Policy on Valuation Adjustments: Global Capital Markets (Sept. 2008) [LBEX-BARFID 0011765]. This discount, called a discount for lack of marketability ("DLOM"), is typically driven by the duration of the restriction and the volatility of the underlying security. The DLOM, which was booked as a liability, would then be amortized, at a constant or "straight-line" pace, over the life of the restriction. *Id.* Such a process would approximate fair market value at any point along the amortizing timeline unless something significant changes, such as the volatility of the underlying stock. However, the volatility of the underlying stock is always changing and this change in volatility should affect the magnitude of the DLOM, and therefore the fair market value of the position held. Because Lehman's method did not take into account potential changes in volatility of the underlying stock, the values reported on Lehman's GAAP balance sheet may not have reflected fair market value. While this suggests a deviation from fair market value for solvency purposes, the potential misstatement is not likely to be significant unless volatility significantly changes over time.

portfolio may have been subject to these issues, or others like them. However, these limitations applied to a minority of Lehman's corporate equity positions. Most of Lehman's corporate equity portfolio was made up of SFAS Level 1 assets,[2132] which benefited from relative price transparency. The Examiner has not found sufficient evidence to support a finding that the valuation of Lehman's Level 1 corporate equity portfolio was unreasonable. For the reasons described above, and noting that the valuation of these assets does not materially enhance the solvency analysis for any LBHI Affiliate, the Examiner draws no conclusions regarding the reasonableness of Lehman's valuation of its Level 2 and 3 equity positions in privately-held companies.

[2132] LBHI 10-Q (filed July 10, 2008) at p. 29; Lehman, REC August 08 as of 17-September Ext Rep.xls [LBEX-LL 1104812].

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	Chapter 11 Case No.
LEHMAN BROTHERS HOLDINGS INC., *et al.*,	:	08-13555 (JMP)
	:	(Jointly Administered)
Debtors.	:	

REPORT OF EXAMINER ANTON R. VALUKAS

Section III.A.3: Survival

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3. Lehman's Survival Strategies and Efforts

a) Introduction to Lehman's Survival Strategies and Efforts

(1) Examiner's Conclusions

With the near collapse of Bear Stearns on March 16, 2008, a widely held belief was that Lehman would be the next investment bank to fail.[2133] SEC Chairman Christopher Cox thought so; FRBNY President Timothy F. Geithner thought so; Treasury Secretary Henry M. Paulson, Jr., thought so; Federal Reserve Chairman Ben S. Bernanke thought so.[2134] More important, Lehman knew that its survival was in question. When Lehman announced its second quarter 2008 losses, Secretary Paulson spoke with Richard S. Fuld, Jr. According to Paulson, Fuld told him that further losses might be reported in the third quarter.[2135] Fuld, though, told the Examiner that he did not recall previewing Lehman's third quarter results with anyone from Treasury, and noted that Lehman was performing well in the first half of June (Lehman pre-announced its second quarter results on June 9, 2008).[2136] In any event, Paulson warned

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[2133] *See*, *e.g.*, Riley McDermid & Alistair Barr, *Wall Street Watches Lehman Walk on Thin Ice*, MarketWatch, Mar. 17, 2008, *available at* http://www.marketwatch.com/story/wall-street-watches-Lehman-walk-on-thin-ice; David Bogoslaw, *Is Lehman Liquid Enough?*, Business Week, Mar. 18, 2008, *available at* http://www.businessweek.com/investor/content/mar2008/pi20080317_703353.htm?chan=top+news_top+news_index_top+story.

[2134] E-mail from Donald L. Kohn, Federal Reserve, to Ben S. Bernanke, Federal Reserve (June 13, 2008) [FRB to LEH Examiner 000781] (informing Bernanke that institutional investors believed that it was not a question of whether Lehman would fail, but when the failure would occur); Examiner's Interview of Ben S. Bernanke, Dec. 22, 2009, at pp. 4-5; Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 2; Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at pp. 8-9; Examiner's Interview of Christopher Cox, Jan. 8, 2010, at p. 8.

[2135] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 14.

[2136] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 20.

Fuld that Lehman needed to have a buyer or other survival plan in place before announcing further losses in quarter three or its survival would be in doubt.[2137]

With that backdrop, the Examiner determined that it was necessary to explore what Lehman did and did not do, to assess whether any officer or director breached a fiduciary duty by not diligently pursuing potential survival strategies. The Order appointing the Examiner directed an investigation into "colorable claims for breach of fiduciary duties . . . arising in connection with the financial condition of the Lehman enterprise prior to the commencement of the LBHI chapter 11 case on September 15, 2008."[2138] Accordingly, the Examiner reviewed the actions of Lehman's management and Board, including their efforts to help Lehman survive, for potential breaches of fiduciary duties. In particular, the Examiner investigated the efforts of Lehman's management and Board to raise capital through public offerings; to strengthen its financial position through transactions with one or more strategic partners and investors; and to restructure the firm by spinning off commercial real estate assets into an entity Lehman internally referred to as SpinCo. With respect to those areas, the Examiner analyzed whether Lehman's officers and directors fulfilled or breached their fiduciary duties of care or loyalty, including the duties of candor, monitoring, and good faith during the period following the near collapse of Bear Stearns.

[2137] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 19.

[2138] Order Directing Appointment of an Examiner Pursuant to Section 1104(c)(2) of the Bankruptcy Code, at p. 3, Docket No. 2569, *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Jan. 16, 2009).

The Examiner concludes:

1. There is no substantial evidence that Lehman's officers breached their duty of care in connection with the substance of their efforts to raise capital, attract strategic investors or spin off Lehman's commercial real estate assets, particularly in light of the protection provided by the business judgment rule.

2. (a) Lehman's senior management appears not to have been aware of some facts that turned out to be significant. Similarly, Lehman's Board was not aware of facts that turned out to be significant. Even so, there is no substantial evidence that Lehman's officers breached their duty of candor or otherwise breached their duty of loyalty to the Board in connection with efforts to raise capital, attract strategic investors or spin off Lehman's commercial real estate assets, except as set forth elsewhere.[2139]

3. There is no substantial evidence that Lehman's officers breached their duty of candor or otherwise breached their duty of loyalty to Lehman's shareholders in connection with efforts to raise capital, attract strategic investors or spin off Lehman's commercial real estate assets, except as set forth elsewhere.[2140]

4. There is no substantial evidence that Lehman's officers breached their duty of good faith in connection with efforts to raise capital, attract strategic investors, or spin off Lehman's commercial real estate assets.

5. There is no substantial evidence that Lehman's directors breached any applicable fiduciary duty in connection with Lehman's efforts to raise capital, attract strategic investors, or spin off Lehman's commercial real estate assets.

6. There is evidence that KDB may have breached a confidentiality agreement with Lehman, but a claim based on that breach does not appear to be worth pursuing because it would be difficult to establish that the breach caused Lehman to collapse or otherwise to incur substantial damages.

[2139] *See* Section III.A.4 of this Report, which discusses Lehman's use of Repo 105 in greater detail.

[2140] *Id.*

(2) Introduction to Lehman's Survival Strategies

By the end of 2007, events in the market, such as the collapse of two Bear Stearns hedge funds in July, combined with Lehman's own challenges in funding all of its commitments, led some Lehman executives to recognize that Lehman had to move away from the growth strategy it had been pursuing since 2006.[2141] In January 2008, Lehman was reducing its positions in some areas but did not see a need to raise additional equity capital.[2142] To the contrary, at that point, LBHI was continuing its longstanding practice of repurchasing its own shares to prevent dilution that otherwise would result from the issuance of new shares as part of Lehman's compensation process.[2143] On February 7, 2008, LBHI shifted course and issued a prospectus for an offering of preferred shares in which Lehman raised $1.59 billion.[2144]

On March 16, 2008, JPMorgan announced that it was acquiring Bear Stearns, saving Bear Stearns from bankruptcy.[2145] After Bear Stearns' near collapse, many

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[2141] *See, e.g.*, Lehman, Global Real Estate Update (Nov. 6, 2007) [LBEX-DOCID 514265]; Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at pp. 10-11. *Accord* Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 10; *see also* Section III.A.1,b of this Report, which discusses events in 2007 in greater detail.

[2142] *See, e.g.*, e-mail from David Goldfarb, Lehman, to Richard S. Fuld, Jr., Lehman (Jan. 9, 2008) [LBHI_SEC07940_670045]; e-mail from Erin M. Callan, Lehman, to Larry Wieseneck, Lehman (Feb. 1, 2008) [LBHI_SEC07940_069737]; e-mail from Erin M. Callan, Lehman, to Philip Lynch, Lehman, *et al.* (Mar. 15, 2008) [LBHI_SEC07940_075250]. *Accord* Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at p. 11.

[2143] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Jan. 29, 2008), at pp. 2-3 [LBHI_SEC07940_027446].

[2144] Lehman Brothers Holdings Inc., Prospectus Supplement as of Feb. 5, 2008 (Form 424B2) (filed on Feb. 7, 2008) ("LBHI 424B2 Feb. 7, 2008").

[2145] J.P.Morgan Chase & Co., Current Report as of Mar. 16, 2008 (Form 8-K), at Ex. 99.1 (filed on Mar. 18, 2008) ("JPMorgan 8-K (Mar 18, 2008)").

financial experts speculated that Lehman was the next most vulnerable investment bank.[2146] However, Lehman's executives were themselves successful investment bankers, skilled in identifying, analyzing, pursuing and consummating strategic deals, and never before had failed to get the deal done when necessary.[2147] The financial markets' reactions to the near collapse of Bear Stearns, including speculation that Lehman might be the next investment bank to fail, led Lehman to refocus its efforts on improving capital and liquidity.[2148] At the same time, Lehman management contrasted itself with Bear Stearns in internal discussions by noting how Lehman's liquidity pool and funding requirements, among other things, differed in important respects from Bear Stearns'.[2149]

After the near collapse of Bear Stearns, Lehman moved to raise additional capital.[2150] Lehman initiated work on an equity offering and restarted efforts to locate candidates willing to make a strategic investment in Lehman.[2151] In late March, Lehman

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[2146] *See, e.g.*, Riley McDermid & Alistair Barr, *Wall Street Watches Lehman Walk on Thin Ice*, Mar. 17, 2008, *available at* http://www.marketwatch.com/story/wall-street-watches-Lehman-walk-on-thin-ice; David Bogoslaw, *Is Lehman Liquid Enough?*, Mar. 18, 2008, *available at* http://www.businessweek.com/investor/content/mar2008/pi20080317_703353.htm?chan=top+news_top+news_index_top+story.

[2147] Examiner's Interview of Hugh E. McGee, III, Aug. 12, 2009, at p. 28.

[2148] See, *infra*, Section III.A.3.c of this Report, which discusses Lehman's efforts after Bear Stearns' near collapse in greater detail.

[2149] Lehman, Lehman Brothers Board of Directors, Liquidity & Market Update (Mar. 25, 2008), at p. 2 [LBHI_SEC07940_027782].

[2150] See *infra*, Section III.A.3.c of this Report, which discusses Lehman's efforts to raise capital after Bear Stearns' near collapse in greater detail.

[2151] See *id.*, *infra* Section III.A.3.c of this Report, which discusses Lehman's efforts to find a strategic partner in greater detail.

undertook discussions with Warren E. Buffett, CEO of Berkshire Hathaway.[2152] However, those discussions did not result in any investment by Buffett, Berkshire Hathaway, or any of its affiliates.[2153] Instead, at the beginning of April 2008, Lehman completed a $4.0 billion convertible preferred stock offering.[2154] Other offerings to bolster Lehman's capital followed in May and June.[2155]

In late May 2008, Lehman began talks with a Korean bank consortium regarding an investment.[2156] By early June, the consortium and Lehman circulated a draft term sheet.[2157] However, Lehman did not complete a deal with the consortium;[2158] instead, Lehman raised capital from other sources.[2159]

[2152] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 8; Examiner's Interview of Warren E. Buffett, Sept. 22, 2009, at pp. 2-3.

[2153] Examiner's Interview of Warren E. Buffett, Sept. 22, 2009, at p. 4; Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 11.

[2154] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Mar. 31, 2008), at p. 1 [LBEX-AM 003597]; Lehman Brothers Holdings Inc., Current Report as of Apr. 1, 2008 (Form 8-K) (filed on Apr. 4, 2008) ("LBHI 8-K (Apr. 4, 2008)").

[2155] *See* Lehman, Presentation to Lehman Brothers Board of Directors, Estimated April 2008 Financial Information (May 7, 2008), at p. 8 [LBHI_SEC07940_028014].

[2156] *See* Memorandum from Kunho Cho, Lehman, to Hugh E. McGee, III, Lehman, *et al.*, re: Opportunity Briefing and Key Issues for Investment by Korea Inc. Consortium in Lehman Brothers (May 29, 2008) [LBEX-DOCID 1374131], attached to e-mail from Kunho Cho, Lehman, to David Goldfarb, Lehman (May 29, 2008) [LBEX-DOCID 1466211].

[2157] Hana Investment Bank, Elements of Strategic Relationship [Draft] (June 4, 2008) [LBEX-DOCID 1401999], attached to e-mail from Chan Lee, Hana Investment Bank, to Larry Wieseneck, Lehman, *et al.* (June 4, 2008) [LBEX-DOCID 1527489].

[2158] See *infra* Section III.A.3.c of this Report, which discusses Lehman's June discussions with KDB in greater detail.

[2159] *See* Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (June 6, 2008), at pp. 1-3 [LBEX-AM 003709]; Lehman Brothers Holdings Inc., Current Report as of June 9, 2008 (Form 8-K) (filed on June 12, 2008) ("LBHI 8-K (June 12, 2008)").

On June 9, 2008, Lehman issued prospectuses for two offerings that totaled $6.0 billion,[2160] on the same day that Lehman pre-announced a $2.8 billion loss for the second quarter of 2008.[2161] Lehman's offering was completed on June 12, 2008.[2162] That same day, Lehman announced that Herbert "Bart" H. McDade, III, was replacing Joseph M. Gregory as President, and Ian T. Lowitt was replacing Erin M. Callan as CFO.[2163] Fuld told the Board that he intended the management change to be a "dramatic" demonstration to Wall Street that Lehman was taking action to make changes.[2164] On June 13, 2008, Federal Reserve Vice Chairman Donald L. Kohn expressed to Bernanke the opinion held by some institutional investors, which Kohn appeared to share, that it was not a matter of whether Lehman would fail, but when.[2165] However, Bernanke told the Examiner that he was "never of the view that [Lehman's] failure was inevitable."[2166]

[2160] Lehman Brothers Holdings Inc., Prospectus Supplement as of June 9, 2008 regarding Common Stock (Form 424B2) (filed on June 9, 2008); Lehman Brothers Holdings Inc., Prospectus Supplement as of June 9, 2008 regarding Preferred Stock (Form 424B2) (filed on June 9, 2008).

[2161] Lehman Brothers Holdings Inc., Current Report as of June 16, 2008 (Form 8-K) (filed on June 16, 2008) ("LBHI 8-K (June 16, 2008)"); *see also* David Ellis, *Lehman Posts $2.8 Billion Loss*, CNNMoney.com, June 9, 2008; *available at* http://money.cnn.com/2008/06/09/news/companies/lehman_results/index.htm?postversion=2008060909.

[2162] LBHI 8-K (June 12, 2008).

[2163] Lehman Brothers Holdings Inc., Current Report as of June 12, 2008 (Form 8-K) (filed on June 17, 2008) ("LBHI 8-K (June 17, 2008)").

[2164] Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 9. *See* Appendix 18 § III to this Report, which discusses the events of June 12, 2008 in greater detail.

[2165] E-mail from Donald L. Kohn, Federal Reserve, to Ben S. Bernanke, Federal Reserve (June 13, 2008) [FRB to LEH Examiner 000781].

[2166] Examiner's Interview of Ben S. Bernanke, Dec. 22, 2009, at p. 7.

By mid-June 2008, the Korean consortium had dropped out and only Korea Development Bank ("KDB")[2167] remained principally involved as a potential investor. At the same time, the possible contours of the investment by KDB expanded.[2168] Lehman also explored potential transactions with other possible partners. By the summer of 2008, Lehman was considering a restructuring of its business to return to what Fuld called "core Lehman."[2169] Under that plan, Lehman would restructure itself by spinning off its commercial real estate assets into an entity provisionally called SpinCo,[2170] and by selling all or part of Lehman's Investment Management Division ("IMD"), including the profitable Neuberger Berman ("NB") asset management group.[2171] Some outside observers were skeptical of the SpinCo plan or of Lehman's ability to execute it quickly enough to improve Lehman's situation.[2172] Nonetheless, Lehman worked with the SEC and rating agencies to move Lehman's restructuring plans forward.[2173] Lehman also consulted with Lazard Frères & Co. to explore available options.[2174]

[2167] KDB is wholly owned by the Republic of South Korea.

[2168] See *infra* Section III.A.3.c of this Report, which discusses Lehman's June negotiations with KDB in greater detail.

[2169] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 5.

[2170] See *infra* Section III.A.3.c of this Report, which discusses SpinCo in greater detail.

[2171] Examiner's Interview of Hugh E. McGee, III, Aug. 12, 2009, at pp. 23-24.

[2172] See *infra* Section III.A.3.c of this Report, which discusses SpinCo in greater detail.

[2173] *See* e-mail from Paolo R. Tonucci, Lehman, to David Goldfarb, Lehman (Aug. 11, 2008) [LBEX-DOCID 1533879]. *Accord* Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at pp. 6-8.

[2174] Examiner's Interview of Gary Parr, Sept. 14, 2009, at p. 6.

In July 2008, rumors circulated globally that Lehman was "done & dusted" with no forthcoming "Bernanke bailout."[2175] Lehman's Board met numerous times in July to monitor and discuss Lehman's efforts to secure investments and react to developments in the markets.[2176] Paulson told the Examiner that he advised Fuld in July that there would be no federal assistance for Lehman.[2177] While Fuld agrees that Paulson never promised federal assistance, Fuld said that Paulson never expressly ruled out the possibility.[2178] Other senior members of the Government, Wall Street executives and experts doubted that the Government really would refuse to make money available for Lehman if necessary. As late as September 10, 2008, the FRBNY circulated a presentation that discussed potential federal monetary assistance to Lehman.[2179] On September 11, 2008, Geithner's discussions with the Financial Services Authority (the

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[2175] E-mail from Steven Berkenfeld, Lehman, to Beth Rudofker, Lehman, *et al.* (July 11, 2008) [LBEX-DOCID 316032].

[2176] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (July 13, 2008) [LBEX-AM 003834]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (July 14, 2008) [LBEX-AM 003837]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (July 15, 2008) [LBEX-AM 003840]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (July 16, 2008) [LBEX-AM 003848]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (July 17, 2008) [LBEX-AM 003850]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (July 18, 2008) [LBEX-AM 003852]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (July 22, 2008) [LBEX-AM 003866]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (July 31, 2008) [LBEX-AM 003875].

[2177] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at pp. 14-15.

[2178] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 11.

[2179] *See* FRBNY, Liquidation Consortium Presentation (Sept. 10, 2008) [FRBNY to Exam. 003517] (document was neither seen nor approved by Geithner), attached to e-mail from Michael Nelson, FRBNY, to Christine Cumming, FRBNY, *et al.* (Sept. 10, 2008) [FRBNY to Exam. 003516]. *Accord* Examiner's Interview of William Brodows, Aug. 20, 2009, at p. 6; Examiner's Interview of Jan H. Voigts, Aug. 25, 2009.

"FSA") left open the possibility that there would be Government assistance.[2180] On September 12, 2008, Paulson advised the FSA that the FRBNY might be prepared to provide Barclays with regulatory assistance if necessary.[2181] Cox told the Examiner that Lehman's apparent belief that the Government would provide help was a "real fact of life" and said that most attendees of the FRBNY meetings on September 12 through 14, 2008, "probably assumed that [Paulson's statement that there would be no Government help] was a negotiation."[2182] Chairman Bernanke told the Examiner that he remained in Washington, D.C., during Lehman's final weekend in part because a possibility existed that Bernanke might need to convene a meeting of the Federal Reserve Board to exercise the Federal Reserve's emergency lending powers under Section 13(3) of the Federal Reserve Act.[2183]

Similarly, executives and experts on Wall Street doubted Paulson's statement. Gregory L. Curl, Bank of America's ("BofA") executive responsible for global strategic planning, told the Examiner that during the weekend's negotiations, the Government gave conflicting signals regarding the availability of some form of federal assistance.[2184] Lehman director Dr. Henry Kaufman believed that, as a tactical matter, Lehman should

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[2180] FSA, Statement of the FSA (Jan. 20, 2010), ¶ 10.
[2181] *Id.* ¶ 23.
[2182] Examiner's Interview of Christopher Cox, Jan. 8, 2010, at p. 15.
[2183] Examiner's Interview of Ben S. Bernanke, Dec. 22, 2009, at p. 9.
[2184] Examiner's Interview of Gregory L. Curl, Sept. 17, 2009, at pp. 11-12.

have opened for business on Monday, September 15, 2008, to impress upon the regulatory authorities that a bankruptcy would pose an enormous systemic risk.[2185]

Throughout the summer of 2008, Lehman undertook exploratory discussions with possible strategic partners.[2186] By August and September, Lehman had considered and rejected a proposal from KDB.[2187] Lehman also rejected term sheets from two other potential investors, MetLife[2188] and the Investment Corp. of Dubai ("ICD").[2189] Although Lehman rejected a KDB proposal, Lehman indicated its willingness to continue discussions with KDB.[2190] Lehman's management apprised the Board of the status of talks with potential partners, although it did not provide the terms or conditions of any proposals.[2191]

[2185] Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at p. 19.

[2186] See Section III.A.3.c of this Report, which discusses Lehman's efforts to find a strategic partner in greater detail.

[2187] Letter from Jasjit Bhattal, Lehman, to Euoo Sung Min, Korea Development Bank, re: Lehman's "intention to continue pursuing alternative paths" (Sept. 1, 2008) [PWP 00001727]; e-mail from Jasjit Bhattal, Lehman, to Brad Whitman, Lehman, *et al.* (Sept. 1, 2008) [LBHI_SEC07940_651987].

[2188] Letter from Steven A. Kandarian, MetLife, to Richard S. Fuld, Jr., Lehman, re: moving forward with a potential transaction (Aug. 6, 2008) [LBHI_SEC07940_741210]; Examiner's Interview of Steven A. Kandarian, Sept. 17, 2009, at p. 5.

[2189] E-mail from Stefano Marsaglia, Rothschild Ltd., to Jeffrey L. Weiss, Lehman, *et al.* (Sept. 3, 2008) [LBHI_SEC07940_653425].

[2190] Letter from Jasjit Bhattal, Lehman, to Euoo Sung Min, Korea Development Bank, re: Lehman's "intention to continue pursuing alternative paths" (Sept. 1, 2008) [PWP 00001727]; e-mail from Jasjit Bhattal, Lehman, to Brad Whitman, Lehman, *et al.* (Sept. 1, 2008) [LBHI_SEC07940_651987]; Examiner's Interview of Jasjit Bhattal, Oct. 12, 2009, at p. 16.

[2191] *See, e.g.*, Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (July 31, 2008), at pp. 1-2 [LBEX-AM 003875]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Aug. 6, 2008), at p. 1 [LBEX-AM 003877]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Aug. 13, 2008), at p. 3 [LBEX-AM 003879]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Aug. 25, 2008), at p. 2 [LBEX-AM 003897]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 9, 2008), at pp. 2-3 [LBEX-AM 003910]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 11, 2008), at pp. 1-2 [LBEX-AM 003918]; Lehman

Events accelerated during the week of September 8, 2008. On Sunday, September 7, the Government announced that it had placed Fannie Mae and Freddie Mac into conservatorship, providing $200 billion in federal money.[2192] On September 9, a Korean government official announced that KDB's talks with Lehman had ended.[2193] KDB publicly confirmed that information the following day.[2194] On the morning of Wednesday, September 10, Lehman pre-announced its third quarter earnings and restructuring plans, including the future spin-off of its commercial real estate assets.[2195] By the late afternoon of September 10, Moody's and other rating agencies had placed Lehman on negative watch for a downgrade.[2196]

Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 12, 2008), at pp. 1-2 [LBEX-AM 003920]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 13, 2008), at pp. 1-4 [LBEX-AM 003927].

[2192] United States Treasury, Press Release: Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), *available at* http://www.ustreas.gov/press/releases/hp1129.htm (last visited Jan. 31, 2010); Mark Jickling, Congressional Research Service, CRE Report for Congress: Fannie Mae and Freddie Mac in Conservatorship (Sept. 7, 2008), *available at*: http://fpc.state.gov/documents/organization/110097.pdf.

[2193] E-mail from Catherine Jones, Lehman, to Hugh E. McGee, III, Lehman, *et al.* (Sept. 9, 2008) [LBEX-DOCID 131058] (forwarding Jin-Young Yook, *Korea FSC: KDB, Lehman Investment Talks Have Ended*, Dow Jones Int'l News, Sept. 9, 2008); e-mail from Tim Sullivan, Lehman, to Mark G. Shafir, Lehman, *et al.* (Sept. 9, 2008) [LBEX-DOCID 131059] (forwarding Steve Goldstein, *Korean regulator says KDB talks with Lehman ended*, MarketWatch, Sept. 9, 2008); e-mail from Hugh E. McGee, III, Lehman, to Jasjit Bhattal, Lehman, *et al.* (Sept. 9, 2008) [LBEX-DOCID 224552] (forwarding Evan Ramstad & Jin-Young Yook, *Talks Between KDB, Lehman On Possible Investment End*, Wall St. J. Online, Sept. 9, 2009).

[2194] E-mail from Shelby Lauckhardt, Lehman, to Richard S. Fuld, Jr., Lehman (Sept. 10, 2008) [LBHI_SEC07940_213466]; Leo Lewis, *Korea Blames "Differences" for Ending Lehman Talks*, Times Online, Sept. 10, 2008; Susanne Craig, *et al.*, *Korean Remarks Hit Lehman*, Wall St. J., Sept. 9, 2008.

[2195] Final Transcript of Lehman Brothers Holdings Inc. Third Quarter 2008 Preliminary Earnings Call (Sept. 10, 2008) [LBHI_SEC07940_612771].

[2196] E-mail from Stephen Lax, Lehman, to Rajiv Muthyala, Lehman, *et al.* (Sept. 9, 2008) [LBHI_SEC07940_557829] (forwarding Fitch Press Release, *Fitch Places Lehman Brothers on Rating Watch Negative* (Sept. 9, 2008)); *S&P Places Lehman on Negative Ratings Watch*, Associated Press (Sept. 9, 2008); e-mail from Paolo R. Tonucci, Lehman, to Carlo Pellerani, Lehman (Sept. 10, 2008)

On September 11, 2008, JPMorgan demanded an additional $5 billion in collateral from Lehman.[2197] That same day, Lehman's management told the Board that "liquidity is forecasted to decrease to $30 billion today as a result of providing collateral," from the previous day's announced liquidity of $42 billion.[2198] On Friday, September 12, 2008, Citibank obtained an amendment to its Clearing Agreement, which strengthened Citibank's lien over LBI's property at Citibank.[2199] By the evening of September 12, Lehman's only hope to survive was federal assistance or a merger. Over the weekend it became clear that those options would not be available.[2200] Lehman also learned that it would not be able to fund opening in Europe that Monday.[2201] Finally, on Sunday, September 14, 2008, the SEC, with the support of the FRBNY and Treasury, all but directed Lehman to declare bankruptcy.[2202]

Some published reports assert that Lehman's hasty bankruptcy filing cost the estate billions, and that bankruptcy planning should have begun earlier than

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[LBHI_SEC07940_558653] (forwarding Moody's Press Release, *Moody's Places Lehman's A2 Rating On Review With Direction Uncertain* (Sept. 9, 2008)).

[2197] E-mail from Paolo R. Tonucci, Lehman, to Daniel Fleming, Lehman, *et al.* (Sept. 12, 2008) [LBEX-DOCID 073346] ("[JPM] want[s] $5bn tomorrow first thing").

[2198] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 11, 2008), at p. 1 [LBEX-AM 003918]; Final Transcript of Lehman Brothers Holdings Inc. Third Quarter 2008 Preliminary Earnings Call (Sept. 10, 2008) [LBHI_SEC07940_612771].

[2199] Citibank, Direct Custodial Services Agreement Deed (Sept. 12, 2008) [CITI-LBHI-EXAM 00005903]; e-mail from Patricia Gomes, HSBC, to Agnes Lau, HSBC, *et al.* (Sept. 12, 2008) [HBUS00001760].

[2200] See *infra* Section III.A.3.c of this Report, which discusses Lehman's negotiations with BofA and Barclays in greater detail. See also Appendix 15, Section IV-X.

[2201] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 12.

[2202] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 14, 2008), at p. 4 [LBEX-AM 003932].

September.[2203] However, Lehman consciously avoided bankruptcy planning because potential strategic partners remained interested and because Lehman's officers and directors believed that bankruptcy planning would become a self-fulfilling prophecy.[2204]

b) Lehman's Actions in 2008 Prior to the Near Collapse of Bear Stearns

In early 2008, prior to the near collapse of Bear Stearns, Lehman received overtures from several entities that were interested in investing in Lehman.[2205] Lehman chose not to pursue those overtures for several reasons. First, Lehman's focus at the time was on selling assets rather than raising capital.[2206] Either route would result in improved net leverage, an important goal for Lehman. However, Lehman preferred to sell assets because that would remove Lehman's troubled assets, including its commercial real estate and leveraged loans, from its balance sheet.[2207] Second, Lehman was concerned that raising capital would signal to the market that Lehman was in a weak position, a perception that Lehman considered harmful.[2208] Fuld told the

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[2203] *See, e.g.*, Jeffrey McCracken, *Lehman's Chaotic Bankruptcy Filing Destroyed Billions in Value*, Wall St. J., Dec. 29, 2008. *Accord* Examiner's Interview of Bryan P. Marsal, Dec. 14, 2009, at p. 2.

[2204] Examiner's Interview of John D. Macomber, Sept. 25, 2009, at p. 5; Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 15; Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at p. 20.

[2205] *See, e.g.*, e-mail from Saleh Faraj, Lehman, to Richard S. Fuld, Jr., Lehman, *et al*. (Jan. 9, 2008) [LBHI_SEC07940_670045]; e-mail from Jeremy M. Isaacs, Lehman, to Richard S. Fuld, Jr., Lehman, *et al.* (Jan. 11, 2008) [LBHI_SEC07940_066820]; e-mail from Joonkee Hong, Lehman, to Larry Wieseneck, Lehman (Jan. 31, 2008) [LBHI_SEC07940_069737]; e-mail from Philip Lynch, Lehman, to Jeremy M. Isaacs, Lehman, *et al.* (Mar. 15, 2008) [LBHI_SEC07940_075250]. *Accord* Examiner's Interview of Jeremy M. Isaacs, Oct. 1, 2009, at pp. 8-13.

[2206] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 27.

[2207] *Id.*

[2208] *Id*. at p. 26.

Examiner that neither he nor the majority of Lehman's Executive Committee was aware of any concerns about Lehman's CSE capital adequacy figures.[2209] Because 2007 had been a record year for Lehman in some respects, Lehman's Board and senior management did not see a need to raise additional equity capital in January 2008.[2210] Third, Lehman did not think that the proposals it received included a sufficient premium to Lehman's then-current stock price to make any of the transactions attractive.[2211]

(1) Rejection of Capital Investment Inquiries

At the beginning of 2008, Lehman declined to pursue investment overtures from the Kuwait Investment Authority ("KIA"), KDB and ICD.[2212] At the same time, Lehman continued to repurchase its own shares to avoid dilution that otherwise would result when Lehman issued new shares as part of its compensation scheme.[2213]

[2209] Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at p. 18. See Section III.A.1 of this Report, which discusses the capital adequacy figures in more detail.

[2210] *Id*. Although Eric Felder was the U.S. Head of Credit Products and not yet a member of Lehman's senior management in January 2008, he made a presentation at the January 29, 2008 Board meeting suggesting that Lehman should front-load issuances for the year. *See* Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Jan. 29, 2008), at p. 9 [LBHI_SEC07940_027446]; Eric Felder, Lehman, 2008 Financial Supply/Demand Dynamics (Jan. 29, 2008), at pp. 16-20 [LBHI_SEC07940_027353].

[2211] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 25.

[2212] On September 4, 2007, Lehman declined an investment overture from CITIC. At the time, however, CITIC's interest was purely financial, while Fuld sought a strategic partner. E-mail from Richard S. Fuld, Jr., Lehman, to David Goldfarb, Lehman (Sept. 2, 2007) [LBEX-DOCID 997624]; Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at p. 18.

[2213] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Jan. 29, 2008), at p. 2 [LBHI_SEC07940_027446].

(a) KIA Offer

On January 9, 2008, KIA approached Lehman about acquiring shares at a discount to the market price.[2214] On January 11, 2008, Jeremy M. Isaacs, CEO of LBIE, responded to KIA that Lehman would be a "reluctant seller[]" at $65 per share, a 12% premium over the $58 closing price on January 11, 2008.[2215] Lehman expressed enthusiasm about developing a broader partnership with KIA but showed no interest in selling shares without receiving a premium.[2216] Neither the minutes of the January 29, 2008 Board meeting nor the handwritten notes taken by Jeffrey A. Welikson, Lehman's corporate secretary, reflect that management advised the Board of KIA's proposal.[2217] However, phone logs suggest that Fuld advised directors individually about KIA's proposal.[2218]

[2214] E-mail from Saleh Faraj, Lehman, to Richard S. Fuld, Jr., Lehman, *et al*. (Jan. 9, 2008) [LBHI_SEC07940_670045]; e-mail from Jeremy M. Isaacs, Lehman, to Richard S. Fuld, Jr., Lehman, *et al.* (Jan. 11, 2008) [LBHI_SEC07940_066820]; Examiner's Interview of Jeremy M. Isaacs, Oct. 1, 2009, at p. 8.

[2215] E-mail from Jeremy M. Isaacs, Lehman, to Richard S. Fuld, Jr., Lehman, *et al.* (Jan. 11, 2008) [LBHI_SEC07940_066820]. Isaacs told the Examiner that he thought Lehman should have negotiated with KIA regarding its interest in buying Lehman stock, but Fuld was not interested without KIA paying a premium. Examiner's Interview of Jeremy M. Isaacs, Oct. 1, 2009, at pp. 8-9.

[2216] E-mail from Jeremy M. Isaacs, Lehman, to Richard S. Fuld, Jr., Lehman, *et al.* (Jan. 11, 2008) [LBHI_SEC07940_066820].

[2217] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Jan. 29, 2008) [LBHI_SEC07940_027446].

[2218] Richard S. Fuld, Jr., Lehman, Call Logs (Jan. 11-15, 2008) [LBEX-WGM 674339].

(b) KDB Makes Its Initial Approach

In January 2008, Korea Investment Corporation, a sovereign wealth fund, invested $2 billion in preferred Merrill Lynch stock.[2219] In early 2008, KDB began considering various potential investment opportunities in U.S. investment banks, and Lehman was one of those banks.[2220] On January 31, 2008, KDB expressed interest in investing in Lehman.[2221] KDB's desired outcome in February was a $2 to $3 billion private equity investment for a minority share of Lehman.[2222] While Lehman was pleased to have KDB buy its stock in the open market, as of February 2008, Lehman was not looking to raise capital or dilute its shareholders through a private placement at a discounted price.[2223] There is no record that management advised the Board of KDB's overture during an official meeting, although phone logs suggest that Fuld may have advised three members of Lehman's Board of Directors, John D. Macomber, Marsha "Marty" Johnson Evans and Sir Christopher Gent, of KDB's interest.[2224]

[2219] Kim Yeon-hee, *S. Korea KIC Changes $2bln into Merrill Common Stock*, Reuters, July 29, 2008 available at http://www.reuters.com/article/is/isUSSE06726320080729.

[2220] Examiner's Interview of KDB, Oct. 26, 2009, at p. 6.

[2221] E-mail from Joonkee Hong, Lehman, to Larry Wieseneck, Lehman (Jan. 31, 2008) [LBHI_SEC07940_069737].

[2222] *Id*.

[2223] E-mail from Erin M. Callan, Lehman to Larry Wieseneck, Lehman (Feb. 1, 2008) [LBHI_SEC07940_069737].

[2224] Richard S. Fuld, Jr., Lehman, Call Logs (Feb. 1-5, 2008), pp. 1-3 [LBEX-WGM 674352].

(c) ICD's Initial Approach

On March 15, 2008, ICD, a sovereign wealth fund, approached Lehman about buying equity, but Lehman declined to pursue that possibility.[2225] Lehman had a prior banking relationship with ICD, having worked on the potential financing and derivative overlay on a substantial position ICD considered acquiring.[2226] Based on that relationship, ICD believed that Lehman's business mix and management were sound.[2227] ICD expressed an interest in making a capital investment, preferably in equity.[2228] Lehman told ICD that Lehman's capital and liquidity positions were very strong and that Lehman was not interested in raising "equity capital" at that time.[2229] ICD responded that if and when Lehman considered raising capital, ICD should be Lehman's "first call in the Middle East."[2230] The March 25, 2008 Board minutes and Welikson's handwritten notes do not reflect that management advised the Board of ICD's interest.[2231]

[2225] *See* e-mail from Philip Lynch, Lehman, to Jeremy M. Isaacs, Lehman, *et al.* (Mar. 15, 2008) [LBHI_SEC07940_075250].

[2226] *Id.*

[2227] *Id.*

[2228] *Id.*

[2229] *Id.*

[2230] *Id.*

[2231] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Mar. 25, 2008) [LBEX-AM 003586]; Jeffrey A. Welikson, Lehman, Board Meeting Notes (Mar. 25, 2008) [WGM_LBEX_00781].

(2) Divergent Views

Although Lehman opted not to raise additional equity on the terms available in early 2008, other financial institutions did raise capital. Some Lehman executives also expressed the belief that Lehman should raise additional equity.[2232]

(a) Competitors Raise Capital

After announcing losses during 2007,[2233] during late 2007 and the first quarter of 2008, Merrill Lynch issued $6.2 billion dollars in common stock.[2234] Merrill sold the shares at $48; Merrill's stock was trading at $54.63 at that time.[2235] In addition, in January 2008, Merrill issued $6.6 billion of convertible preferred shares to KIA, the Korean Consortium, and Mizuho with a dividend yield of 9%.[2236]

Similarly, during late 2007 and the first quarter of 2008, after announcing losses during 2007,[2237] Citibank issued $30 billion of preferred stock, trust preferred, and forward purchase contracts. That capital raise included $7.5 billion of equity units that

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[2232] *See, e.g.*, Eric Felder, Lehman, 2008 Financial Supply/Demand Dynamics, Presentation to the Board of Directors (Jan. 29, 2008), at pp. 16-20 [LBHI_SEC07940_027353].

[2233] Merrill Lynch & Co., Inc., Current Report as of Oct. 24, 2007 (Form 8-K) (filed on Oct. 24, 2007), at p. 1 of Ex. 99.1 ("Merrill 8-K (Oct. 24, 2007)"); Merrill Lynch & Co., Inc., Current Report as of Jan. 17, 2008 (Form 8-K) (filed on Jan. 17, 2008), at p. 1 of Ex. 99.1 ("Merrill 8-K (Jan. 17, 2008)").

[2234] Merrill Lynch & Co., Inc., Annual Report for 2007 as of Dec. 28, 2007 (Form 10-K) (filed on Feb. 25, 2008), at p. 23 ("Merrill 2007 10-K").

[2235] Kristina Cooke, *U.S. Stocks - Market Climbs as Merrill Deal Lifts Financials*, Reuters, Dec. 24, 2007.

[2236] Merrill 2007 10-K at pp. 53-56.

[2237] Citigroup Inc., Current Report as of Jan. 15, 2008 (Form 8-K) (filed on Jan. 15, 2008), at Ex. 99.1 ("Citi 8-K (Jan. 15, 2008)").

the Abu Dhabi Investment Authority purchased in a private placement on December 3, 2007.[2238]

In December 2007, after posting its first-ever quarterly loss,[2239] Morgan Stanley raised $5 billion through an investment by the China Investment Corporation.[2240] Morgan Stanley sold equity units that included futures contracts to buy common shares.[2241]

Following a decline in income in 2007,[2242] on January 24, 2008, Bank of America sold $6 billion in depositary shares, each representing a 1/25th interest in a share of fixed-to-floating preferred stock.[2243] That same month, Bank of America also sold $6.9 billion of convertible preferred securities.[2244]

On March 5, 2008, after announcing a CHF[2245] 4.4 billion loss (roughly $3.9 billion)[2246] on January 30, 2008,[2247] UBS issued CHF 13 billion (roughly $11.7 billion) in

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[2238] Citigroup Inc., Annual Report for 2007 as of Dec. 31, 2007 (Form 10-K) (filed on Feb. 22, 2008), at pp. 75-77 ("Citi 2007 10-K") .

[2239] Morgan Stanley & Co., Current Report as of Dec. 19, 2007 (Form 8-K) (filed on Dec. 19, 2007), at Ex. 99.1 ("Morgan 8-K (Dec. 19, 2007)").

[2240] Tomoeh Murakami Tse & David Cho, *First Quarterly Loss Posted In Morgan Stanley's 72 Years*, Washington Post, Dec. 20, 2007.

[2241] Morgan Stanley & Co., Annual Report for 2007 as of Nov. 30, 2007 (Form 10-K) (filed on Jan. 29, 2008), at pp. 178-79 ("Morgan 2007 10-K").

[2242] Bank of America Corp., Current Report as of Oct. 18, 2007 (Form 8-K) (filed Oct. 18, 2007), at Ex. 99.1 ("BofA 8-K (Oct. 18, 2007)"); Bank of America Corp., Current Report as of Jan. 22, 2008 (Form 8-K) (filed on Jan. 22, 2008), at Ex. 99.1 ("BofA 8-K (Jan. 22, 2008)").

[2243] Bank of America Corp., Annual Report for 2007 as of Dec. 31, 2007 (2007 Form 10-K) (filed on Feb. 28, 2008), at p. 125 ("BofA 2007 10-K").

[2244] *Id*.

[2245] CHF is the abbreviation for Swiss francs.

[2246] The converted U.S. dollar amounts are approximations based on the exchange rates in effect at the time.

convertible stock to the government of Singapore Investment Corporation and an undisclosed investor from the Middle East.[2248]

(b) Internal Warnings Regarding Capital

In February 2008, Eric Felder, then Lehman's U.S. head of Global Credit Products, voiced concern to Lehman management about Lehman's real estate exposures, continuing a theme he began in March 2007.[2249] He warned that Lehman's situation would worsen, particularly in terms of market access.[2250] In early March 2008,

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[2247] UBS AG, Report of Foreign Issuer as of Jan. 30, 2008 (Form 6-K) (filed on Jan. 30, 2008), at p. 1 ("UBS 6-K (Jan. 30, 2008)").

[2248] UBS AG, Report of Foreign Issuer as of Feb. 27, 2008 (Form 6-K) (filed on Feb. 28, 2008), at p. 1 ("UBS 6-K (Feb. 28, 2008)").

[2249] E-mail from Eric Felder, Lehman, to Andrew J. Morton, Lehman (Feb. 20, 2008) [LBEX-DOCID 1229335]; e-mail from Eric Felder, Lehman, to Andrew J. Morton, Lehman, *et al.* (Feb. 21, 2008) [LBHI_SEC07940_071680]. Beginning as early as March 4, 2007, Felder began to express bearish views on the markets' future. E-mail from Eric Felder, Lehman, to Brian Maggio, Lehman (Mar. 4, 2007) [LBEX-DOCID 1268976] ("I think it's the end of financials as a safe haven"). On July 17, 2007, two of Bear Stearns' hedge funds collapsed. *See, e.g.*, Ben White, *et al.*, *Subprime Losses Ravage Bear Funds*, Financial Times, July 17, 2007. On August 5, 2007, Felder warned about the impact of the collapse of the Bear Stearns hedge funds, predicting that "[i]f bear spreads widen significantly I would also expect we will see pressure on lehman spreads and considerable selling of cash paper." E-mail from Eric Felder, Lehman, to Alex Kirk, Lehman (Aug. 5, 2007) [LBEX-DOCID 184521]. Felder was not always consistent in his bearish views during 2007. On February 28, 2007, Felder wrote: "I don't think subprime will take the whole market down and if I had more flexibility I would be way bigger than we are. I view this as a once in 5 year opportunity and I'm not going to miss it." E-mail from Eric Felder, Lehman, to Jonathan Hoffman, Lehman (Feb. 27, 2007) [LBEX-DOCID 4075098]. On May 25, 2007, Felder wrote: "We need everyone to be shooting beyond high. Gelband is gone because he didn't. I know roger will make us try for 2 b at some point. I actually think we are supposed to get rid of budgets. They do nothing but constrain. Also have plenty of room to take the risk up. We won't get any resources if we don't think really big." E-mail from Eric Felder, Lehman, to Thomas Corcoran, Lehman (May 25, 2007) [LBEX-DOCID 4244988]. See Section III.A.1 of this Report, which discusses events in 2007 in greater detail.

[2250] E-mail from Eric Felder, Lehman, to Andrew J. Morton, Lehman (Feb. 20, 2008) [LBEX-DOCID 1229335] ("I remain concerned as a lehman shareholder about our resi and cmbs exposure. . . . [H]aving 18b of tangible equity and 90b in resi (including alt a) and cmbs (including bridge equity) scares me"); e-mail from Eric Felder, Lehman, to Andrew J. Morton, Lehman, *et al.* (Feb. 21, 2008) [LBHI_SEC07940_071680] ("We are again underperforming the market significantly on the backs of

Felder repeatedly warned Lowitt, Callan and Paolo R. Tonucci, Lehman's Global Treasurer, about the difficulty of accessing the markets to raise capital, coupled with an anticipated increase in loans to fund.[2251] Felder urged that Lehman aggressively sell assets, specifically its contingent commitments, in order to bring down its balance sheet.[2252] On March 12, 2008, Felder expressed concerns to Callan focusing on dealer liquidity and shrinking leverage.[2253] Felder forwarded an e-mail from a Lehman trader that warned that dealers were demanding increased haircuts and refusing to take assignments of any Bear or Lehman trades even if the trades were "in-the-money."[2254] On March 17, 2008, the day after JPMorgan made its Bear Stearns offer, Felder warned Lowitt, Callan and McDade that collapsing equity values eventually would compel Lehman to sell assets, and that the distressed prices available would create a need for additional capital, forcing further sales.[2255]

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rumors of writedowns. . . . [Due to widening spreads,] it wil[l] become very difficult for us to access the market in any significant size on a regular basis (as bsc is going through)").

[2251] *See* e-mail from Eric Felder, Lehman, to Ian T. Lowitt, Lehman, *et al*. (Feb. 29, 2008) [LBHI_SEC07940_053967]; e-mail from Eric Felder, Lehman, to Paolo R. Tonucci, Lehman (Mar. 4, 2008) [LBHI_SEC07940_439441]; e-mail from Eric Felder, Lehman, to Erin M. Callan, Lehman (Mar. 12, 2008) [LBHI_SEC07940_074441].

[2252] *See* e-mail from Eric Felder, Lehman, to Paolo R. Tonucci, Lehman (Mar. 4, 2008) [LBHI_SEC07940_439441]. *Accord* Examiner's Interview of Eric Felder, May 21, 2009, at pp. 7-8; Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at pp. 27-28.

[2253] E-mail from Eric Felder, Lehman, to Erin M. Callan, Lehman (Mar. 12, 2008) [LBHI_SEC07940_074441].

[2254] *Id*.

[2255] *See* e-mail from Eric Felder, Lehman, to Ian T. Lowitt, Lehman (Mar. 17, 2008) [LBHI_SEC07940_075534] (forwarded to Erin M. Callan); e-mail from Eric Felder, Lehman, to Herbert H. McDade, III, Lehman (Mar. 17, 2008) [LBHI_SEC07940_623492].

c) Actions and Efforts Following the Near Collapse of Bear Stearns

Following the near collapse of Bear Stearns, Wall Street perceived Lehman to be the next most vulnerable bank.[2256] Bernanke, Geithner, Cox and Paulson all told the Examiner that they shared that view.[2257]

Bernanke told the Examiner that the Federal Reserve, SEC and "markets in general" viewed Lehman as the next most vulnerable investment bank because of Lehman's funding model.[2258] Bernanke did not believe that Fuld appreciated Lehman's vulnerability, and believes that Fuld should have worked more aggressively to find ways to strengthen Lehman.[2259] Bernanke told the Examiner that he believed that Fuld was always more optimistic about Lehman's condition than the markets were.[2260]

Geithner told the Examiner that his concerns about Lehman began in August 2007 and grew steadily into 2008.[2261] Geithner told the Examiner that, following Bear Stearns' near collapse, he considered Lehman to be the "most exposed" investment bank.[2262] Geithner told the Examiner that he considered Lehman's proposals to convert

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[2256] *See, e.g.*, Riley McDermid & Alistair Barr, *Wall Street watches Lehman walk on thin ice*, MarketWatch, Mar. 17, 2008, *available at* http://www.marketwatch.com/story/wall-street-watches-lehman-walk-on-thin-ice; David Bogoslaw, *Is Lehman Liquid Enough*?, Business Week, Mar. 18, 2008, *available at* http://www.businessweek.com/investor/content/mar2008/pi20080317_703353.htm.

[2257] Examiner's Interview of Ben S. Bernanke, Dec. 22, 2009, at pp. 4-5; Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 2; Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 9; Examiner's Interview of Christopher Cox, Jan. 8, 2010, at p. 8.

[2258] Examiner's Interview of Ben S. Bernanke, Dec. 22, 2009, at p. 5.

[2259] *Id.* at pp. 3, 5-6.

[2260] *Id.* at p. 6.

[2261] Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 2.

[2262] *Id*.

to a bank holding company "gimmicky."[2263] On the other hand, both Goldman Sachs and Morgan Stanley converted themselves into bank holding companies on September 21, 2008.[2264]

Similarly, Paulson told the Examiner that he began to have concerns about Lehman in 2007 when he learned about the Archstone deal.[2265] Paulson told the Examiner that he pressed Lehman "less hard" prior to the near collapse of Bear Stearns due to Lehman's record 2007 results, but that after Bear Stearns' near collapse, he focused on Lehman as the most vulnerable investment bank.[2266] Paulson believes that Fuld heard what he wanted to hear and was more optimistic than he should have been.[2267] Paulson also told the Examiner that Fuld had "quixotic . . . ideas" about boosting market confidence, citing the removal of Callan, which Paulson thought could be viewed as more alarming than calming.[2268]

In the weeks following Bear Stearns' near collapse, Lehman took steps: (1) to increase its liquidity; (2) to continue efforts begun in 2007 to reduce its balance sheet; (3) to raise equity from public and private investors; (4) to implement SpinCo; and (5) to find a strategic partner. This Section discusses those efforts in turn.

[2263] *Id.* at p. 6.

[2264] Federal Reserve System, Orders Approving Formation of Bank Holding Companies (Sept. 21, 2008), *available at* http://www.federalreserve.gov/newsevents/press/orders/orders20080922a1.pdf and http://www.federalreserve.gov/newsevents/press/orders/orders20080922a2.pdf. See Appendix 13 §II to this Report, which discusses Lehman's bank holding company proposal in greater detail.

[2265] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 9.

[2266] *Id.* at pp. 10-11.

[2267] *Id.* at pp. 6, 11.

[2268] *Id.* at p. 14.

(1) Lehman's Attempt to Increase Liquidity

On March 25, 2008, Lehman's Board met for a regularly noticed meeting. The Board focused in significant part on Lehman's position following the near collapse of Bear Stearns. In materials provided to the Board, Lehman's management asserted that it had "the strongest liquidity position of the brokers" and that Lehman's funding framework was "significantly different" than Bear Stearns'.[2269] The materials note that Bear Stearns' liquidity pool relied on short-term debt, a large free credit balance and repo financing.[2270] The materials imply that Lehman's funding framework did not suffer from the same defects.[2271] Callan informed the Board that Lehman did not rely on free credit balances, asset-backed commercial paper or secured funding for whole loans.[2272] Callan also reported that Lehman operated at near-record levels of liquidity.[2273] Lehman director Marsha "Marty" J. Evans told the Examiner that the tone of the meeting was not about preventing a Lehman collapse similar to Bear Stearns but rather about navigating the troubled waters and moving forward.[2274]

[2269] Lehman, Presentation to the Board of Directors, Liquidity & Market Update (Mar. 25, 2008), at p. 2 [LBHI_SEC07940_027782].

[2270] *Id*.

[2271] *Id*.

[2272] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Mar. 25, 2008), at p. 3 [LBEX-AM 003586].

[2273] *Id*.

[2274] Examiner's Interview of Marsha J. Evans, May 22, 2009, at p. 15.

In late March and early April 2008, Lehman reported near-record levels of liquidity to rating agencies.[2275] At the same time, though, Lehman told the rating agencies that it was focused on building its "liquidity fortress."[2276] However, Fuld asserted that, even as late as September 15, 2008, he was unaware of any problems with Lehman's liquidity pool.[2277] Similarly, none of the directors who were asked recalled being apprised of any problem with Lehman's liquidity pool at the March 25, 2008 meeting or at any other time prior to September.[2278]

(2) Lehman's Attempt to Reduce its Balance Sheet

In the second half of 2007, individuals at Lehman began to discuss the need to reduce Lehman's balance sheet in order to reduce risk and improve Lehman's reported leverage ratio.[2279] Fuld told the Examiner that by January 2008 he had directed that

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[2275] *See, e.g.,* Lehman, Fitch Ratings Q1 2008 Update (Mar. 27, 2008), at p. 4 [LBEX-DOCID 1409767] ("Despite market conditions, we have been able to operate close to record levels throughout the period. Closed Q1 2008 with $34B of liquidity, representing $7B excess over our cash capital requirements. Maintained strength over BSC collapse: $31B (3/14), $30B (3/17), $33B (3/20). Therefore no need access to financing for over one year."). Lehman also advised the Board of near-record levels of liquidity on March 25, 2008. Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Mar. 25, 2008), at p. 3 [LBEX-AM 003586].

[2276] *See, e.g.*, Lehman, Moody's Investors Service Q2 2008 Update (May 29, 2008), at p. 12 [LBEX-DOCID 1021230]. See Section III.A.5.i of this Report and Appendix 20 to this Report, which discusses the problems with Lehman's liquidity pool in greater detail.

[2277] Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at p. 19.

[2278] Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at p. 12; Examiner's Interview of Thomas H. Cruikshank, Oct. 8, 2009, at p. 9; Examiner's Interview of Sir Christopher Gent, Oct. 21, 2009, at p. 23; Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at pp. 6-7; Examiner's Interview of Roland A. Hernandez, Oct. 2, 2009, at pp. 16, 20; Examiner's Interview of John D. Macomber, Sept. 25, 2009, at p. 20.

[2279] *See* Lehman, Global Real Estate Update (Nov. 6, 2007) [LBEX-DOCID 514265] (GREG proposing an estimated $15 billion reduction in its global balance sheet). *Accord* Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at pp. 10-11; Examiner's Interview of Roger Nagioff, Sept. 30, 2009, at p. 10; see also Section III.A.1 of this Report, which discusses events during 2006 and 2007 in greater detail.

Lehman reduce its balance sheet in areas in which Lehman was vulnerable.[2280] In March 2008, Fuld appointed McDade to be "balance sheet czar"[2281] and instructed him to sell off assets and take other actions necessary to reduce the size of Lehman's balance sheet.[2282] The chart below shows how aspects of Lehman's financial condition changed between December 31, 2006, and May 31, 2008.

[2280] Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at p. 11. Fuld initially told the Examiner that he directed the reduction of all positions but matched book. Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 26. Fuld then told the Examiner that he directed the reduction of less liquid assets. Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at pp. 8-9.

[2281] Examiner's Interview of Andrew J. Morton, Sept. 21, 2009, at p. 11.

[2282] See Section III.A.1 of this Report, which discusses Lehman's efforts to reduce the balance sheet in greater detail.

	Q4 06[2283]	Q1 07[2284]	Q2 07[2285]	Q3 07[2286]	Q4 07[2287]	Q1 08[2288]	Q2 08[2289]
Net Assets ($ Billions)	268.936	300.797	337.667	357.102	372.959	396.673	327.774
Total Shareholder Equity ($ Billions)	19.191	20.005	21.129	21.733	22.490	24.832	26.276

While Lehman's net assets grew between the end of the fourth quarter of 2007 and the close of the first quarter of 2008, Lehman reduced its holdings in some asset classes.[2290] During the first quarter of 2008, Lehman reduced its mortgage-related inventory by $2.7 billion, its high yield instruments by $2.9 billion and acquisition facilities by $6.1 billion.[2291]

Although Fuld told the Examiner that he directed a reduction in the balance sheet in January 2008, Lehman did not meaningfully reduce its balance sheet in its most

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[2283] Lehman Brothers Holdings Inc., Annual Report for 2006 as of Nov. 30, 2006 (Form 10-K) (filed Feb. 13, 2007), at pp. 28-29 ("Lehman 2006 10-K").
[2284] Lehman Brothers Holdings Inc., Quarterly Report as of Feb. 28, 2007 (Form 10-Q) (filed Apr. 9, 2007), at pp. 59, 61 ("Lehman 10-Q (Apr. 9, 2007)").
[2285] Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2007 (Form 10-Q) (filed July 10, 2007), at p. 65 ("Lehman 10-Q (July 10, 2007)").
[2286] Lehman Brothers Holdings Inc., Quarterly Report as of Aug. 31, 2007 (Form 10-Q) (filed Oct. 10, 2007), at p. 68 ("Lehman 10-Q (Oct. 10, 2007)").
[2287] Lehman Brothers Holdings Inc., Annual Report for 2007 as of Nov. 30, 2007 (Form 10-K) (filed Jan. 29, 2008), at pp. 29-30 ("Lehman 2007 10-K").
[2288] Lehman Brothers Holdings Inc., Quarterly Report as of Feb. 28, 2008 (Form 10-Q) (filed Apr. 9, 2008), at p. 72 ("Lehman 10-Q (Apr. 9, 2008)").
[2289] Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2008 (Form 10-Q) (filed July 10, 2008), at pp. 85, 88 ("Lehman 10-Q (July 10, 2008)").
[2290] *See* Lehman, Balance Sheet and Key Disclosures, 2008 3Q Targets [Draft] (June 19, 2008), at p. 3 [LBHI_SEC07940_6952937].
[2291] *Id.*

vulnerable area – commercial real estate – until the second quarter of 2008.[2292] As disclosed in its periodic filings, Lehman's reduction of its "commercial mortgage-related assets, other asset-backed-related positions and real estate-related investments generally"[2293] is shown in the chart below.

	Q4 07[2294]	**Q1 08**[2295]	**Q2 08**[2296]
Commercial Real Estate At Risk ($ Billions)	38.938	36.110	29.390

The reduction during the first quarter of 2008 included a large proportion of writedowns – writedowns represented $1.4 billion of the $2.8 billion gross reduction in commercial real estate.[2297] Asset dispositions accelerated during the second quarter of

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[2292] *See, e.g.*, e-mail from Gary Mandelblatt, Lehman, to Alex Kirk, Lehman, *et al.* (Jan. 15, 2008) [LBEX-DOCID 1600235] (noting that "the business continues to increase its balance sheet usage but is not selling or syndicating at the same pace putting pressure on funding needs"); e-mail from Mark A. Walsh, Lehman, to Andrew J. Morton, Lehman (Feb. 26, 2008) [LBHI_SEC07940_115814] (stating that a "zero origination" model had been imposed to get the balance sheet down quickly); e-mail from Kenneth Cohen, Lehman, to Carmine Visone, Lehman, *et al.* (Mar. 27, 2008) [LBEX-DOCID 1374413] ("We are very much in need of balance sheet. We must move things off by the end of the quarter. I need you all to go back to clients and offer them discounts to move things off. We have a lot of wood to chop in a short period of time but we can't afford to fail. If this means leaving p&l on the table so be it. If you have questions get back to me but we HAVE TO DO THIS!!"); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 21, 2008 (Apr. 22, 2008), at p. 2 [LBEX-DOCID 3187588] (showing continued growth of GREG balance sheet); e-mail from Erin M. Callan, Lehman, to Herbert H. McDade, III, Lehman, *et al*. (Apr. 3, 2008) [LBEX-DOCID 1538729] (expressing dismay in the growth of the balance sheet); e-mail from Erin M. Callan, Lehman, to Joseph M. Gregory, Lehman, *et al*. (May 13, 2008) [LBHI_SEC07940_034732].

[2293] Lehman 2007 10-K at p. 104.

[2294] *Id.*

[2295] Lehman 10-Q (Apr. 9, 2008) at p. 20.

[2296] Lehman 10-Q (July 10, 2008) at p. 69.

[2297] *See id.* at p. 67.

2008, when writedowns represented only $900 million of the $6.7 billion gross reduction in commercial real estate assets.[2298]

Lehman set its balance sheet targets and net leverage ratio targets, in part at least, to improve the firm's stature with the rating agencies. Senior Lehman management made a concerted effort to manage and reduce the firm's balance sheet with an eye towards the rating agencies' views of Lehman.[2299] Fuld explained that although raising equity also could reduce the net leverage ratio, Lehman had to improve its net leverage by ridding itself of inventory because there was a "perception issue" with raising equity, and because raising equity would not eliminate Lehman's problem assets.[2300] Fuld told the Examiner that if Lehman had raised equity, it would have brought down the net leverage number but would not really have fixed anything.[2301]

(3) Lehman Sells Stock to Private and Public Investors

On March 28, 2008, Lehman approached Buffett about a potential $3.5 billion private investment in convertible preferred stock with a conversion price of $54 per share.[2302] Lehman and Buffett did not agree on terms for an investment, and Lehman proceeded instead with a public offering. On March 31, 2008, Lehman's management

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[2298] *Id*.

[2299] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 27.

[2300] *Id.*

[2301] *Id*.

[2302] See *infra* Section III.A.3.c of this Report, which discusses Lehman's conversations with Buffett in greater detail.

presented a $4 billion offering of convertible preferred shares to the Board.[2303] Management's presentation to the Board states that the offering constituted part of the firm's plan to deleverage, and that the firm also intended to reduce assets as part of the plan.[2304] The Board passed a resolution authorizing the offering.[2305] On April 4, 2008, LBHI raised $4 billion by issuing convertible preferred stock.[2306] Paulson told the Examiner that Fuld was resistant initially. According to Paulson, Fuld preferred to find a strategic investor, rather than pursue other methods of raising capital.[2307] Although LBHI did raise capital in April 2008, Paulson said that he recommended issuing common rather than preferred stock.[2308]

On April 30, 2008, LBHI issued $1 billion (£500 million) in 10-year senior notes.[2309] On May 2, 2008, LBHI issued $2 billion in 30-year subordinated notes and $2.5 billion in 10-year senior notes.[2310]

On June 6, 2008, Lehman's management presented a stock offering totaling $6 billion to the Board.[2311] The Board passed a resolution authorizing the offering.[2312] On

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[2303] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Mar. 31, 2008), at p. 2 [LBEX-AM 003597].

[2304] *Id*.

[2305] *Id*. at pp. 2-3.

[2306] LBHI 8-K (Apr. 4, 2008).

[2307] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 11.

[2308] *Id*.

[2309] *See* Lehman, Presentation to Lehman Brothers Board of Directors, Estimated April 2008 Financial Information (May 7, 2008), at p. 8 [LBHI_SEC07940_028014].

[2310] *Id*.

[2311] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (June 6, 2008), at p. 3 [LBEX-AM 003709].

June 12, 2008, LBHI sold 2 million shares of convertible preferred stock for $2 billion.[2313] That same day, LBHI sold 143 million shares of common stock for $4 billion ($28 per share), completing the $6 billion offering.[2314]

The Government spoke favorably of Lehman's June 2008 actions to raise capital. Treasury Undersecretary Robert Steel publicly stated that Lehman was "addressing the issues" through its June 2008 capital raise.[2315] Paulson told the Examiner that he did not know of any chief executives who lost their jobs for raising too much equity capital.[2316]

(4) SpinCo

The SpinCo idea was a variation on a good bank/bad bank structure.[2317] Among Lehman's strategic options, SpinCo had a longer time horizon than other options, because substantial advance work would be needed. By early August 2008,[2318] Lehman anticipated completing the spin-off in the first quarter of 2009.[2319] Lehman intended SpinCo to accomplish four interrelated purposes. The first and primary purpose of

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[2312] *Id*.

[2313] LBHI 8-K (June 12, 2008).

[2314] *Id*.

[2315] *See* e-mail from Thomas A. Russo, Lehman, to Richard S. Fuld, Jr., Lehman (June 13, 2008) [LBHI_SEC07940_212723].

[2316] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 11.

[2317] Examiner's Interview of Gary Parr, Sept. 14, 2009, at p. 10.

[2318] *See* Lehman, Commercial Real Estate Spin-off Summary (Aug. 6, 2008), at p. 8 [LBHI_SEC07940_013317] ("Preliminary Summary Timeline" shows SpinCo distribution date during the week of 1/2/2009); *accord* Lehman, Project Green - Revised Projected Capital Analysis (Aug. 14, 2008), at p. 1 [LBEX-DOCID 236909] ("CRE assets of $31.7B spun off at the end of 1Q09."), attached to e-mail from Brad Whitman, Lehman, to Kunho Cho, Lehman, *et al.* (Aug. 14, 2008) [LBEX-DOCID 407341].

[2319] Final Transcript of Lehman Brothers Holdings Inc. Third Quarter 2008 Preliminary Earnings Call (Sept. 10, 2008), at p. 5 [LBHI_SEC07940_612771].

SpinCo was to relieve Lehman's balance sheet of its "outsized" commercial real estate exposure that had become a source of increasing market concern and pressure.[2320] Second, by moving those assets to a separate entity, Lehman hoped to avoid the necessity of having to continue marking down those assets as the market continued to deteriorate. That process had exposed Lehman to criticism in the press and by analysts in what Hugh "Skip" E. McGee, III, the head of Lehman's Investment Banking Division, referred to as the "are we marked correctly game."[2321]

Third, by spinning off those assets, Lehman would avoid a "fire sale for the vultures"[2322] that would have locked in its paper losses.[2323] Instead, SpinCo would allow Lehman to manage those assets on a value-maximizing basis for the benefit of Lehman's shareholders, either by selling the SpinCo assets or holding them to maturity.[2324]

[2320] *See* Lehman, Lehman Commercial Mortgage Exposure is Outsized Relative to Peers [LBHI_SEC07940_339455], attached to e-mail from Kevin Thatcher, Lehman, to Ian T. Lowitt, Lehman, *et al.* (June 10, 2008) [LBHI_SEC07940_339451]; Lehman, The Gameplan (Sept. 2008), at p. 4 [LBEX-DOCID 2727665] ("In recent months, shareholders, creditors, and counterparties have expressed increasing concern about the size and concentration of our positions and their impact on our overall creditworthiness, and they have put increasing pressure on the firm to reduce our exposure."). *Accord* Examiner's Interview of Thomas A. Russo, May 11, 2009, at p. 9.

[2321] E-mail from Hugh E. McGee, III, Lehman, to Steven R. Hash, Lehman, *et al*. (June 11, 2008) [LBHI_SEC07940_398653]; Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at p. 14; Examiner's Interview of Hugh E. McGee, III, Aug. 12, 2009, at pp. 20-21.

[2322] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 6.

[2323] *See* e-mail from Larry Wieseneck, Lehman, to Brad Whitman, Lehman (July 5, 2008) [LBHI_SEC07940_401266] ("[CRE spin-off] does not require negotiations with someone who will feel they have leverage against us and demand a lower price."). *Accord* Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 6; Examiner's Interview of David O'Reilly, Oct. 26, 2009, at p. 3; Examiner's Interview of Lisa Beeson, Oct. 23, 2009, at pp. 8-9.

[2324] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at pp. 5-6 (SpinCo would take care of the valuation problem for some of the assets); Examiner's Interview of Hugh E. McGee, III, Aug. 12, 2009, at p. 23 (spinning off the commercial real estate assets to the shareholders, who owned them already

Fourth, once Lehman had purged its balance sheet of "toxic" commercial real estate assets, it hoped that the post-spin "clean" or "core" Lehman (a.k.a. "CleanCo") could achieve returns on equity in the low teens, twelve times net leverage, and maintain an A rating.[2325]

However, SpinCo faced substantial structural and execution issues that led some observers to question its feasibility. Paulson told the Examiner that he expressed great skepticism about SpinCo to Fuld and advised him to abandon the plan.[2326] James L. "Jamie" Dimon, JPMorgan's CEO, told the Examiner that he did not believe that SpinCo would work, thinking that the proposal was too leveraged, too complex, and involved too much real estate.[2327] When the concept was described to Buffett, he dismissed it.[2328] Ultimately, Lehman was not able to carry out the SpinCo plan prior to its bankruptcy.

(a) Evolution of SpinCo

Lehman executives first considered shifting Lehman's troubled real estate assets to an off-balance-sheet entity in March 2008.[2329] On March 12, 2008, Callan asked Mark

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anyway, would relieve the mark-to-market pressure on Lehman while letting the assets mature out of the glare of the market); Examiner's Interviews of Steven Berkenfeld, Oct. 5 and 7, 2009, at p. 17.

[2325] *See, e.g.*, Lehman, Transaction Summary [Draft] (Sept. 5, 2008) [LBEX-DOCID 237627] (investor term sheet describing option to invest in "Cleanco" shares); Lehman, SpinCo Concept and Rationale - Investor Presentation Outline (Aug. 12, 2008), at p. 3 [LBEX-DOCID 2929104] ("Post SpinCo, the remaining 'Clean Lehman' will be well positioned for success"), attached to e-mail from Timothy Lyons, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Aug. 12, 2008) [LBEX-DOCID 3116194]. *Accord* Examiner's Interview of Gary S. Barancik, Sept. 25, 2009, at p. 4.

[2326] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at pp. 3, 24.

[2327] Examiner's Interview of Jamie L. Dimon, Sept. 29, 2009, at p. 5.

[2328] Examiner's Interview of Warren E. Buffett, Sept. 22, 2009, at p. 4.

[2329] *See* e-mail from Erin M. Callan, Lehman, to Mark A. Walsh, Lehman (Mar. 12, 2008) [LBHI_SEC07940_116854]; e-mail from Steven R. Hash, Lehman, to Daniel Kerstein, Lehman, *et al*. (Apr.

A. Walsh, the Head of Global Real Estate, what he thought of putting some of Lehman's commercial mortgage assets into a new real estate investment trust and "spinning" it (*i.e.*, transferring ownership of the new entity) to Lehman's shareholders.[2330] Walsh responded with concerns about how the new entity would trade and its impact on how Lehman would trade.[2331] Lehman did not pursue the idea at that time.

On June 11, 2008, McGee proposed his own version of the commercial real estate spin-off concept to a group of Lehman's investment bankers.[2332] The initial response was that other Lehman executives already had rejected the idea because it "required too much equity beneath it."[2333] Nonetheless, the SpinCo idea gained traction in June 2008 and became a central component of Lehman's post-Bear Stearns survival strategy.

Led by McGee,[2334] the SpinCo plan (code-named by Lehman "Project Green Acres") was a key component of the Firm's self-help strategy. It was supposed to be a way to address Lehman's problems without a strategic partner, before collapsing

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11, 2008) [LBHI_SEC07940_089122]; e-mail from Erin M. Callan, Lehman, to Steven R. Hash, Lehman, *et al.* (Apr. 17, 2008) [LBHI_SEC07940_274912]; e-mail from David Baron, Lehman, to David Goldfarb, Lehman, *et al.* (Apr. 23, 2008) [LBEX-DOCID 1558959, 1400312] (attaching slides re "Managing to a 'Bad Asset' Solution").

[2330] E-mail from Erin M. Callan, Lehman, to Mark A. Walsh, Lehman (Mar. 12, 2008) [LBHI_SEC07940_116854].

[2331] E-mail from Mark A. Walsh, Lehman, to Erin M. Callan, Lehman (Mar. 12, 2008) [LBHI_SEC07940_116854].

[2332] *See* e-mail from Hugh E. McGee, III, Lehman, to Larry Wieseneck, Lehman, *et al*. (June 11, 2008) [LBHI_SEC07940_398653].

[2333] E-mail from Larry Wieseneck, Lehman, to Hugh E. McGee, III, Lehman, *et al*. (June 11, 2008) [LBHI_SEC07940_398653] ("[Daniel] Kerstein proposed this 3 months ago. Combo of Goldfarb and parts of RE rejected it. I think Hash knows why it was challenging. I believe because it required too much equity beneath it.").

[2334] Lehman, Green Acres - Working Group (July 23, 2008) [LBHI_SEC07940_125904] (showing McGee as head).

commercial real estate values "[took] down the mother ship."[2335] As Fuld told David Goldfarb, Lehman's Chief Strategy Officer, in a July 19, 2008 e-mail: "The key to our success is the viability of the spinco."[2336] At the July 22, 2008 Board meeting, McGee presented SpinCo as a "strategic alternative," and Gary Parr, Deputy Chairman of Lazard, Lehman's strategic advisor, told the Board that SpinCo was "a great idea that should be aggressively pursued."[2337] Appendix 13 to this Report provides greater detail on SpinCo.

(b) Execution Issues

From the outset, Lehman recognized that the SpinCo plan faced significant obstacles.[2338] First, providing the new entity with substantial cash capital threatened to leave an equity hole in Lehman's own capital structure. Second, Lehman needed to find investors who would be willing, in a troubled market, to finance an entity comprised of Lehman's commercial real estate assets. Third, Lehman needed to clear critical accounting issues with the SEC. Fourth, preparing financial models for SpinCo would

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[2335] *See* e-mail from Hugh E. McGee, III, Lehman, to Mark A. Walsh, Lehman (June 13, 2008) [LBHI_SEC07940_123660]. *Accord* Examiner's Interview of Hugh E. McGee, III, Aug. 12, 2009, at p. 23; Examiner's Interview of Herbert H. McDade, III, Sept. 16, 2009, at p. 3; Examiner's Interview of Lisa Beeson, Oct. 23, 2009, at p. 9.

[2336] E-mail from Richard S. Fuld, Jr., Lehman, to David Goldfarb, Lehman (July 19, 2008) [LBHI_SEC07940_213011].

[2337] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (July 22, 2008), at p. 6 [LBEX-AM 003866]. See Appendix 13 §§ IV,V, which discusses Lazard's proposed alternative and SpinCo in greater detail.

[2338] *See* e-mail from Erin M. Callan, Lehman, to Mark A. Walsh, Lehman (Mar. 12, 2008) [LBHI_SEC07940_116854]; Lehman, Managing to a "Bad Asset" Solution [Draft] [LBEX-DOCID 1400312] (key challenges to Bad Asset solution included financing "NewCo assets" and replenishing "capital lost in asset dispositions"), attached to e-mail from David Baron, Lehman, to David Goldfarb, Lehman, *et al*. (Apr. 23, 2008) [LBEX-DOCID 1558959].

require Lehman to value thousands of rapidly devaluing commercial real estate positions.

(i) Equity Hole

To establish SpinCo as a viable independent entity and to avoid consolidation with Lehman, Lehman would have to capitalize SpinCo with substantial equity, amounting to at least 20 to 25 percent of SpinCo's net asset value.[2339] Providing that equity from Lehman's own cash capital would leave a corresponding "hole" in Lehman's capital structure, which already was depleted by write-downs and losses.[2340] Indeed, when McGee floated the "good bank/bad bank" concept in early June 2008, Larry Wieseneck, Lehman's Global Head of Risk Solutions, responded that Goldfarb and Lehman's Global Real Estate Group had "rejected" the idea because it "required too much equity beneath it."[2341]

[2339] *See* e-mail from Daniel Kashdin, Lehman, to Daniel Kerstein, Lehman, *et al*. (July 11, 2008) [LBHI_SEC07940_401374] ("To preclude consolidation, there will need to be a substantial amount of equity in the deal"); e-mail from David Goldfarb, Lehman, to Richard S. Fuld, Jr., Lehman (July 21, 2008) [LBEX-DOCID 1224222] ("There is a minimum of capital needed to de-consolidate which is approx $6 billion and obviously we would like to raise much more to reduce our ongoing financing of Spinco"). *Accord* Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 7; Examiner's Interview of Hugh E. McGee, III, Aug. 12, 2009, at p. 23.

[2340] *See, e.g.,* e-mail from Gerard Reilly, Lehman, to Martin Kelly, Lehman (July 19, 2008) [LBEX-DOCID 2117905] ("I have heard as much as 14b of equity needed on 35b of assets. Does not leave remaining co w much."); e-mail from Eric Felder, Lehman, to Paolo R. Tonucci, Lehman (Aug. 10, 2008) [LBHI_SEC07940_538151] ("We are too small post spinco in my opinion").

[2341] E-mail from Larry Wieseneck, Lehman, to Hugh E. McGee, III, Lehman (June 11, 2008) [LBHI_SEC07940_398653]; *see also* e-mail from Daniel Kerstein, Lehman, to Larry Wieseneck, Lehman (July 22, 2008) [LBHI_SEC07940_404505] ("Have been thinking this through and coming to conclusion we won't do spin because too much equity and financing won't work for the spinco"); e-mail from Timothy Lyons, Lehman, to Alex Kirk, Lehman (July 22, 2008) [LBHI_SEC07940_174554] ("Given your views on the likelihood of spinco, I think we need to move hard down the path of Plan B"); e-mail from Eric Felder,

For McGee and Goldfarb, the questions were how big the hole would be and whether Lehman would have to fill it pre- or post-spin.[2342] To fill that "hole" and bolster its own position,[2343] Lehman would need to raise capital.[2344] By mid-summer 2008, Lehman's ability to raise capital by issuing shares was severely constrained by its previous capital raises as well as a constricting market.[2345] The next option was to sell assets, so Lehman looked to its "crown jewel," IMD, and especially, NB, which was IMD's private asset management arm.[2346] During July 2008, Lehman considered selling

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Lehman, to Paolo R. Tonucci, Lehman (Aug. 10, 2008) [LBEX-DOCID 1297372] ("We are too small post spinco in my opinion.").

[2342] *See, e.g.,* e-mail from David Goldfarb, Lehman, to Richard S. Fuld, Jr., Lehman (July 20, 2008) [LBHI_SEC07940_213013] ("The construct of Spinco does work. The challenge is getting the outside capital . . . . There is a minimum of capital needed to de-consolidate which is approx $6 billion and obviously we would like to raise much more to reduce our ongoing financing of Spinco"); e-mail from Brad Whitman, Lehman, to Hugh E. McGee, III, Lehman (Aug. 5, 2008) [LBEX-DOCID 4067934] ("Model suggesting that maintaining 12x leverage would require about $7B in capital in clean RemainderCO. Ian [Lowitt] thinks that we should be targeting higher leverage ratio (because have gotten rid of higher risk weighted assets). Which is to say, he's thinking capital [to fill equity hole] of some number north of $5B."); e-mail from Hugh E. McGee, III, Lehman, to Brad Whitman, Lehman (Aug. 10, 2008) [LBHI_SEC07940_538201] ("We have already raised a lot of capital. Can we use some of what we already raised to bridge us here. Then we raise capital at time of diversion of equity to spinco"). *Accord* Examiner's Interview of Hugh E. McGee, III, Aug. 12, 2009, at p. 23.

[2343] *See* Lehman, SEC talking points [Draft] (Aug. 11, 2008), at p. 2 [EY-LE-LBHI-KEYPERS 0907480] ("The distributed equity [for SpinCo] will not be replaced on a dollar-for-dollar basis as Lehman will no longer be supporting the commercial real estate portfolio").

[2344] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at pp. 9-11; Examiner's Interview of Hugh E. McGee, III, Aug. 12, 2009, at p. 23; Examiner's Interview of Gary Parr, Sept. 14, 2009, at pp. 10-11.

[2345] *See, e.g.,* e-mail from Paolo R. Tonucci, Lehman, to Christian Wait, Lehman (July 17, 2008) [LBHI_SEC07940_529261] (forwarding Moody's Investors Service, Press Release (July 17, 2008) ("Lehman has very limited capacity for additional preferred securities in its capital structure, and the difficult market environment for Lehman in raising common equity capital . . . limits its ability to respond to further unexpected losses")).

[2346] Examiner's Interviews of Steven Berkenfeld, Oct. 5 and 7, 2009, at p. 18; Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at pp. 9-11; Examiner's Interview of Hugh E. McGee, III, Aug. 12, 2009, at pp. 23-24; Examiner's Interview of Gary Parr, Sept. 14, 2009, at pp. 9-10. Lehman senior management had contemplated the possibility of selling off all or part of IMD since 2007. *See* Memorandum from Hugh E. McGee, III, Lehman, to Richard S. Fuld, Jr., Lehman, *et al.,* re: analysis of possible sale or carve

IMD as part of its "Project Green" survival strategies.[2347] By early August 2008, McGee and other Lehman executives had come to regard an IMD sale as one of the primary options for addressing the equity hole.[2348] Lehman was concerned that selling IMD would have a negative impact on Lehman's credit ratings, but by the end of August 2008, Lehman's management and the Board had accepted the need to sell at least part of IMD to fill the equity hole that SpinCo would create.[2349]

In early September 2008, a Lehman presentation circulated among senior management, "Capital Hole Analysis," estimates that spinning off $31.6 billion in assets

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out of IMD (May 29, 2007) [LBEX-DOCID 711211]; David Erickson, Project Hercules (May 18, 2007) [LBEX-DOCID 727278].

[2347] *See* Lehman, Discussion Materials for the Executive Committee (July 21, 2008), at p. 3 [LBEX-DOCID 612664] (estimates that, at $6 billion total valuation of IMD, sale of 100% will generate after-tax cash proceeds of $1.7 billion, plus $3 billion gain to Lehman equity via reduced goodwill), attached to e-mail from Timothy Sullivan, Lehman, to Jasjit Bhattal, Lehman, *et al*. (July 21, 2008) [LBEX-DOCID 741718]; Lazard, Discussion Materials-Project Green [Draft] (Aug. 7, 2008) [LBHI_SEC0794_647930] (comparing effects on Lehman of commercial real estate spin-off with or without a sale of 51% or 100% of IMD); Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (July 31, 2008), at p. 2 [LBEX-AM 003875-76] (Fuld reported to the Board about "the three-part transaction that had been previously reviewed with the Board of Directors involving a spin-out of the commercial real estate business, the sale of the Investment Management Division, and the raising of capital"). *Accord* Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 9.

[2348] *See, e.g.*, Lehman, Discussion Materials for the Executive Committee (July 21, 2008), at p. 3 [LBEX-DOCID 612664], attached to e-mail from Timothy Sullivan, Lehman, to Jasjit Bhattal, Lehman, *et al*. (July 21, 2008) [LBEX-DOCID 741718]; e-mail from Angela Judd, Lehman, to Hugh E. McGee, III, Lehman, *et al*. (Aug. 8, 2008) [LBHI_SEC07940_647930] (forwarding "Project Green" presentation prepared by Lazard, comparing effects on Lehman of commercial real estate spin-off with or without a sale of 51% or 100% of IMD); Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (July 31, 2008), at p. 2 [LBEX-AM 003875]. *Accord* Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 9.

[2349] Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at pp. 16-17; Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 13; Examiner's Interviews of Steven Berkenfeld, Oct. 5 and 7, 2009, at p. 18. *But see* e-mail from Hugh E. McGee, III, Lehman, to Richard S. Fuld, Jr., Lehman (Aug. 25, 2008) [LBHI_SEC07940_213294] (forwarding talking points that include the need "[t]o fill the equity hole from SpinCo, will need to raise $3-4B of equity. May raise this via partial sale of IMD but that is not the preferred route. Running a process for all of IMD; initial indications for the whole thing range from $8-11B. Total market cap of Green today is ~$9.5 B -- makes no sense").

would require Lehman to transfer $7.9 billion equity to SpinCo for SpinCo to achieve a 75% loan-to-value ratio.[2350] To provide that $7.9 billion, Lehman hoped to raise $2.5 billion through a sale of 51% of IMD and to raise another $3 billion by issuing equity, but that still would leave $2 billion or more to be raised from a third-party investor.[2351]

When Lehman pre-announced its earnings on September 10, 2008, Lehman had not yet finalized its approach to filling the equity hole. During the earnings call, Lehman announced its plan "to separate a vast majority of our commercial real estate assets from our core business by spinning off those assets to our shareholders and to an independent, publicly traded entity which will be adequately capitalized," and stated that Lehman was "in the final stages of raising capital with sale of a majority stake in IMD."[2352] Analysts asked whether Lehman needed additional capital in order to capitalize SpinCo, and whether the sale of IMD was expected to result in only $3 billion, to which Lowitt responded: "We don't feel that we need to raise that extra amount to cover the $7 billion because you will have less leverageable equity in core Lehman than in where you are at the end of this quarter."[2353]

[2350] Lehman, Capital Hole Analysis (Sept. 8, 2008), at p. 1 [LBHI_SEC07940_409438].

[2351] *Id*. *But see* Lehman, SEC talking points [Draft] (Aug. 11, 2008), at p. 2 [EY-LE-LBHI-KEYPERS 0907480] ("The distributed equity [for SpinCo] will not be replaced on a dollar-for-dollar basis as Lehman will no longer be supporting the commercial real estate portfolio").

[2352] Final Transcript of Lehman Brothers Holdings Inc. Third Quarter 2008 Preliminary Earnings Call (Sept. 10, 2008), at p. 3 [LBHI_SEC07940_612771].

[2353] *Id*. at 19.

After the call, analysts reacted skeptically to Lehman's explanations and zeroed in on the equity hole.[2354] Barclays Capital analyst Robert Ferguson wrote:

> The key problem is the amount of equity that it will take for the new REI spinoff. They really seemed to dodge the question on the call. . . . [H]ow would they expect to transfer the CRE portfolio at its current mark to the SpinCo if the market bids for that are significantly lower? Wouldn't they have to hold some provision in a non MTM book?[2355]

Vincent Curotto, an analyst for Sanford Bernstein, wrote:

> While Lehman's management yesterday said that it does not expect to have to raise capital in order to reach its destination of being a 'new' LEH (sale of NEU, spinoff of CRE/CMBS, etc), we are skeptical. Our work in our Monday piece implies that LEH would have to raise $7.5 billion in order to capitalize this spin off adequately and maintain a 20x leverage ratio.[2356]

Analysts estimated that Lehman would have to raise at least $6 to $9 billion to capitalize the spin-off and restore Lehman's leverage ratio.[2357]

(ii) Outside Financing for SpinCo

In addition to providing the cash equity needed to capitalize SpinCo, Lehman also would need to finance at least some of the assets that it transferred to the new

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[2354] *See, e.g.*, e-mail from Robert Ferguson, Barclays Capital, to Mike Keegan, Barclays Capital (Sept. 10, 2008) [BCI-EX-(S)-00035195].

[2355] *Id.*

[2356] E-mail from Vincent Curotto, Sanford Bernstein, to Stuart Schwadron, Sanford Bernstein (Sept. 11, 2008) [SB-SEC 048150].

[2357] *See, e.g., id.* (estimating that Lehman would have to raise $7.5 billion in order to adequately capitalize the spin-off and maintain its leverage ratio); UBS, Notes regarding Lehman's commercial real estate spinoff (Sept. 11, 2008) [SECUBS 00663] (estimating that Lehman would need between $6 billion and $9 billion in equity to fund SpinCo, taking a "pretty good chunk of capital out of the 'good' Lehman and potentially caus[ing] it to raise common equity").

entity.[2358] Lehman executives recognized from the outset that it would be critical to find independent financing for the new entity.[2359] While the spin-off would relieve Lehman's balance sheet of the transferred assets, Lehman would hold SpinCo's notes — as Fuld noted to Goldfarb: "We need to get others to finance [SpinCo] so it doesn't sit on our balance sheet."[2360]

Lehman hoped to attract outside financing for SpinCo by tranching Lehman's seller financing.[2361] The initial goal was to sell $2 to $6 billion of the highest-risk, highest-return "mezzanine" tranches of the debt.[2362] By August 2008, Lehman's "Project Green Acres" team had reached out to selected investors,[2363] mostly private equity

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[2358] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at pp. 6-8.

[2359] *See* e-mail from Erin M. Callan, Lehman, to Mark A. Walsh, Lehman (Mar. 12, 2008) [LBHI_SEC07940_116854] ("Clearly have to address financing of the assets which we would primarily have to provide to Newco from the outset"); e-mail from Steven R. Hash, Lehman, to Erin M. Callan, Lehman, *et al.* (Apr. 14, 2008) [LBHI_SEC07940_274912] ("I thought we had decided the structure would not work because independent financing is not available"); e-mail from Steven R. Hash, Lehman, to Daniel Kerstein, Lehman, *et al*. (June 10, 2008) [LBEX-DOCID 1475676] ("[P]roblem is financing and the assets that greg owns. Ie there is really no independent financing for these assets in the market today. No financing means no actual business plan").

[2360] E-mail from Richard S. Fuld, Jr., Lehman, to David Goldfarb, Lehman (July 19, 2008) [LBHI_SEC07940_213011].

[2361] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at pp. 6-7.

[2362] *See* Lehman, Project Green - Talking Points for Potential Investors (Aug. 6, 2008) [LBEX-DOCID 363782] (describing option to purchase up to 20% stake in post-spin Lehman (via $5 billion forward payment), conditional on purchase of "meaningful portion" ($3-4 billion) of SpinCo mezzanine securities); *see also* e-mail from David Goldfarb, Lehman, to Martin Kelly, Lehman, *et al.* (July 21, 2008) [LBEX-DOCID 2997880] ("SpinCo . . . if we get outside party to purchase full Mezz piece, 5-6 billion-we can own all senior 20 bill and shareholders own equity and we still get to deconsolidate. Right?"). *Accord* Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 7.

[2363] Notably, McGee stated that he was not aware whether anyone at Lehman approached investors to test the water in the marketplace for SpinCo notes, or made any other effort prior to the September 10, 2008 earnings call to line up investors for SpinCo debt. Examiner's Interview of Hugh E. McGee, III, Aug. 12, 2009, at pp. 24-25.

groups, about SpinCo's mezzanine debt.[2364] Lehman also hoped to syndicate part of the senior debt financing.[2365] The rating agencies that reviewed the SpinCo plan in mid-August underscored the importance of Lehman being able to syndicate some of SpinCo's senior debt.[2366] Eileen Fahey, a managing director of Fitch, told the Examiner that her preliminary conclusion was that Lehman would be left financing SpinCo's assets and would still "be on the hook" for any SpinCo losses.[2367]

In March 2008, Lehman had approached Buffett concerning a private investment.[2368] In mid-July 2008, Lehman again considered approaching Buffett about

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[2364] *See*, Lehman, Project Green Acres - Daily Update (Aug. 8, 2008) [LBEX-DOCID 2253477], attached to e-mail from Sarah Kadetz, Lehman, to Lisa Beeson, Lehman, *et al.* (Aug. 8, 2008) [LBEX-DOCID 2151027]; e-mail from Lisa Beeson, Lehman, to Larry Wieseneck, Lehman, *et al.* (Aug. 8, 2008) [LBEX-DOCID 544666]; Lehman, Summary of Conversations with Potential Capital Providers (Aug. 27, 2008) [LBEX-DOCID 947915] (listing potential investors including Apollo, Blackstone, Carlyle, Cerberus, Colony, Fortress, J.E. Roberts, Lone Star, Lubert Adler, Och-Ziff, Vornado, and Walton Street), attached to e-mail from Alex Kirk, Lehman, to Michael Gelband, Lehman (Aug. 27, 2008) [LBEX-DOCID 961894].

[2365] *See* e-mail from David Goldfarb, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (July 19, 2008) [LBHI_SEC07940_404388] ("Need some creative ways to fund Spinco. Best to get some relationships which do commercial real estate lending in scale. They could buy seniors or mezz's. Start thinking, this is key challenge that needs to be nailed"); e-mail from Gerard Reilly, Lehman, to Ian T. Lowitt, Lehman, *et al.* (July 22, 2008) [LBEX-DOCID 2997880] ("[S]elling mezz certainly helps as it supports validity of capital structure. If we can find other SR debt in market and gain some comfort on our spread then we could call it [a Level II asset]. Placing some Sr is best"). *Accord* Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 7.

[2366] *See, e.g.,* e-mail from Hugh E. McGee, III, Lehman, to Jeffrey L. Weiss, Lehman, *et al*. (Aug. 13, 2008) [LBHI_SEC07940_406811] (forwarding Tonucci e-mail summarizing a meeting with Fitch re: SpinCo: "[S]elling the senior debt - ability to do so seemed important in their assessment of what had been accomplished"); e-mail from Ian T. Lowitt, Lehman, to Hugh E. McGee, III, Lehman (Aug. 13, 2008) [LBHI_SEC07940_364012] ("[Rating agencies] don't think [SpinCo's] operators will find alternative sources of financing as easily as implied in our model. Will have to work hard to convince agencies and other potential funders. Must make sure this is not [G]oldfarb over exuberance at work here").

[2367] Examiner's Interview of Eileen A. Fahey, Sept. 17, 2009, at p. 6.

[2368] See *infra* Section III.A.3.c of this Report, which discusses Lehman's talks with Buffett in greater detail.

investing in SpinCo debt.[2369] In late August or early September 2008, McGee called MidAmerican Energy Holdings' President David L. Sokol, hoping to entice Sokol either to have MidAmerican Energy Holdings invest in the SpinCo plan or to advocate the plan to Buffett.[2370] McDade and McGee showed Sokol Lehman's "Gameplan" presentation, explaining that Lehman was ready to execute the plan if Lehman had an investor.[2371] Sokol was not interested in investing, but relayed the basic premise of the SpinCo plan to Buffett.[2372] During that discussion, Buffett dismissed the idea as unrealistic.[2373]

Lehman discussed the SpinCo plan in detail during its pre-announcement earnings call on September 10, 2008, but it did not discuss its efforts to sell portions of Lehman's SpinCo debt, because the syndication was not yet in place.[2374]

[2369] *See* e-mail from Larry Wieseneck, Lehman, to Brad Whitman, Lehman, *et al*. (July 18, 2008) [LBHI_SEC07940_404298] ("We should consider getting the [SpinCo] loan rated and possibly wrapped by Berkshire").

[2370] Examiner's Interview of Hugh E. McGee, III, Aug. 12, 2009, at p. 17; Examiner's Interview of David L. Sokol, Sept. 22, 2009, at p. 2.

[2371] Lehman, The Gameplan (Sept. 2008) [LBHI_SEC07940_653681], attached to e-mail from Hugh E. McGee, III, Lehman, to David L. Sokol, MidAmerican Energy Holdings Co. (Sept. 4, 2008) [LBHI_SEC07940_653680]; Examiner's Interview of Hugh E. McGee, III, Aug. 12, 2009, at p. 17; Examiner's Interview of David L. Sokol, Sept. 22, 2009, at p. 4.

[2372] Sokol does not recall specifically whether he communicated Lehman's SpinCo plan to Buffett; however, Buffett recalled Sokol briefing him on the basic contours of the plan – or at least, "something they tossed out" about a CRE spin. Examiner's Interview of David L. Sokol, Sept. 22, 2009, at p. 3; Examiner's Interview of Warren E. Buffett, Sept. 22, 2009, at p. 4.

[2373] Examiner's Interview of Warren E. Buffett, Sept. 22, 2009, at p. 4.

[2374] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2008, at p. 8.

(iii) SEC Issues

For SpinCo to work as planned, the SEC had to approve the accounting treatment Lehman proposed to use.[2375] First, Lehman hoped to avoid the requirement that SpinCo provide three years of audited financial statements covering the assets that Lehman would transfer.[2376] Second, Lehman sought to avoid using mark-to-market or "fair value" accounting of SpinCo's loan assets and sought to account for SpinCo's debt securities on a "hold to maturity" basis.[2377] Third, Lehman hoped to structure the SpinCo transaction in such a way that the spin-off would be tax-free to Lehman and its shareholders.[2378] Lehman was able to obtain SEC approval of the first two goals but the SEC agreement effectively doomed Lehman's tax treatment goal.

a. Auditing and Accounting Issues

Lehman's accountants regarded preparation of historical financial statements for SpinCo's Form 10 as a major problem.[2379] SEC rules typically require a company to

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[2375] *See* e-mail from Daniel Kashdin, Lehman, to Daniel Kerstein, Lehman, *et al.* (July 11, 2008) [LBHI_SEC07940_401374] ("Likely that E&Y would require Lehman to pre-clear [SpinCo] transaction with SEC"); Lehman, SEC Discussion Materials [Draft] (July 28, 2008) [LBHI_SEC07940_404819]; Lehman, Green Acres - Overview of Potential Alternatives [Draft] (July 30, 2008) [LBHI_SEC07940_405303]. *Accord* Examiner's Interview of Thomas A. Russo, May 11, 2009, at p. 9.

[2376] Examiner's Interview of Thomas H. Cruikshank, Oct. 8, 2009, at p. 9.

[2377] *Id.*; Examiner's Interview of David O'Reilly, Oct. 26, 2009, at p. 4; Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at pp. 9-10.

[2378] *See, e.g.*, Lehman, Key Execution Considerations for Spin-Off [Draft] (July 11, 2008) [LBHI_SEC07940_401591] ("Transaction likely can be structured as tax-free to shareholders if SpinCo is a C-Corp"). *Accord* Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 7.

[2379] *See* e-mail from Martin Kelly, Lehman, to David Goldfarb, Lehman, *et al.* (July 17, 2008) [LBEX-DOCID 560179] ("Single largest issue here will be the form of financial statements required by the s e c - if we need to prepare and have audited a separate set of f[i]nancials for the real estate business that will be a huge undertaking"); Lehman, SpinCo Talking Points for SEC [Draft] (Aug. 6, 2008) [LBEX-DOCID

provide three years of audited financial statements for newly acquired real estate operations.[2380] Because of the number and diversity of the underlying CRE assets, compiling those statements for SpinCo would be a "huge undertaking" that could delay SpinCo's execution "beyond a practical time horizon."[2381]

In August 2008, Lehman sought a waiver from the SEC.[2382] Lehman argued that complete historical documentation of the financial performance and administrative costs of SpinCo's numerous, diverse assets simply did not exist.[2383] Instead of audited historical financial statements, Lehman proposed to provide investors with an audited opening balance sheet and up to three years of *prospective* financial statements, along with specific information on individual assets that would be limited to "type of property, occupancy percentage, geographic location, square footage, acquisition cost, indebtedness and property level cash flows."[2384]

1295521], attached to e-mail from Daniel Kerstein, Lehman, to Steven Berkenfeld, Lehman (Aug. 6, 2008) [LBEX-DOCID 1297492].

[2380] *See* Lehman, SEC Talking Points [Draft] (Aug. 8, 2008) [LBEX-DOCID 851411], attached to e-mail from Michael J. Langer, Lehman, to Thomas A. Russo, Lehman, *et al*. (Aug. 8, 2008) [LBEX-DOCID 965295]; *see also* 17 C.F.R. § 210.3-14 (2008), SEC Reg. S-X Rule 3-14, Special Instructions for Real Estate Operations to be Acquired.

[2381] E-mail from Martin Kelly, Lehman, to David Goldfarb, Lehman (July 17, 2008) [LBEX-DOCID 560179]; Lehman, SpinCo - Proposed Term Sheet [Draft] (Aug. 19, 2008), at p. 5 [EY-LE-LBHI-KEYPERS 3670025], attached to e-mail from Robert Downs, Sullivan & Cromwell, to Martin Kelly, Lehman, *et al*. (Aug. 19, 2008) [EY-LE-LBHI-KEYPERS 3670025]; Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 8.

[2382] *See* Lehman, SEC Talking Points [Draft] (Aug. 11, 2008) [EY-LE-LBHI-KEYPERS 0907480], attached to e-mail from Daniel Kerstein, Lehman, to William Schlich, Ernst & Young, *et al*. (Aug. 11, 2008) [EY-LE-LBHI-KEYPERS 0907479].

[2383] *Id. Accord* Examiner's Interviews of Steven Berkenfeld, Oct. 5 and 7, 2009, at p. 14.

[2384] Lehman, SEC Talking Points [Draft] (Aug. 11, 2008) [EY-LE-LBHI-KEYPERS 0907480], attached to e-mail from Daniel Kerstein, Lehman, to William Schlich, Ernst & Young, *et al*. (Aug. 11, 2008) [EY-LE-LBHI-KEYPERS 0907479]; Lehman, SpinCo - Proposed Term Sheet (Aug. 19, 2008), at p. 3 [EY-LE-LBHI-

Following an initial meeting with the SEC on August 12, 2008, Lehman was "cautiously optimistic" and concluded that the SEC was ready to be "helpful" in waiving the requirement of three years of historical financials.[2385] However, an agreement was not reached quickly.[2386] The SEC offered to grant Lehman's waiver request in exchange for an agreement that SpinCo would use "fair value," also known as mark-to-market, accounting.[2387] On August 20, 2008, Fuld reported to the Board that Lehman had "resolved" all major accounting issues with the SEC apart from the mark-to-market accounting question.[2388]

As Fuld indicated to the Board, Lehman's second major challenge was to obtain the SEC's agreement that SpinCo would not need to use mark-to-market or "fair value" accounting (*i.e.*, SFAS 157 and 159) in reporting the value of its commercial real estate

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KEYPERS 3670027], attached to letter from John W. Bostelman, Sullivan & Cromwell, to John White, SEC (Aug. 19, 2008) [EY-LE-LBHI-KEYPERS 3670025]. Lehman's outside accountants, Ernst & Young, reportedly felt "blindsided" and put in the "hot seat" by the SEC's expectation that Lehman's auditors would certify SpinCo's financial projections. *See* e-mail from Kenneth T. Marceron, Ernst & Young, to Randy G. Fletchall, Ernst & Young, *et al.* (Aug. 13, 2008) [EY-LE-LBHI-KEYPERS 3669425] ("In this fact pattern, the client would sell securities based solely on a financial forecast rather than any historical financial statements. . . . I don't see practically how we could ever get there given the information that would be required in order to do a forecast even if we wanted to accept this type of engagement").

[2385] E-mail from Ian T. Lowitt, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Aug. 12, 2008) [LBEX-DOCID 2642438].

[2386] *See* letter from Martin Kelly, Lehman, to Wayne Carnall, SEC, re: SEC request that Lehman address why spin-off should not be regarded as the acquisition of a business and why SpinCo should not be required to use fair value accounting (Aug. 21, 2008) [LBEX-DOCID 1298065], attached to e-mail from Robert W. Downes, Sullivan & Cromwell, to Larry Wieseneck, Lehman, *et al.* (Aug. 21, 2008) [LBEX-DOCID 1297924].

[2387] E-mail from David Goldfarb, Lehman, to Larry Wieseneck, Lehman, *et al.* (Aug. 27, 2008) [LBEX-SIPA 007017].

[2388] *See* Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Aug. 20, 2008), at p. 2 [LBEX-AM 003891].

assets.[2389] Lehman executives believed that using "hold to maturity" accounting for SpinCo's assets was critical to SpinCo's feasibility, but that would require Lehman to be a pioneer in obtaining the SEC's agreement to allow that accounting treatment.[2390]

On August 21, 2008, Lehman presented its request to the SEC.[2391] Lehman argued that under U.S. GAAP, an entity that can demonstrate the intent and ability to hold debt securities[2392] to maturity is entitled to use "hold to maturity" accounting for those assets, as long as they are valued at their fair values at the time of transfer.[2393] In response, the SEC sought Lehman's agreement to use mark-to-market accounting by citing "investor

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[2389] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2008, at p. 7; *see also* Fair Value Measurements, Statement of Fin. Accounting Standards No. 157 (Fin. Accounting Standards Bd. 2008); The Fair Value Option for Financial Assets and Financial Liabilities, Statement of Fin. Accounting Standards No. 159 (Fin. Accounting Standards Bd. 2008).

[2390] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2008, at p. 7; Examiner's Interview of David O'Reilly, Oct. 26, 2009, at p. 4; Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at pp. 9-10; Examiner's Interview of Thomas A. Russo, May 11, 2009, at p. 9.

[2391] *See* letter from Martin Kelly, Lehman, to Wayne Carnall, SEC, re: SEC request that Lehman address why spin-off should not be regarded as the acquisition of a business and why SpinCo should not be required to use fair value accounting (Aug. 21, 2008) [LBEX-DOCID 1298065], attached to e-mail from Robert W. Downes, Sullivan & Cromwell, to Larry Wieseneck, Lehman, *et al.* (Aug. 21, 2008) [LBEX-DOCID 1297924].

[2392] While the "hold to maturity" issue applied specifically to debt securities which would constitute only 10% of SpinCo's assets, Lehman also argued that it should not be required to use "fair value" accounting for the bulk of the loans which would make up almost 70% of SpinCo's assets. Lehman wanted to account for the loans "at amortized cost with amortization of discount under the effective yield method and subject to reserve for loan losses," or essentially the same method Lehman wanted to use for debt securities. *See id.* at pp. 10-12.

[2393] *Id*. at p. 2. ("[It is] critical to Spinco's asset management philosophy, as well as investors in Spinco, that the accounting framework of Spinco reflect fundamental asset valuations realizable over longer time horizons, as opposed to valuations reflective of current market liquidity. This is the foundation of Spinco and the key to its success. . . . If Spinco were subject to fair value accounting, we believe that it would be at a competitive disadvantage to its peers and would not be able to manage the assets in a fundamentally different manner than how Lehman must manage the assets now and therefore would not be able to maximize value for its shareholders"). The letter defines "hold to maturity" accounting as valuation "at amortized cost with amortization of discount or premium under the effective yield method and recognition of any other-than-temporary declines in value in earnings." *Id.* at p. 10.

protection" concerns and offering to grant Lehman other waivers instead (*e.g.*, three years' historical financials, auditor-reviewed financial projection, and updated projections and financial statements).[2394]

On August 28, 2008, Lehman reached an agreement with the SEC. SpinCo's initial balance sheet would be prepared at fair value.[2395] SpinCo would not use mark-to-market accounting for its loan assets but instead would account for its debt securities on a "hold to maturity" basis (with provisions for expected loan losses).[2396] SpinCo would still value its equity securities at their market values.[2397] The SEC also agreed not to require SpinCo to file three years of audited historical financial statements.[2398] David

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[2394] *See* e-mail from Martin Kelly, Lehman, to Thomas A. Russo, Lehman, *et al.* (Aug. 27, 2008) [LBEX-SIPA 007017]. Lehman executives pushed back, arguing that using non-fair value accounting was "critical" to SpinCo's success and that Lehman's proposed accounting treatment was the "right answer." E-mail from David Goldfarb, Lehman, to Larry Wieseneck, Lehman, *et al.* (Aug. 27, 2008) [LBEX-SIPA 007017]. Lehman also pressured Ernst & Young to intervene with the SEC on Lehman's behalf. *See id.*; e-mail from David Goldfarb, Lehman, to William Schlich, Ernst & Young (Aug. 28, 2008) [LBEX-DOCID 2997901].

[2395] *See* e-mail from Martin Kelly, Lehman, to Larry Wieseneck, Lehman, *et al.* (Aug. 28, 2008) [EY-LE-LBHI-KEYPERS 0907577]; *see also* e-mail from David Goldfarb, Lehman, to Beth Rudofker, Lehman, *et al.* (Aug. 30, 2008) [LBHI_SEC07940_015928] ("[T]he debt will be accounted for @ hold to maturity with appropriation provisions for expected loan losses, and equity investments @ lower of cost or market."); e-mail from Martin Kelly, Lehman, to Daniel Kerstein, Lehman, *et al.* (Sept. 10, 2008) [LBHI_SEC07940_916922] ("More factually correct would be to say it is 'non-mark to market accounting.' Meaning loan accounting for loans, non-trading (ie non MTM) security accounting for securities and real estate accounting (lower of cost or fair value less cost to sell) for consolidated real estate. . . . We MUST NOT reference any discussion with SEC around this").

[2396] E-mail from David Goldfarb, Lehman, to Beth Rudofker, Lehman, *et al.* (Aug. 30, 2008) [LBHI_SEC07940_015928].

[2397] *Id.*

[2398] *See* e-mail from Martin Kelly, Lehman, to Larry Wieseneck, Lehman, *et al.* (Aug. 28, 2008) [EY-LE-LBHI-KEYPERS 0907577].

Goldfarb lauded the result as a "[g]reat answer for us."[2399] However, the terms of the SEC's agreement effectively would doom Lehman's hopes for a tax-free spin-off.[2400]

b. Tax-Free Status

A key advantage of the SpinCo idea, as originally conceived, was that the spin-off would be tax-free to Lehman's shareholders.[2401] From SpinCo's earliest iteration, Lehman worked to ensure that the spin-off transaction would qualify for tax-free status.[2402] As planning progressed, however, Lehman's effort to structure SpinCo to avoid historical financials and mark-to-market accounting complicated the tax-free status of the spin-off.[2403] In particular, Lehman considered organizing SpinCo as a "liquidating trust" rather than an active business in order to avoid mark-to-market

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[2399] E-mail from David Goldfarb, Lehman, to Beth Rudofker, Lehman (Aug. 29, 2008) [LBEX-DOCID 1609099].

[2400] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at pp. 7-8.

[2401] I.R.S. Code Section 355 permits a corporation to distribute equity ownership of a subsidiary under its control to the corporation's shareholders, tax free to both the shareholders and the corporation, as long as both the spun-off subsidiary (which may be newly formed) and the controlling corporation each remains in the same "active trade or business" after the distribution. *See* I.R.C. § 355 (2008).

[2402] *See* Lehman, Managing to a "Bad Asset" Solution [Draft] (Apr. 23, 2008) [LBEX-DOCID 1400312] (real estate spin-off would be "Tax-free to Parent and to shareholders"); Lehman, Green Acres – Summary of Structural Alternatives (July 3, 2008), at p. 2 [LBHI_SEC07940_008342], attached to e-mail from Brad Whitman, Lehman, to Hugh E. McGee, III, Lehman (July 3, 2008) [LBHI_SEC07940_008341]; *see also* Lehman, Discussion Materials for the Board of Directors [Draft] (July 19, 2008), at p. 10 [LBHI_SEC07940_404357] ("SpinCo will need to be deemed a viable stand-alone operating business for '40 Act, accounting purposes and to effect a tax-free distribution").

[2403] *See* Lehman, Green Acres – Overview of Potential Alternatives [Draft] (July 30, 2008) [LBHI_SEC07940_405303] (comparing spin-off as operating business versus spin-off as liquidating entity), attached to e-mail from Daniel Kerstein, Lehman, to Larry Wieseneck, Lehman, *et al.* (July 30, 2008) [LBHI_SEC07940_405302]; email from Michael Langer, Lehman, to Larry Wieseneck, Lehman, *et al.* (Aug. 10, 2008) [EY-LE-LBHI-KEYPERS 0850862] (noting that in draft talking points for the SEC "we have been intentionally vague on operating company vs. liquidating trust to keep our alternatives open").

accounting, but the "liquidating trust" structure threatened the tax-free status of the spin-off.[2404] Lehman was not able to resolve the tax issue before its bankruptcy.[2405]

(iv) Valuation of Assets

To accomplish the spin-off, the SEC required that SpinCo's initial balance sheet show the fair value of the transferred assets.[2406] As early as June 2008, some members of Lehman's real estate investment banking team worried that "the assets and their value"

[2404] *See id.*; *see also* e-mail from Larry Wieseneck, Lehman, to Hugh E. McGee, III, Lehman (Aug. 5, 2008) [LBHI_SEC07940_406125]; e-mail from Mark A. Walsh, Lehman, to Kenneth Cohen, Lehman, *et al.* (Aug. 10, 2008) [LBHI_SEC07940_303607]; memorandum from Spencer Kagan, Lehman, to Mark A. Walsh, Lehman, *et al.*, re: Green Acres - Preliminary Estimated Liquidating Trust Rated Debt Proceeds (Aug. 8, 2008) [LBHI-SEC07940_303609]; Lehman, Fitch Ratings - Project Green Acres [Draft] (Aug. 12, 2008), at p. 3 [LBEX-DOCID 612634] ("How 'SpinCo' Will Work: Liquidating Trust"). *But see* Lehman, Fitch Ratings - Project Green Acres (Aug. 12, 2008), at p. 3 [LBEX-DOCID 011904]; Lehman, SEC talking points [Draft] (Aug. 11, 2008), at p. 3 [EY-LE-LBHI_KEYPERSO 0907480]; Lehman, SpinCo - Proposed Term Sheet (Aug. 19, 2008), at p. 1 [EY-LE-LBHI-KEYPERS 3670025]; e-mail from Ian T. Lowitt, Lehman, to Daniel Kerstein, Lehman, *et al.* (Aug. 30, 2008) [LBEX-SIPA 003759] ("At the risk of stating the extremely obvious, [a] key issue [in deciding between C-Corp or partnership] is not upsetting our SEC agreement." Earlier in the e-mail chain, Yoav Wiegenfeld, Lehman, states: "If we want to do a tax free spin for shareholders the entity will have to be a c-corp. We need to determine whether we can do a tax free spin, which depends on (I) identifying a qualifying active trade or business (we discussed Aurora) and (ii) having a sign off from the SEC that having this business doesn't change the financial reporting agreement we reached with them"); Lehman, The Gameplan (Sept. 2008), at p. 4 [LBHI_SEC07940_653637].

[2405] *See, e.g.*, e-mail from Larry Wieseneck, Lehman, to Shaun Butler, Lehman, *et al.* (Aug. 29, 2008) [LBHI_SEC07940_651788] ("[W]e can not refer to Spinco as a Liquidating Trust. It can never be discussed as akin to one not that it is one. It neither is liquidating no[r] is it a trust. I want to highlight this because it is currently referenced as such in the document and this is a huge accounting issue. If it were a liq trust, we would end up in a very bad place accounting wise"); Lehman, Q3 Firmwide Q&A - Summary (no date), at p. 47 [LBHI_SEC07940_750660] ("We are in the process of finalizing the tax and legal structure of the REI Global entity"). *Accord* Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at pp. 7-8 (Fuld recalled that SpinCo had to be a non-operating entity to avoid mark-to-market treatment, but as a result, the spin-off was no longer tax-free. Fuld said that Lehman never resolved that issue).

[2406] *See* e-mail from Martin Kelly, Lehman, to Thomas A. Russo, Lehman, *et al.* (Aug. 27, 2008) [LBEX-SIPA 007017] (terms of deal with SEC include "[i]nitial opening audited [balance sheet] at fair value").

would be SpinCo's greatest obstacle, not the structure or feasibility of the spin-off itself.[2407]

McGee told the Examiner that the issue was not the valuations of the assets *per se*, but rather the combination of the size and complexity of Lehman's CRE portfolio.[2408] Moreover, as SpinCo planning progressed, the deteriorating real estate market made asset valuations a moving target as Lehman modeled SpinCo's operations as an independent entity.[2409] Lehman discussed aggressively writing down the assets pre-spin, recognizing that the write-downs would reduce the size of the equity hole.[2410] In August 2008, Lehman considered engaging a third party to perform an independent valuation of SpinCo's proposed assets.[2411]

[2407] E-mail from Steven R. Hash, Lehman, to Larry Wieseneck, Lehman (June 11, 2008) [LBHI_SEC07940_398658]; *see also* e-mail from Steven R. Hash, Lehman, to David Erickson, Lehman, *et al.* (June 10, 2008) [LBEX-DOCID 1475677] ("[P]roblem is financing and the assets that greg owns. [T]here is really no independent financing for these assets in the market today"). *But see, e.g.*, e-mail from Larry Wieseneck, Lehman, to Hugh E. McGee, III, Lehman (July 11, 2008) [LBHI_SEC07940_401362] ("Issue is the use of cash capital not the marks").

[2408] Examiner's Interview of Hugh E. McGee, III, Aug. 12, 2009, at pp. 20-21; *accord* Examiner's Interview of Herbert H. McDade, III, Sept. 16, 2009, at p. 3 (McDade denied that Lehman mis-marked its assets, and asserted that by summer 2008 Lehman's commercial real estate portfolio was "cleaner" than any of its competitors and would have been a profitable investment).

[2409] Examiner's Interview of David O'Reilly, Oct. 26, 2009, at p. 4; *see also* e-mail from Larry Wieseneck, Lehman, to Timothy Sullivan, Lehman, *et al*. (July 18, 2008) [LBHI_SEC07940_404327] ("Need to build in slippage for a mark on commercial pre-spin ($2 - $3 billion)"); Lehman, Breakeven Comparison Between Spin Off and Writedown (Aug. 6, 2008) [LBHI_SEC07940_406362] (comparing SpinCo with a 29% writedown of commercial real estate assets).

[2410] *See* e-mail from Larry Wieseneck, Lehman, to Hugh E. McGee, III, Lehman, *et al.* (Aug. 6, 2008) [LBEX-DOCID 2274043]. *Accord* Examiner's Interview of Lisa Beeson, Oct. 23, 2009, at p. 9.

[2411] *See* Lehman, Project Green Acres - Daily Update (Aug. 7, 2008) [LBEX-DOCID 2253476] ("Consider engaging Blackstone (or other third party) to perform independent valuation . . . Responsibility[:] Goldfarb").

SpinCo was seen by some as validation of their suspicion that Lehman's assets were not properly valued.[2412] David Einhorn, President of Greenlight Capital, told the Examiner that the creation of SpinCo supported his contention that Lehman had not been marking down its commercial assets.[2413] Einhorn believes that Lehman's efforts to spin out its commercial real estate into a company where the assets did not have to be marked to fair value revealed that Lehman had not been marking those assets to fair value.[2414]

(c) Barclays' "SpinCo"

Lehman was not able to implement the SpinCo plan prior to Lehman's bankruptcy. Nonetheless, Lehman's senior managers believed that SpinCo was an innovative and elegant plan and that Lehman simply ran out of time before it could execute SpinCo.[2415] Lehman's management points to the SEC's waiver of the requirement of three years of audited financial statements and its approval of "hold to maturity" accounting as support to show that SpinCo would have been feasible.[2416]

[2412] *See, e.g.*, e-mail from Don Benningfield, Bank of America, to Rochelle Dobbs, Bank of America, *et al.* (Sept. 12, 2008) [BofA-SEC-00002774]. *Accord* Examiner's Interview of David Einhorn, Nov. 19, 2009, at p. 10.

[2413] Examiner's Interview of David Einhorn, Nov. 19, 2009, at p. 10.

[2414] *Id*.

[2415] Lehman, The Gameplan - September 2008 (Sept. 2008), at p. 4 [LBEX-DOCID 2727665]. *Accord* Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 6; Examiner's Interview of Lisa Beeson, Oct. 23, 2009, at p. 9.

[2416] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at pp. 7-8; Examiner's Interview of Paul A. Hughson, Oct. 28, 2009, at pp. 9-10.

McGee, one of SpinCo's primary architects, moved to Barclays following Lehman's demise.[2417] In September 2009, Barclays launched its own SpinCo-like entity, selling $12.3 billion of high-risk credit assets to Protium Finance, a newly formed partnership run by former Barclays employees.[2418] Barclays stated that it was seeking to restructure a significant tranche of credit market exposure in a way that would secure reliable returns for its shareholders over time.[2419] Barclays provided Protium with $12.6 billion first-loss seller financing, meaning that any potential upside to the assets sold by Protium would accrue solely to Protium's independent investors, not to Barclays or its shareholders.[2420] Nonetheless, analysts regarded the spin-off as beneficial to Barclays, helping it slash its net exposure to risky credit assets.[2421] In October 2009, during market conditions much different than a year earlier, Barclays announced plans for a second spin-off of $6.3 billion in complex credit assets.[2422]

(5) Potential Strategic Partners

Following the near collapse of Bear Stearns, Lehman reached out to numerous potential partners regarding possible investments or mergers with Lehman. After Lehman issued its second quarter 2008 financials, Fuld received increasingly blunt

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[2417] *See* William D. Cohan, *The Highest Paid Man on Wall Street*, The Daily Beast, Jan. 9, 2009.
[2418] *See* Jane Croft & Sam Jones, *Barclays De-Risk Deal Leaves Analysts Puzzled*, FT.com, Sept. 16, 2009.
[2419] *Id*.
[2420] *Id*.
[2421] *Id.*; Tracy Alloway, *Barclays' Protium-Purified Balance Sheet*, FT.com, Nov. 10, 2009.
[2422] *Barclays Said to Plan $6.3 Billion Spin-Off*, N.Y. Times, Oct. 12, 2009.

pressure from Paulson and Geithner to sell Lehman or find a strategic partner.[2423] Paulson told the Examiner that he perceived that Lehman's announcement of its loss in the second quarter of 2008 convinced Fuld that dramatic action was necessary to save Lehman.[2424] According to Paulson, the release of the numbers served as a wake-up call to Fuld who, at that point, appreciated Lehman's fragility and comprehended that the future portended nothing better.[2425] However, Paulson described Fuld to the Examiner as both one of the most optimistic people Paulson has ever met and a person who heard only what he wanted to hear.[2426]

Geithner explained to the Examiner that Lehman faced the difficult task of having to persuade an investor or investor group to buy into Lehman just at the time the souring economy made potential investors highly skittish about absorbing more risk.[2427] Geithner added: "if you get in a position where you are late, then all of your choices are bad and all the classic avenues you can use to make yourself stronger make you look weaker. That's how you get to the point of no return."[2428]

[2423] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 14; Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 6.

[2424] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 14.

[2425] *Id*.

[2426] *Id.* at p. 6.

[2427] Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 6.

[2428] *Id.* By the end of the summer, the New York Times "Dealbook" blog was openly asking, "when will Lehman Brothers die? Judging by the headlines, you'd think the troubled investment bank would go belly up any day now." *See* Andrew Ross Sorkin, *Lehman's Woes Haunt the Last Days of Summer*, N.Y. Times (Aug. 26, 2008), *available at* http://dealbook.blogs.nytimes.com/2008/08/26/the-storylines-of-the-last-days-of-summer.

(a) Buffett and Berkshire Hathaway

(i) March 2008

In late March 2008, McGee suggested that Lehman reach out to Buffett.[2429] McGee had a pre-existing banking relationship with Sokol of MidAmerican Energy,[2430] which is majority-owned by Buffett's Berkshire Hathaway. Either McGee or Joseph G. Sauvage, LBI Vice-Chairman, called Sokol to ask if Buffett would take Fuld's call.[2431] Jerry A. Grundhofer, who was about to join Lehman's Board, also asked Buffett if he would take Fuld's call.[2432] Buffett agreed.[2433]

Before calling Buffett, Fuld called Sokol on March 27, 2008.[2434] That same day, Lehman prepared a draft of a letter, to be sent by Fuld to Lehman employees, outlining a $3.5 billion investment from Buffett in Lehman's preferred stock at a $54 per share conversion price.[2435] Fuld told the Examiner that he did not know how that letter came to be prepared, and it does not appear that Fuld saw the draft.[2436] Fuld also did not recall Buffett indicating a willingness to invest $3.5 billion.[2437] Buffett was surprised that

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[2429] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 8.

[2430] At the time, Sokol was President of MidAmerican. In August 2009, Sokol became CEO of NetJets, Inc., another Berkshire Hathaway subsidiary.

[2431] Examiner's Interview of David L. Sokol, Sept. 22, 2009, at p. 3.

[2432] Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 10.

[2433] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 8; Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 10; Examiner's Interview of Warren E. Buffett, Sept. 22, 2009, at p. 2.

[2434] Richard S. Fuld, Jr., Lehman, Call Logs (Mar. 27, 2008) [LBHI_SEC07940_016916].

[2435] E-mail from Timothy Lyons, Lehman, to Scott J. Freidheim, Lehman (Mar. 27, 2008) [LBHI_SEC07940_849386].

[2436] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at pp. 9-10.

[2437] *Id*. at p. 10.

Lehman had prepared a draft letter announcing the deal, because he never got close to a deal with Lehman.[2438]

Fuld and Buffett spoke on Friday, March 28, 2008. They discussed Buffett investing at least $2 billion in Lehman.[2439] Two items immediately concerned Buffet during his conversation with Fuld.[2440] First, Buffett wanted Lehman executives to buy under the same terms as Buffett.[2441] Fuld explained to the Examiner that he was reluctant to require a significant buy-in from Lehman executives, because they already received much of their compensation in stock.[2442] However, Buffett took it as a negative that Fuld suggested that Lehman executives were not willing to participate in a significant way.[2443] Second, Buffett did not like that Fuld complained about short sellers.[2444] Buffett thought that blaming short sellers was indicative of a failure to admit one's own problems.[2445]

[2438] Examiner's Interview of Warren E. Buffett, Sept. 22, 2009, at p. 4.

[2439] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 10; Examiner's Interview of Warren E. Buffett, Sept. 22, 2009, at p. 4.

[2440] Examiner's Interview of Warren E. Buffett, Sept. 22, 2009, at p. 4.

[2441] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at pp. 9-10; Examiner's Interview of Warren E. Buffett, Sept. 22, 2009, at p. 3.

[2442] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at pp. 9-10.

[2443] Examiner's Interview of Warren E. Buffett, Sept. 22, 2009, at p. 3.

[2444] *Id*. at p. 4. Paulson told the Examiner that he did not think that Buffett would be interested in Lehman. Paulson told the Examiner that he thought Fuld's suggestion of Buffett as a potential investor indicated that Fuld was "scared, but not scared enough" and did not appreciate the gravity of Lehman's situation in March 2008. Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 12.

[2445] Examiner's Interview of Warren E. Buffett, Sept. 22, 2009, at p. 3.

Following his conversation with Buffett, Fuld asked Paulson to call Buffett, which Paulson reluctantly did.[2446] Buffett told the Examiner that during that call, Paulson signaled that he would like Buffett to invest in Lehman, but Paulson "did not load the dice."[2447]

Buffett spent the rest of Friday, March 28, 2008, reviewing Lehman's 10-K and noting problems with some of Lehman's assets.[2448] Buffett's concerns centered around Lehman's real estate and high yield investments, lending-related commitments, derivatives and their related credit-market risk, Level III assets and Lehman's securitization activity.[2449] On Saturday, March 29, 2008, Buffett learned of a $100 million problem in Japan that Fuld had not mentioned during their discussions, and Buffett was concerned that Fuld had not been forthcoming about the issue.[2450] The problems Buffett saw in the 10-K along with Fuld's failure to alert Buffett to the issue in Japan cemented Buffett's decision not to invest in Lehman.[2451]

At some point in their conversations, Fuld and Buffett also discovered that there had been a miscommunication about the conversion price. Buffett was interested only

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[2446] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 12; Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 8.

[2447] Examiner's Interview of Warren E. Buffett, Sept. 22, 2009, at p. 2.

[2448] *Id*. at p. 3.

[2449] *Id.* Buffett made notes on many of the 10-K pages about Lehman's financials. Those notes illustrate that Buffett had questions or took issue with much of what Lehman was reporting, as he stated during his interview. Additionally, Buffett seems to have had a heightened focus on Lehman's real estate and high yield assets and on accounting issues relating to the stock price, assets, or liabilities. *Id.*

[2450] *Id.* at pp. 3-4. *Accord* Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 10.

[2451] Examiner's Interview of Warren E. Buffet, Sept. 22, 2009, at p. 4.

in convertible preferred shares.[2452] Buffett told Fuld that he was willing to agree to a $40 conversion price per share, while Fuld thought Buffett was offering to buy in at "up-40," or 40% above the current market price, which would have been about $56 per share.[2453] On Friday, March 28, 2008, Lehman's stock closed at $37.87.[2454]

Fuld spoke to Lehman's Executive Committee and several Board members about his conversations with Buffett.[2455] Lehman recognized that an investment by Buffett would provide a "stamp of approval." However, Lehman already had better offers for its April capital raise, and Lehman did not think it could give a better deal to Buffett at the same time it gave a less attractive deal to others.[2456]

On Monday, March 31, 2008, before Buffett could tell Fuld that he was not interested, Fuld called Buffett to say that Lehman could not accept his terms.[2457]

(ii) Last-Ditch Effort with Buffett

McGee contacted Sokol again in late August or early September 2008 and outlined Lehman's "Gameplan" for survival, specifically SpinCo.[2458] During a

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[2452] *Id.* at p. 2.

[2453] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 10.

[2454] *See* Yahoo! Finance, Historical LEH stock prices, *available at* http://finance.yahoo.com/q?s=LEHMQ.PK.

[2455] Richard S. Fuld, Jr., Lehman, Call Logs (Mar. 28 - Apr. 3, 2008) [LBHI_SEC07940_016911]; Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 11; Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 10; Examiner's Interview of John D. Macomber, Sept. 25, 2009, at p. 20.

[2456] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 11.

[2457] Examiner's Interview of Warren E. Buffett, Sept. 22, 2009, at p. 4; Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 11.

[2458] Lehman, The Gameplan (Sept. 2008) [LBHI_SEC07940_653681], attached to e-mail from Hugh E. McGee, III, Lehman, to David L. Sokol, MidAmerican Energy Holdings Co., *et al.* (Sept. 4, 2008) [LBHI_SEC07940_653680]; Examiner's Interview of David L. Sokol, Sept. 22, 2009, at p. 4.

subsequent telephone call with Sokol, McGee explained the "good bank/bad bank" scenario and stated that Lehman would need an investor.[2459] Sokol believed the e-mail and call were intended to induce Sokol to pass that information on to Buffett, so Sokol briefed Buffett on SpinCo. Buffett thought the idea would not solve Lehman's problems.[2460]

Sometime during the week prior to Lehman's bankruptcy, McGee again reached out to Sokol with what both Sokol and McGee described to the Examiner as a "Hail Mary" pass.[2461] McGee asked, "Do you have any ideas to save us?"[2462] Sokol, who was bear hunting in Alaska at the time, told McGee that he did not.[2463]

(b) KDB

(i) Discussions Begin

In late May 2008, Hana Financial Group ("Hana") led a consortium of Korean financial institutions in talks concerning a possible investment in Lehman.[2464] According to KDB, KDB started discussions with Lehman and Hana concerning an investment in Lehman through a consortium of Korean investors in early June 2008.[2465] The contemplated consortium included KDB, Korea Investment Corporation ("KIC"), Korea

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[2459] Examiner's Interview of David L. Sokol, Sept. 22, 2009, at p. 4.
[2460] *Id*.
[2461] *Id*.; Examiner's Interview of Hugh E. McGee, III, Aug. 12, 2009, at p. 16.
[2462] Examiner's Interview of David L. Sokol, Sept. 22, 2009, at p. 4.
[2463] *Id*.
[2464] Examiner's Interview of Kunho Cho, Jan. 7, 2010, at p. 5.
[2465] Examiner's Interview of KDB, Oct. 26, 2009, at pp. 6-7.

National Pension Service ("KNPS") and Hana.[2466] Hana's intended goal was for Hana and KDB each to obtain approximately five percent of Lehman.[2467] The anticipated total Korean investment was between $3 and $5 billion.[2468]

Lehman and the Korean entities differed over the nature of a possible investment. Lehman's draft term sheet, presented to its Executive Committee on June 5, 2008, called for participation by the Korean consortium in joint ventures for Lehman's funded and unfunded commitments, as well as real estate.[2469] A revised version circulated on June 5, 2008, indicated that each of the joint ventures would include $10

[2466] *See* memorandum from Kunho Cho, Lehman, to Hugh E. McGee, III, Lehman, *et al.*, re: Opportunity Briefing and Key Issues for Investment by Korea Inc. Consortium in Lehman Brothers (May 29, 2008) [LBEX-DOCID 1374131], attached to e-mail from Kunho Cho, Lehman, to David Goldfarb, Lehman (May 29, 2008) [LBEX-DOCID 1466211].

[2467] KDB told the Examiner that in the first round of negotiations with Lehman and Hana in early June 2008, Hana wanted Hana and KDB to each obtain approximately 5% of Lehman, with an investment of approximately $3 billion. However, KDB said that it was not privy to all details because Hana was leading the negotiations. Examiner's Interview of KDB, Oct. 26, 2009, at p. 7. Bhattal told the Examiner that Hana could invest $1-2 billion by itself, but could invest up to $5 billion with a consortium of other Korean banks. Examiner's Interview of Jasjit Bhattal, Oct. 12, 2009, at p. 6. According to Kunho Cho, while Lehman and the Korean consortium initially discussed a $5 billion investment, that number fluctuated throughout the discussions. Examiner's Interview of Kunho Cho, Jan. 7, 2010, at p. 7. Lehman and Hana discussed a potential $5 billion investment. *See* memorandum from Kunho Cho, Lehman, to Hugh E. McGee, III, Lehman, *et al.*, re: Opportunity Briefing and Key Issues for Investment by Korea Inc. Consortium in Lehman Brothers (May 29, 2008) [LBEX-DOCID 1374131], attached to e-mail from Kunho Cho, Lehman, to David Goldfarb, Lehman (May 29, 2008) [LBEX-DOCID 1466211].

[2468] *Id.*

[2469] Lehman, Strategic Relationship Term Sheet [Draft] (June 5, 2008) [LBHI_SEC07940_103438], attached to e-mail from Joseph M. Gregory, Lehman, to Jasjit Bhattal, Lehman, *et al*. (June 5, 2008) [LBHI_SEC07940_103437] (forwarding strategic elements term sheet to Executive Committee).

billion worth of Lehman assets.[2470] Hana deleted those joint ventures when it sent back further revised term sheets.[2471]

Jasjit "Jesse" Bhattal, the CEO of Lehman Asia-Pacific, told the Examiner that those term sheets were not "real term sheets" because they did not indicate a price per share or the nature of the security.[2472] Rather, each side prepared the documents to summarize what had been discussed and as a basis for further discussions.[2473] Bhattal did not recall the joint ventures ever becoming a sticking point in the negotiations.[2474] Thomas A. Russo, Lehman's Chief Legal Officer, told the Examiner that the term sheets were not formal term sheets, but instead were drafted for the purpose of putting deal points on paper.[2475] Russo did not recall the joint ventures as being a sticking point in the negotiations.[2476] Although Russo did not believe the talks progressed to the point where Hana commented on the term sheets,[2477] documents reflect that Hana provided comments that included deleting Lehman's commercial real estate joint ventures from

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[2470] Lehman, Elements of Strategic Relationship Term Sheet [Draft] (June 5, 2008), at p. 2 [LBEX-DOCID 817385], attached to e-mail from Jay Clayton, Sullivan & Cromwell, to Brad Whitman, Lehman, *et al.* (June 5, 2008) [LBEX-DOCID 941706].

[2471] Hana Investment Bank, Elements of Strategic Relationship [Draft] (June 4, 2008) [LBEX-DOCID 1401999], attached to e-mail from Chan Lee, Hana Bank, to Larry Wieseneck, Lehman, *et al*. (June 4, 2008) [LBEX-DOCID 1527489] (providing Hana's comments to Strategic Elements term sheet).

[2472] Examiner's Interview of Jasjit Bhattal, Oct. 12, 2009, at p. 9.

[2473] *Id*.

[2474] *Id*.

[2475] Examiner's Interview of Thomas A. Russo, Dec. 1, 2009, at pp. 10-11.

[2476] *Id.* at p. 11.

[2477] *Id*.

the deal.[2478] Kunho Cho, head of Lehman Asia investment banking, recalled discussions about the joint ventures but did not think they were a "major focus" of the negotiations.[2479]

One of Hana's goals for an investment in Lehman was to induce Lehman to make Seoul its Asian headquarters, moving Lehman's sophisticated investment banking operations to South Korea.[2480] Lehman was not willing to agree, because Lehman was unwilling to abandon its headquarters in Tokyo.[2481] However, Lehman was willing to make Seoul a co-headquarters in Asia.[2482]

Lehman hoped to announce an investment at the same time that it announced its second quarter losses.[2483] Lehman's second quarter earnings call was originally

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[2478] *See* Hana Investment Bank, Elements of Strategic Relationship [Draft] (June 4, 2008) [LBEX-DOCID 1401999] attached to e-mail from Chan Lee, Hana Bank, to Larry Wieseneck, Lehman, *et al*. (June 4, 2008) [LBEX-DOCID 1527489].

[2479] Examiner's Interview of Kunho Cho, Jan. 7, 2010, at p. 6.

[2480] Examiner's Interview of Jasjit Bhattal, Oct. 12, 2009, at p. 7; Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 23; Examiner's Interview of Thomas A. Russo, Dec. 1, 2009, at p. 9.

[2481] *Id*.

[2482] *Id*.

[2483] *See* memorandum from Kunho Cho, Lehman, to Hugh E. McGee, III, Lehman, *et al*., re: Opportunity Briefing and Key Issues for Investment by Korea Inc. Consortium in Lehman Brothers (May 29, 2008), at p. 2 [LBEX-DOCID 1374131], attached to e-mail from Kunho Cho, Lehman, to David Goldfarb, Lehman (May 29, 2008) [LBEX-DOCID 1466211]; e-mail from Eric Felder, Lehman, to Paolo R. Tonucci, Lehman (June 3, 2008) [LBEX-DOCID 808343]; e-mail from David Erickson, Lehman, to Hugh E. McGee, III, Lehman (June 4, 2008) [LBEX-DOCID 224486]; e-mail from Kunho Cho, Lehman, to Hugh E. McGee, III, Lehman (June 5, 2008) [LBEX-DOCID 392569]; e-mail from Brad Whitman, Lehman, to Larry Wieseneck, Lehman, *et al.* (June 5, 2008) [LBEX-DOCID 227666]; e-mail from Scott J. Freidheim, Lehman, to Richard S. Fuld, Jr., Lehman (June 6, 2008) [LBEX-DOCID 1165719]. *Accord* Examiner's Interview of Kunho Cho, Jan. 7, 2010, at pp. 6-7. However, Jasjit Bhattal expressly stated that he was not aware of any link between the discussions with the Koreans in May and June 2008, and Lehman's $6 billion capital raise that Lehman completed on June 12, 2008. Examiner's Interview of Jasjit Bhattal, Oct. 12, 2009, at pp. 7-8.

scheduled for the week of June 16, 2008, but Lehman pre-announced its second quarter results on June 9, 2008.[2484]

According to KDB, when it learned that Hana was negotiating for less than a majority stake in Lehman,[2485] KDB quickly lost interest in the effort.[2486] When talks with the Korean group failed in June 2008, Lehman turned to other sources to raise capital before announcing second quarter results.[2487] Although no consortium of Korean banks invested in Lehman in June 2008, the talks ended amicably.[2488]

Lehman's negotiations with KDB in May and June 2008 became important later in the year because of KDB's public statements. On June 2, 2008, Lehman and KDB signed a Confidentiality Agreement (the "KDB Confidentiality Agreement") covering

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[2484] *See, e.g.*, Steven M. Sears, *Lehman Bros. is Losing More than Money*, Barrons Online, June 9, 2008, *available at* http://online.barrons.com/article/SB121298433687756653.html.

[2485] Documents indicate that KIC also was reluctant to enter the transaction to buy a minority stake in Lehman, but Jasjit Bhattal told the Examiner that KIC was not reluctant. E-mail from Brad Whitman, Lehman, to Larry Wieseneck, Lehman, *et al*. (June 5, 2008) [LBEX-DOCID 227666]; Examiner's Interview of Jasjit Bhattal, Oct. 12, 2009, at pp. 9-10. According to Russo, Lehman did not fail to interest KIC in the investment. Rather, Hana was going to "front" the entire investment in Lehman. Once Hana pulled out, Hana suggested that KIC might still be interested. Lehman then made a last-minute pitch to KIC, but that was unsuccessful. Examiner's Interview of Thomas A. Russo, Dec. 1, 2009, at p. 12. Kunho Cho recalled a meeting with KIC, but he believed it was a standard presentation for relationship purposes. Cho did not have meetings with individual members of the proposed Korean consortium, and when he spoke to Hana, he assumed Hana was speaking for the entire consortium. Cho did not know if some members of the consortium may have opposed the deal while others may have been in favor of it. Examiner's Interview of Kunho Cho, Jan. 7, 2010, at p. 7.

[2486] Examiner's Interview of KDB, Oct. 26, 2009, at pp. 7-8.

[2487] Kunho Cho told the Examiner that the talks with the Korean entities at that point were clearly linked to Lehman's June capital raise. Hana was holding out for better terms than Lehman was offering to other participants. Unable to reach an agreement on price, Lehman raised capital from non-Korean sources. Examiner's Interview of Kunho Cho, Jan. 7, 2010, at pp. 6-7.

[2488] *See* e-mail from Thomas A. Russo, Lehman, to Richard S. Fuld, Jr., Lehman, *et al.* (June 9, 2009) [LBHI_SEC07940_212670].

the parties' negotiations.[2489] The KDB Confidentiality Agreement prohibited disclosure of "the fact that you are considering a possible transaction with the Company [,] . . . that discussions or negotiations are taking place concerning a possible transaction involving the Company or any of the terms, conditions or other facts with respect thereto (including the status thereof) . . . ."[2490]

(ii) Discussions Resume: Second Round of Talks between KDB and Lehman

After a hiatus, talks between Lehman and KDB resumed in late June 2008.[2491] In the new round, KDB and Hana were interested in an investment banking joint venture in South Korea, while Lehman was focused on joint ventures for Lehman's commercial real estate and other assets.[2492] Fuld apprised Lehman's Board of developments related to KDB during a series of phone calls.[2493]

The talks progressed to the point where, at the end of July 2008, Lehman envisaged that a consortium of Korean banks led by KDB would make a tender offer for

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[2489] Lehman, Confidentiality Agreement with Korea Development Bank (June 2, 2008) [LBEX-DOCID 816276]. Lehman also signed a confidentiality agreement with Hana on June 2, 2008, and with KIC on June 5, 2008. *See* Lehman, Confidentiality Agreement with Hana Financial Group (June 2, 2008) [LBEX-DOCID 816281]; Lehman, Confidentiality Agreement with Korea Investment Corporation (June 5, 2008) [LBEX-DOCID 816279].

[2490] Lehman, Confidentiality Agreement with Korea Development Bank (June 2, 2008) [LBEX-DOCID 816276].

[2491] *See* e-mail from Walter Heindl, Lehman, to Jasjit Bhattal, Lehman, *et al*. (June 30, 2008) [LBHI_SEC07940_401001] (summarizing key points from meeting with KDB and Hana); e-mail from Jeffrey L. Weiss, Lehman, to Hugh E. McGee, III, Lehman (June 30, 3008) [LBEX-DOCID 224507].

[2492] *See* e-mail from Walter Heindl, Lehman, to Jasjit Bhattal, Lehman, *et al*. (June 30, 2008) [LBHI_SEC07940_401001] (summarizing key points from meeting with KI); e-mail from Brad Whitman, Lehman, to Jeffrey L. Weiss, Lehman, *et al*. (July 6, 2008) [LBHI_SEC07940_401267] (discussing next steps for real estate and debt purchase).

[2493] Richard S. Fuld, Jr., Lehman, Call Logs (Mar. 15 - Sept. 15, 2008) [LBHI_SEC07940_016911].

approximately 50% of Lehman.[2494] Bhattal recalled that the core of the deal was a $5 billion tender offer for up to 50% of Lehman's common stock.[2495] Fuld recalled KDB wanting 51% of Lehman through a tender offer, as well as significant portions of Lehman's commercial real estate, residentials and leveraged loan assets.[2496] Fuld told the Examiner that KDB changed its focus to a 49% acquisition because of legal concerns that would arise from a change in majority ownership.[2497]

According to KDB, Lehman approached KDB in mid-July with a proposal whereby KDB would obtain a controlling share of Lehman through a $5 to $6 billion tender offer.[2498] Lehman reportedly packaged that offer with a proposal that KDB acquire some of Lehman's commercial real estate positions.[2499] KDB was willing to consider acquiring some of Lehman's commercial real estate positions but only because KDB thought that it would be necessary to do so in order to acquire a controlling stake in Lehman.[2500]

On or about July 28, 2008, senior Lehman executives, including Fuld, McDade, McGee, Bhattal and Cho met in Hong Kong with KDB Governor Euoo Sung Min and other KDB executives, as well as Gary S. Barancik of Perella Weinberg Partners, KDB's

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[2494] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (July 31, 2008), at p. 1 [LBHI_SEC07940_028534].
[2495] Examiner's Interview of Jasjit Bhattal, Oct. 12, 2009, at p. 13.
[2496] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at pp. 23-24.
[2497] *Id*. at p. 24.
[2498] Examiner's Interview of KDB, Oct. 26, 2009, at p. 9.
[2499] *Id*.
[2500] *Id*.

U.S. advisor.[2501] Following those meetings, the parties agreed that KDB would begin due diligence in New York.[2502] The same group scheduled follow-up meetings in New York on August 5 and 6, 2008.[2503]

At the July 31, 2008 Board meeting, Fuld updated the Board on meetings with a "potential foreign partner" (most likely KDB), noting that due diligence was underway, and that the transaction would be a tender offer for approximately 50% of Lehman's common stock.[2504] He also said that government approval in the potential partners' home country could impact the timeframe.[2505] Fuld further noted that the parties discussed possible joint ventures for commercial real estate, residential mortgages, acquisition finance and investment banking in the partner's home country.[2506]

Fuld told the Examiner that in June 2008, Lehman directors John D. Macomber and John F. Akers had warned him that Lehman never would sign a deal with KDB because Korean companies historically dragged out discussions without ever completing a deal.[2507] Fuld said that at the end of the July 29, 2008 meeting, he was beginning to think that Macomber and Akers were prescient in their warning.[2508]

[2501] Examiner's Interview of Jasjit Bhattal, Oct. 12, 2009, at p. 12.
[2502] Examiner's Interview of KDB, Oct. 26, 2009, at p. 10; Examiner's Interview of Kunho Cho, Jan. 7, 2010, at p. 8.
[2503] *Id*.
[2504] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (July 31, 2008), at p. 1 [LBHI_SEC07940_028534].
[2505] *Id*.
[2506] *Id*.
[2507] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 23.
[2508] *Id.* at p. 25.

Barancik, KDB's advisor, told the Examiner that Fuld was so aggressive in pushing Lehman's commercial real estate assets that the August 2008 meetings were uncomfortable.[2509] Fuld told the Examiner that he suggested that if KDB did not want to invest in Lehman, it could invest in "Clean Lehman" after SpinCo, that is, Lehman after it transferred its illiquid commercial real estate assets to SpinCo.[2510]

By August 6, 2008, after KDB had commenced due diligence, KDB had lost interest in the tender offer and joint ventures.[2511] KDB was concerned that Lehman had not taken sufficient write-downs on Lehman's commercial real estate positions and residential mortgage assets.[2512] KDB also expected that further write-downs would be necessary as real estate markets deteriorated.[2513] In addition, KDB had concerns about Lehman's high yield debt and high yield equity assets, which KDB believed could turn sour.[2514] Those concerns led KDB to reject the idea of making a tender offer for a significant stake in Lehman as the company currently was structured.[2515] At the

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[2509] Examiner's Interview of Gary S. Barancik, Sept. 25, 2009, at p. 4.

[2510] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 25.

[2511] *See* e-mail from Hugh E. McGee, III, Lehman, to Herbert H. McDade, III, Lehman (Aug. 5, 2008) [LBHI_SEC07940_647147]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Aug. 6, 2008), at pp. 1-2 [LBEX-AM 003877]. *Accord* Examiner's Interview of KDB, Oct. 26, 2009, at pp. 10-11.

[2512] Examiner's Interview of KDB, Oct. 26, 2009, at pp. 10-11.

[2513] *Id*.

[2514] *Id*.

[2515] *Id*.

August 6, 2008 Board Meeting, Fuld reported that KDB no longer wanted to do a transaction unless Lehman spun off its commercial real estate.[2516]

(iii) Third Round of Talks between KDB and Lehman

Almost as soon as the discussions regarding a tender offer ended in early August 2008, KDB, Lehman and Perella Weinberg worked to find a way for KDB to invest in Clean Lehman.[2517] Although KDB expressed interest in investing in Clean Lehman, many difficult issues remained.[2518] KDB did not want to assume any risk associated with future write-downs, did not want Clean Lehman to retain any risky assets and was worried about how the SpinCo notes that would remain on Clean Lehman's balance sheet would be rated.[2519] KDB also needed to be able to obtain approval from skeptical Korean regulators.[2520]

[2516] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Aug. 6, 2008), at p. 1 [LBEX-AM 003877].

[2517] Cho told the Examiner that KDB proposed an investment in Clean Lehman following a spin-off of Lehman's commercial real estate toward the end of the meetings in New York in early August 2008. Only when KBD and Lehman were unable to agree upon a metric for valuing Clean Lehman did that round of negotiations ultimately break down. Examiner's Interview of Kunho Cho, Jan. 7, 2010, at p. 9.

[2518] *See* e-mail from Hugh E. McGee, III, Lehman, to Brad Whitman, Lehman, *et al.* (Aug. 13, 2008) [LBHI_SEC07940_406804].

[2519] *Id*. For concerns about the need for a truly clean CleanCo, *see also* e-mail from Hugh E. McGee, III, Lehman, to Larry Wieseneck, Lehman (Aug. 14, 2008) [LBHI_SEC07940_406900]; e-mail from Arjay Jensen, Perella Weinberg Partners, to Chan Lee, Hana Bank (Aug. 28, 2008) [PWP 00000806]. For concerns about the SpinCo notes, *see also* e-mail from Brad Whitman, Lehman, to Martin Kelly, Lehman, *et al.* (Aug. 14, 2008) [LBHI_SEC07940_406973]; e-mail from Larry Wieseneck, Lehman, to Brad Whitman, Lehman (Aug. 19, 2008) [LBHI_SEC07940_407659]; e-mail from Chan Lee, Hana Bank, to Gary S. Barancik, Perella Weinberg Partners (Aug. 23, 2008) [PWP 00001054]; e-mail from Gary S. Barancik, Perella Weinberg Partners, to Chan Lee, Hana Bank (Aug. 31, 2008) [PWP 00000707].

[2520] *See* e-mail from Catherine Jones, Lehman, to Scott J. Freidheim, Lehman (Aug. 25, 2008) [LBHI_SEC07940_856773] (forwarding Heidi N. Moore, *Lehman, The Tooth Fairy and the Revenge of the Short Sellers*, Wall St. J., Aug. 25, 2008); e-mail from Hugh E. McGee, III, Lehman, to Jasjit Bhattal, Lehman (Aug. 29, 2008) [LBHI_SEC07940_651737].

On August 31, 2008, KDB sent Lehman a "Preliminary Term Sheet," under which KDB would make a $6 billion investment in Clean Lehman.[2521] KDB would receive two Board seats and would have the ability to remove senior executives if Lehman did not meet performance targets.[2522] Shortly thereafter, KDB sent Lehman a financial analysis, which showed Lehman's valuation of its own assets producing a purchase price of $17.50 per share, while KDB's conservative-case valuation amounted to a purchase price of $6.40 per share.[2523] KDB thought $6.40 was a fair price, although it did not expect Lehman immediately to accept that offer.[2524] Cho told the Examiner that Min warned him that Lehman would be surprised by the offer.[2525] Perella Weinberg thought that KDB's highly conservative valuation was unrealistic.[2526]

Lehman executives have insisted that KDB never made an offer, either because KDB was not authorized by the Korean government to make an actionable offer, or on the basis that the Preliminary Term Sheet did not constitute an offer but rather an outline to begin negotiations.[2527] Indeed, the Preliminary Term Sheet expressly states

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[2521] KDB, Project H – Preliminary Term Sheet for Proposed Investment and the Strategic Relationship [Draft] (Aug. 31, 2008) [LBEX-DOCID 281214], attached to e-mail from Gary S. Barancik, Perella Weinberg Partners, to Hugh E. McGee, III, Lehman, *et al.* (Aug. 31, 2008) [LBEX-DOCID 315383].

[2522] *Id*.

[2523] Hana Investment Bank, Scenario Analysis [Draft] (Sept. 1, 2008), at p. 2 [LBEX-DOCID 407413], attached to e-mail from Arjay Jensen, Perella Weinberg Partners, to Hugh E. McGee, III, Lehman, *et al.* (Aug. 31, 2008) [LBEX-DOCID 315396].

[2524] Examiner's Interview of KDB, Oct. 26, 2009, at pp. 12-13.

[2525] Examiner's Interview of Kunho Cho, Jan. 7, 2010, at p. 10.

[2526] Examiner's Interview of Gary S. Barancik, Sept. 25, 2009, at p. 6.

[2527] *See* e-mail from Herbert H. McDade, III, Lehman, to Monique Wise, Lehman (Sept. 3, 2008) [LBHI_SEC07940_653467]; e-mail from Monique Wise, Lehman, to Scott J. Freidheim, Lehman (Sept. 18,

that it is not an offer.[2528] However, KDB has said in interviews that it was prepared to proceed with the transaction at the $6.40 price had Lehman agreed to that price.[2529] Although KDB still would have needed approval from its own board of directors and from South Korean regulatory bodies, KDB believed that it could have obtained those permissions.[2530] Barancik warned KDB about being unreasonably low in its starting offer and stated to the Examiner that he had expected Lehman to reject KDB's $6.40 starting offer because it was well below market price at the time.[2531] Indeed, Barancik believed that KDB's offer was so low that, had Lehman accepted it, it would have further driven down Lehman's share price and would have been detrimental to KDB.[2532]

Lehman quickly rejected KDB's proposal but simultaneously suggested further negotiations in New York.[2533] Although KDB initially agreed to those talks, KDB did not hold any further discussions with Lehman.[2534] KDB decided that the global financial situation was deteriorating and that, as a state-owned bank, it was no longer

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2008) [LBHI_SEC07940_857773]. *Accord* Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at pp. 26-27; Examiner's Interview of Hugh E. McGee, III, Aug. 12, 2009, at pp. 17-19; Examiner's Interview of Jasjit Bhattal, Oct. 12, 2009, at p. 15.

[2528] KDB, Project H – Preliminary Term Sheet for Proposed Investment and the Strategic Relationship [Draft] (Aug. 31, 2008) [LBEX-DOCID 281214], attached to e-mail from Gary S. Barancik, Perella Weinberg Partners, to Hugh E. McGee, III, Lehman, *et al.* (Aug. 31, 2008) [LBEX-DOCID 315383].

[2529] Examiner's Interview of KDB, Oct. 26, 2009, at pp. 12-13.

[2530] *Id*.

[2531] Examiner's Interview of Gary S. Barancik, Sept. 25, 2009, at pp. 5-6.

[2532] *Id*.

[2533] Letter from Jasjit Bhattal, Lehman, to Euoo Sung Min, Korea Development Bank, re: terms of proposed deal (Sept. 1, 2008) [PWP 00001727] (letter stating Lehman's "intention to continue pursuing alternative paths"); e-mail from Jasjit Bhattal, Lehman, to Brad Whitman, Lehman, *et al.* (Sept. 1, 2008) [LBHI_SEC07940_651987]; Examiner's Interview of Jasjit Bhattal, Oct. 12, 2009, at p. 16.

[2534] Examiner's Interview of KDB, Oct. 26, 2009, at p. 13; Examiner's Interview of Kunho Cho, Jan. 7, 2010, at pp. 10-11.

appropriate for KDB to pursue Lehman.[2535] Indeed, South Korea's currency, the won, sank by as much as 6% in the first week of September 2008, and South Korea's stock market declined by 12% from early August to early September 2008.[2536] According to Cho, the Korean government ordered KDB to terminate its discussions with Lehman because of the pressure on the won.[2537] KDB indicated that it relayed its decision not to continue talks with Lehman on September 2, 2008.[2538] KDB did not inform Perella Weinberg of its decision to stop negotiations until a few days later, on September 3 or 4, 2008.[2539]

During Lehman's final week, as its stock price plummeted, Barancik tried to renew negotiations between Lehman and KDB. Barancik told the Examiner that KDB stated that it was not interested.[2540] Lehman, on the other hand, believed that Min of KDB was coming to New York for continued meetings on September 3, 2008.[2541] Those

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[2535] Examiner's Interview of KDB, Oct. 26, 2009, at p. 13; Examiner's Interview of Kunho Cho, Jan. 7, 2010, at pp. 10-11.

[2536] *See* e-mail from Michael Flaherty, Thomson Reuters, to undisclosed (Sept. 5, 2008) [LBEX-DOCID 1388783] (article reporting turmoil in South Korean markets); Yahoo Finance, South Korean Won historical chart (Aug. 1, 2008 - Sept. 15, 2008), *available at* http://finance.yahoo.com/currency-investing (follow investing, currencies; then enter KRW and follow interactive charts).

[2537] Examiner's Interview of Kunho Cho, Jan. 7, 2010, at p. 11.

[2538] Examiner's Interview of KDB, Oct. 26, 2009, at p. 13.

[2539] *Id.*; Examiner's Interview of Gary S. Barancik, Sept. 25, 2009, at p. 6.

[2540] Examiner's Interview of Gary S. Barancik, Sept. 25, 2009, at p. 7.

[2541] *See* e-mail from Kunho Cho, Lehman, to Brad Whitman, Lehman, *et al.* (Sept. 1, 2008) [LBHI_SEC07940_651987]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 3, 2008), at p. 2 [LBEX-AM 003899]. *Accord* Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 26; Examiner's Interview of Jasjit Bhattal, Oct. 12, 2009, at p. 16.

meetings never took place.[2542] Lehman's Board met on September 3, 2008, and Fuld informed the Board of the cancelled meeting with KDB.[2543] Fuld told the Board that financial concerns in the potential investor's home country had prevented the investment.[2544]

Lehman's Board was not informed that Lehman received the Preliminary Term Sheet or that Lehman summarily had rejected KDB's proposal.[2545] However, several directors have indicated that term sheets by themselves are preliminary in nature and generally should not be presented to the Board.[2546]

(iv) KDB's September 9, 2008 Announcement

Notwithstanding the provisions of the KDB Confidentiality Agreement,[2547] South Korean officials and KDB made a series of statements throughout August and early September 2008 regarding the status of the negotiations between Lehman and KDB, both to the general public and to executives at JPMorgan.

[2542] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 26; Examiner's Interview of Jasjit Bhattal, Oct. 12, 2009, at p. 16.

[2543] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 3, 2008), at p. 2 [LBEX-AM 003899].

[2544] *Id*.

[2545] Examiner's Interview of Michael L. Ainslie, Sept. 22, 2009, at p. 11; Examiner's Interview of Roland A. Hernandez, Oct. 2, 2009, at pp. 19-20; Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at pp. 17-18.

[2546] Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 13; *accord* Examiner's Interview of Michael L. Ainslie, Sept. 22, 2009, at pp. 11-12; Examiner's Interview of John D. Macomber, Dec. 17, 2009, at p. 4.

[2547] Lehman, Confidentiality Agreement with Korea Development Bank (June 2, 2008) [LBEX-DOCID 816276].

On August 22, 2008, a MarketWatch news article reported that Lehman shares rose on news that a KDB spokesman confirmed that KDB was in talks with Lehman about a potential transaction: "We are studying a number of options and are open to all possibilities, which could include (buying) Lehman."[2548] The article also quotes a Korean "government official" as saying that after reviewing Lehman's books in early August, KDB decided that insolvency was a serious concern and a deal would be risky.[2549] The article cites Min as saying that "it is normal that several negotiations and ruptures occur" before a final deal.[2550]

On August 22, 2008, a Reuters article reported that Lehman and KDB were involved in negotiations, and attributed that fact to a KDB spokesperson.[2551] Also on August 22, 2008, Min called JPMorgan, following up on a meeting that had occurred a few days earlier, indicating that he wanted to pursue a significant investment in Lehman and was interested in JPMorgan possibly advising KDB.[2552]

On August 25, 2008, the Wall Street Journal quoted Jun Kwang-woo, the head of South Korea's Financial Services Commission, as saying that it might not be appropriate

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[2548] *See* e-mail from Timothy Sullivan, Lehman, to Hugh E. McGee, III, Lehman, *et al.* (Aug. 22, 2008) [LBHI_SEC07940_408101] (forwarding MarketWatch article).

[2549] *Id*.

[2550] *Id*.

[2551] Kim Yeon-hee, *S. Korea's KDB Says Buying Lehman a Possibility*, Reuters, Aug. 22, 2008, *available at* http://www.reuters.com/article/ousiv/idUSSEO26101520080822.

[2552] *See* e-mail from Olivier de Grivel, JPMorgan, to Steven D. Black, JPMorgan, *et al.* (Aug. 22, 2008) [JPM-2004 0005910].

for a state-owned institution to take on "excessive burdens."[2553] The next day, an e-mail from Steven Lim (JPMorgan's Senior Country Officer and Managing Director, Investment Banking for Korea) to Steven D. Black (JPMorgan co-CEO), Dimon and other JPMorgan executives recounted that JPMorgan had spoken to KDB and that the statements from South Korea's Financial Services Commission were important; as a result, KDB wanted to stop pursuing Lehman for the time being.[2554]

On August 31, 2008, the Dow Jones Newswires reported that Jun Kwang-woo had stated that "KDB was considering a possible investment in Lehman Brothers as well as other global banks."[2555] Kwang-woo noted that KDB had not yet submitted a plan to the regulatory body, and that government approval would take more than a day or two.[2556]

A September 1, 2008, e-mail from Lim to Black, Dimon and other JPMorgan executives noted that Lim had called Min on August 31, 2008 to persuade Min to select JPMorgan as a financial advisor on the Lehman deal.[2557] Min reportedly thanked

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[2553] E-mail from Catherine P. Jones, Lehman, to Scott J. Freidheim, Lehman, *et al.* (Aug. 25, 2008) [LBHI_SEC07940_856773].

[2554] E-mail from Steven Lim, JPMorgan, to Steven D. Black, JPMorgan, *et al.* (Aug. 26, 2008) [JPM-2004 0005989]; e-mail from Tim Main, JPMorgan, to Steven Lim, JPMorgan, *et al*. (Aug. 26, 2008) [JPM-2004 0006015].

[2555] E-mail from Shelby Lauckhardt, Lehman, to Richard S. Fuld, Jr., Lehman (Sept. 1, 2008) [LBHI_SEC07940_213366] (forwarding Dow Jones Newswires article).

[2556] *Id*.

[2557] E-mail from Steven Lim, JPMorgan, to Steven D. Black, JPMorgan, *et al.* (Sept. 1, 2008) [JPM-2004 0006139]; e-mail from Steven D. Black, JPMorgan, to Jamie L. Dimon, JPMorgan, *et al.* (Sept. 1, 2008) [JPM-2004 0006152].

JPMorgan for the follow-up but said there were issues that needed to be sorted out with the Korean government and Lehman's asset quality.[2558]

On September 2, 2008, Min publicly confirmed that KDB was talking with Lehman, stating that discussions were underway "to form a consortium with private banks as (we) believe it is more desirable to acquire Lehman Brothers jointly rather than alone."[2559]

A September 3, 2008 Bloomberg article noted that KDB released an e-mailed statement reporting: "We have been reviewing acquiring an overseas investment bank, including Lehman Brothers, or an asset management company, but nothing specific has been determined including whether such a deal will succeed."[2560] Lehman management internally commented at the time that KDB's confirmation of talks raised expectations and conditioned the markets to expect that Lehman would announce a strategic partner by the end of the third quarter.[2561]

[2558] *Id*.

[2559] E-mail from Anne Lui, Lehman, to Scott J. Freidheim, Lehman, *et al.* (Sept. 2, 2008) [LBHI_SEC07940_857041]; *see also* e-mail from Monique Wise, Lehman, to Herbert H. McDade, III, Lehman, *et al.* (Sept. 2, 2008) [LBEX-DOCID 224538]; e-mail from David Erickson, Lehman, to Hugh E. McGee, III, Lehman, *et al.* (Sept. 2, 2008) [LBEX-DOCID 224548]; e-mail from Randall Whitestone, Lehman, to Scott J. Freidheim, Lehman, *et al.* (Sept. 2, 2008) [LBEX-DOCID 224642].

[2560] E-mail from Frank Mackinney, James Caird Asset Management Group, to Eric Felder, Lehman, *et al.* (Sept. 3, 2008) [LBEX-DOCID 808050] (forwarding article, Bomi Lim, *et al.*, *HSBC, Chinese Banks in Race to Bid for Lehman, Chosun Reports*, Bloomberg, Sept. 3, 2008); *see also* e-mail from Michael Carrier, UBS, to Glenn Schorr, UBS, *et al.* (Sept. 2, 2008) [LBEX-UBS 00048970].

[2561] E-mail from Herbert H. McDade, III, Lehman, to Monique Wise, Lehman (Sept. 3, 2008) [LBHI_SEC07940_653467].

On September 5, 2008, Lim again e-mailed Dimon, Black and other JPMorgan executives and stated that he did not believe KDB would be able to get the deal done by Lehman's September 10, 2008 deadline.[2562]

That same day, JPMorgan decided that it needed additional collateral from Lehman.[2563] At an internal meeting, JPMorgan executives discussed the fact that a deal between Lehman and KDB did not seem to be moving forward.[2564] JPMorgan considered the status of Lehman's negotiations with KDB to be another instance of Lehman's deteriorating market position.[2565]

On September 9, 2008, Jun Kwang-woo made a public statement, which was confirmed by another government official, that talks between KDB and Lehman were over.[2566] KDB declined to comment, although Min noted that KDB could become one of Asia's top three investment banks without Lehman.[2567]

[2562] E-mail from Steven Lim, JPMorgan, to Jamie L. Dimon, JPMorgan (Sept. 5, 2008) [JPM-2004 0006258].

[2563] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 2.

[2564] *Id*.

[2565] See Section III.A.5.b of this Report, which discusses KDB's impact on JPMorgan in greater detail.

[2566] Jin-Young Yook, *Korea FSC: KDB, Lehman Investment Talks Have Ended*, Dow Jones International News, Sept. 9, 2008 [LBEX-DOCID 131058]; Steve Goldstein, *Korean regulator says KDB talks with Lehman ended*, MarketWatch, Sept. 9, 2008 [LBEX-DOCID 131059]; Evan Ramstad & Jin-Young Yook, *Talks Between KDB, Lehman On Possible Investment End*, Wall St. J. Online, Sept. 9, 2008 [LBEX-DOCID 224552].

[2567] *Id*.

On September 9, 2008, Lim e-mailed Dimon, Black and others at JPMorgan to inform the group that KDB's Min had called him to confirm that KDB had ended negotiations with Lehman.[2568]

On September 9, 2008, following the public disclosure that Lehman's negotiations with KDB had terminated, many of Lehman's hedge fund clients pulled out, short-term creditors cut lending lines, and the cost of insuring Lehman's debt surged by almost 200 basis points.[2569] On the same day, Lehman executed amended Security and Guaranty Agreements with JPMorgan at their insistence.[2570] Citi also sought a guarantee agreement to cover its exposure to LBI and so that Citi could continue to clear in Asia.[2571]

Lehman's officers believe that KDB's disclosures had a strong downward impact on Lehman's stock.[2572] The decline in Lehman's share price was a driving force behind the decision by Lehman's management to accelerate the third quarter earnings call.[2573] Fuld told the Examiner that on September 9, 2008, he called Kenneth D. Lewis, BofA's

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[2568] E-mail from Steven Lim, JPMorgan, to Jamie L. Dimon, JPMorgan, *et al.* (Sept. 9, 2008) [JPM-2004 0006320].

[2569] *See* Yalman Onaran & John Helyar, *Lehman's Last Days*, Bloomberg Markets, January 2009.

[2570] *Id*.

[2571] *Id. Accord* Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 8. See Section III.A.5.c of this Report, which discusses those agreements in greater detail.

[2572] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 11; Examiner's Interview of Thomas A. Russo, May 11, 2009, at p. 7.

[2573] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 11; Examiner's Interview of Thomas A. Russo, May 11, 2009, at p. 7.

CEO, to advise Lewis of KDB's announcement and that the rating agencies "were making noise," therefore Lehman was going to pre-announce.[2574]

On September 10, 2008, prior to Lehman's pre-announcement earnings call, KDB publicly confirmed that talks were over, citing difficulties in the domestic and international financial markets.[2575]

During a November 16, 2009 interview, Min said: "We missed a very good opportunity . . . I think we could have avoided a situation where Lehman collapsed so rapidly."[2576] During the interview, Min said that he had been prepared to raise his offer as high as $9 per share.[2577] Min blamed the confidentiality agreement for preventing KDB from explaining the proposed transaction to Korean regulators while the negotiations were ongoing.[2578]

(c) MetLife

During 2008, Lehman contacted MetLife several times in an effort to raise capital.[2579] According to Steven A. Kandarian, MetLife's Executive Vice President and

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[2574] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 5.

[2575] *See* e-mail from Shelby Lauckhardt, Lehman, to Richard S. Fuld, Jr., Lehman (Sept. 10, 2008) [LBHI_SEC07940_213466] (forwarding headlines about mounting pressure against Lehman); Leo Lewis, *Korea Blames "Differences" for Ending Lehman Talks*, Times Online, Sept. 10, 2008.

[2576] Bomi Lim, *KDB's Min Rues "Very Good Opportunity" Missed in Lehman Failure*, Bloomberg, Nov. 18, 2009.

[2577] *Id*.

[2578] *Id*.

[2579] Examiner's Interview of Steven A. Kandarian, Sept. 17, 2009, at p. 4.

CIO, a transaction never occurred because MetLife did not have enough time to conduct due diligence on any of those occasions.[2580]

Kandarian watched as Lehman's stock price fell from approximately $85.00 per share to $12.50 per share.[2581] Kandarian told the Examiner that he considered purchasing Lehman at a distressed price, to provide it with a "safe harbor" during tough times and then take it public in three to seven years once the markets had recovered.[2582] Fuld told the Examiner that he thought that MetLife's proposal to take Lehman private and then spin it back out was an elegant solution and Fuld was willing to give MetLife control of Lehman to do so.[2583] Because Kandarian expected the markets to deteriorate in the short term, however, Kandarian wanted to make sure that any price MetLife offered contained enough of a "buffer" that Lehman could sustain further write-downs without MetLife taking a loss.[2584] Shortly before July 23, 2008,[2585] Kandarian communicated his idea to Steven M. Lessing, head of Lehman's private client group.[2586] Lehman then followed up and the parties arranged for subsequent meetings.[2587]

[2580] *Id*.
[2581] *Id*.
[2582] *Id*. at p. 5.
[2583] Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at p. 19.
[2584] Examiner's Interview of Steven A. Kandarian, Sept. 17, 2009, at p. 5.
[2585] *See* MetLife, Calendar entry re: Lehman meeting (July 23, 2008) [ML-LEH 00012220]. *Accord* Examiner's Interview of Steven A. Kandarian, Sept. 17, 2009, at p. 5.
[2586] Kandarian could not recall whether he called Lessing or Lessing called him. Examiner's Interview of Steven A. Kandarian, Sept. 17, 2009, at p. 5.
[2587] *Id*.

At Lehman's July 31, 2008 Board meeting, Fuld informed the Board about the talks with MetLife. Fuld stated that MetLife had begun due diligence and that MetLife had "the likely intention of spinning its interest" in Lehman back out after the markets improved.[2588]

On August 5, 2008, Lehman officers, including Fuld, met with MetLife executives, including Kandarian.[2589] According to Kandarian, Fuld explained at the meeting that he did not like the aspects of MetLife's proposal that called for MetLife to acquire a controlling stake of Lehman with the ability to appoint a majority of Lehman's Board.[2590] That did not concern Kandarian, however. Kandarian told Lehman that MetLife was not going to be Lehman's first choice; instead, MetLife was a safe harbor in a storm, and Lehman should think of MetLife as a backup.[2591] According to Fuld, Kandarian never said that Lehman should view the deal as a "backup," and Fuld was more than willing to cede control to MetLife.[2592]

MetLife began due diligence of Lehman. By August 12, 2008, MetLife had a negative view concerning Lehman's assets, particularly its commercial real estate and

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[2588] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (July 31, 2008), at p. 2 [LBEX-AM 003875].

[2589] *See* letter from Steven A. Kandarian, MetLife, to Richard S. Fuld, Jr., Lehman, *et al.* (Aug. 6, 2008) [LBHI_SEC07940_741210]. *Accord* Examiner's Interview of Steven A. Kandarian, Sept. 17, 2009, at p. 5.

[2590] Examiner's Interview of Steven A. Kandarian, Sept. 17, 2009, at pp. 5-6. *See also* e-mail from Steven J. Goulart, MetLife, to Steven A. Kandarian, MetLife, *et al.* (Aug. 13, 2008) [ML-LEH 00012231]; letter from Steven A. Kandarian, MetLife, to Richard S. Fuld, Jr., Lehman, *et al.*, re: Meeting [LBHI_SEC07940_741211].

[2591] Examiner's Interview of Steven A. Kandarian, Sept. 17, 2009, at pp. 5-6.

[2592] Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at p. 19.

residential mortgage assets.[2593] MetLife continued due diligence beyond that point because it had reviewed only a small portion of Lehman's balance sheet. Kandarian stated that it also would have been difficult to end MetLife's due diligence investigation so quickly for relationship reasons.[2594] Nonetheless, MetLife's view of Lehman remained negative.[2595] MetLife decided that it would not have the "buffer" that Kandarian wanted, especially after future market deterioration.[2596]

Lehman also pitched MetLife to invest in either SpinCo or CleanCo.[2597] However, based on what MetLife had seen of Lehman's assets, MetLife was not interested in those alternatives.[2598]

On August 20, 2008, MetLife informed Lehman that it was not interested in a deal.[2599] At the Board of Directors meeting later that day, Fuld informed the Board that

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[2593] E-mail from Mark Wilsmann, MetLife, to Steven A. Kandarian, MetLife, *et al.* (Aug. 12, 2008) [ML-LEH 00072857]; Examiner's Interview of Steven A. Kandarian, Sept. 17, 2009, at pp. 5-6.

[2594] Examiner's Interview of Steven A. Kandarian, Sept. 17, 2009, at p. 7.

[2595] E-mail from John Rosenthal, MetLife, to Steven A. Kandarian, MetLife (Aug. 13, 2008) [ML-LEH 00030453]; e-mail from John Rosenthal, MetLife, to Steven A. Kandarian, MetLife (Aug. 14, 2008) [ML-LEH 00031559]; M. Mazzola & J. Ellermeyer, MetLife, Preliminary View on LEH Private Equity and Alternative Investment Holdings (Aug. 15, 2008) [ML-LEH 00009589].

[2596] Examiner's Interview of Steven A. Kandarian, Sept. 17, 2009, at p. 6.

[2597] *See* e-mail from Hugh E. McGee, III, Lehman, to Jeffrey L. Weiss, Lehman, *et al.* (Aug. 20, 2008) [LBHI_SEC07940_407903] (email subject line "M is out." McGee adds that there was "[n]ot enough cushion after incorporating their view of CRE. Not even a player for cleanco."). *Accord* Examiner's Interview of Steven A. Kandarian, Sept. 17, 2009, at p. 9.

[2598] *Id.*

[2599] E-mail from Hugh E. McGee, III, Lehman, to Jeffrey L. Weiss, Lehman, *et al.* (Aug. 20, 2008) [LBHI_SEC07940_407903]; Examiner's Interview of Steven A. Kandarian, Sept. 17, 2009, at p. 10.

MetLife was no longer interested in a deal with Lehman "largely because the proposed transaction was too large a financial commitment for this party."[2600]

After Lehman's bankruptcy, Fuld had a breakfast meeting with Kandarian.[2601] Fuld told the Examiner that at that meeting, Kandarian confirmed that the deal died because MetLife already had substantial exposure to commercial real estate and could not take on Lehman's commercial real estate positions as well.[2602]

(d) ICD

In early August 2008, Lehman considered Investment Corp. of Dubai ("ICD") as a potential investor for up to $250 million in SpinCo junior, or mezzanine, debt.[2603] Talks between Lehman and ICD picked up, with an exchange of draft term sheets by August 22, 2008.[2604] At the August 25, 2008 Board meeting, management informed the Board that there would be meetings with a new potential foreign investor in the coming days.[2605]

[2600] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Aug. 20, 2008), at p. 1 [LBEX-AM 003891].

[2601] Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at p. 6.

[2602] *Id*.

[2603] *See* Lehman, Potential Junior Debt Investors (Aug. 1, 2008) [LBHI_SEC07940_012597].

[2604] *See* e-mail from Hugh E. McGee, III, Lehman, to Carol Welter, Lehman (Aug. 20, 2008) [LBHI_SEC07940_2221725]; e-mail from Kelsey Surbaugh, Lehman, to Hugh E. McGee, III, Lehman, *et al.* (Aug. 22, 2008) [LBHI_SEC07940_408063]; e-mail from Jeffrey L. Weiss, Lehman, to Herbert H. McDade, III, Lehman, *et al.* (Aug. 24, 2008) [LBHI_SEC07940_650284]; e-mail from Timothy Sullivan, Lehman, to Scott J. Freidheim, Lehman, *et al.* (Aug. 27, 2008) [LBHI_SEC07940_856902]; e-mail from Larry Wieseneck, Lehman, to Brad Whitman, Lehman, *et al.* (Aug. 28, 2008) [LBHI_SEC07940_408482]; e-mail from Kelsey Surbaugh, Lehman, to Gerard Reilly, Lehman (Aug. 29, 2008) [LBHI_SEC07940_2159297].

[2605] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Aug. 25, 2008), at p. 2 [LBEX-AM 003898].

By September 2, 2008, McGee developed "Project Indigo," which called for ICD to make a $2 billion post-SpinCo investment in Lehman, and also to consider other strategic partnership opportunities.[2606] However, Rothschild Ltd., ICD's strategic advisor, informed Lehman that ICD had concerns about the real estate market and future write-downs.[2607] Rothschild told Lehman that ICD was interested in investing in Lehman's IMD as a backup.[2608]

On September 4, 2008, ICD made two proposals to Lehman. Under the first proposal, ICD would pay between $3.25 billion and $4 billion for 50.1% of "NB/IMD," that is, NB, the private wealth management arm of Lehman's Investment Management Division.[2609] There is no evidence that Lehman responded to ICD's first proposal. ICD's second proposal was a $3.25 billion investment in Lehman preferred convertible shares after the spin-off of commercial real estate positions, conditioned on Lehman raising an additional $3.25 billion in capital, and requiring protection for ICD against up to $2 billion in write-downs by Lehman over the next year.[2610] ICD proposed that, in the

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[2606] *See* e-mail from Ryan Morrell, Lehman, to Hugh E. McGee, III, Lehman, *et al*. (Sept. 2, 2008) [LBHI_SEC07940_2222099].

[2607] *See* e-mail from Ara Cho, Lehman, to Brad Whitman, Lehman, *et al.* (Aug. 20, 2008) [LBEX-DOCID 210862]; e-mail from Jeffrey L. Weiss, Lehman, to Hugh E. McGee, III, Lehman, *et al.* (Aug. 30, 2008) [LBHI_SEC07940_651921]; e-mail from Jeffrey L. Weiss, Lehman, to Herbert H. McDade, III, Lehman (Sept. 2, 2008) [LBHI_SEC07940_652802]; e-mail from Jeffrey L. Weiss, Lehman, to Hugh E. McGee, III, Lehman, *et al.* (Sept. 3, 2008) [LBHI_SEC07940_653425].

[2608] *See* e-mail from Jeffrey L. Weiss, Lehman, to Hugh E. McGee, III, Lehman, *et al.* (Sept. 3, 2008) [LBHI_SEC07940_653425].

[2609] Lehman, Project Green – Transaction Structure Proposal 1 (Sept. 4, 2008) [LBHI_SEC07940_408977].

[2610] Lehman, Project Green – Transaction Structure Proposal 2 (Sept. 4, 2008) [LBHI_SEC07940_408980].

event of substantial write-downs or a ratings downgrade, ICD would have the option for two years to convert its Lehman shares into shares of IMD.[2611]

Fuld knew that ICD was interested in NB as "collateral," but he did not recall hearing that ICD wanted the ability to obtain Neuberger at its option.[2612] Indeed, Fuld could not understand how such a structure would be possible, as Neuberger was so integrated into Lehman that it could not easily be carved out.[2613]

Lehman responded to ICD's second proposal with a term sheet that attempted to protect ICD against future write-downs but that did not allow ICD to convert its shares in Lehman into shares in IMD.[2614] Management did not mention the ICD term sheets to the Board. However, several Board members informed the Examiner that discussing term sheets, in the absence of a firm, fleshed-out offer, would have been a waste of the Board's time.[2615]

Contacts between Lehman and ICD appear to have ceased by September 9, 2008. According to McGee, ICD said that it needed a "time out" after Lehman's stock declined by nearly 50% in a single day on September 9, 2008.[2616] By September 14, 2008,

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[2611] *Id*.

[2612] Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at p. 21.

[2613] *Id*.

[2614] Lehman, Green Term Sheet [Draft] (Sept. 5, 2008) [LBEX-DOCID 612702], attached to e-mail from Brad Whitman, Lehman, to Faisal Mikou, Investment Corp. of Dubai, *et al.* (Sept. 6, 2008) [LBEX-DOCID 741921].

[2615] Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 13; Examiner's Interview of Michael L. Ainslie, Sept. 22, 2009, at pp. 11-12; Examiner's Interview of John D. Macomber, Dec. 17, 2009, at p. 4.

[2616] Examiner's Interview of Hugh E. McGee, III, Aug. 12, 2009, at p. 22.

Lazard listed ICD as a party that recently performed due diligence but was not interested in Lehman.[2617]

(e) Bank of America

(i) Initial Discussions in the Summer of 2008

In mid-July 2008, Lehman began talks with BofA regarding a potential merger between Lehman and BofA's investment banking division, under which Lehman would own approximately two-thirds of the resulting company.[2618] On July 13, 2008, Curl, BofA's Global Corporate Strategic Development and Planning Executive, met with Fuld, McDade and H. Rodgin Cohen, Chairman of Sullivan & Cromwell, LLP, to discuss a potential transaction.[2619] At the meeting, Fuld proposed a deal in which BofA would acquire a 30% interest in Lehman in exchange for BofA's investment banking and advising businesses.[2620] According to Fuld, the resulting entity would have been two-thirds owned by Lehman and one-third owned by BofA.[2621] Curl said that Fuld told him that the deal would be a good one for BofA because BofA was made up of commercial bankers, not investment bankers, and Lehman was more experienced than BofA in managing a global investment firm.[2622] Curl further stated that Fuld said that

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[2617] Lazard, Situation Overview (Sept. 13, 2008) [LBHI_SEC07940_410298], attached to e-mail from Brad Whitman, Lehman, to Hugh E. McGee, III, Lehman, *et al.* (Sept. 14, 2008) [LBHI_SEC07940_410297].
[2618] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 4.
[2619] Examiner's Interview of Gregory L. Curl, Sept. 17, 2009, at p. 5.
[2620] *Id.* at pp. 5-6.
[2621] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 4.
[2622] Examiner's Interview of Gregory L. Curl, Sept. 17, 2009, at pp. 5-6.

through the deal BofA could capitalize on Lehman's great brand, great future, and robust client list in Europe.[2623]

Following the meeting, Curl was not in favor of the proposed deal for several reasons.[2624] Curl did not believe Lehman was as profitable as BofA in the areas that the deal would include.[2625] He was put off by the fact that Lehman would control the entity while BofA would retain only a 30% interest.[2626] Curl also was concerned that the proposal did not provide BofA the protection of an option to sell the stock at a pre-set price.[2627] Curl saw Lehman's proposal as a risky proposition that would expose BofA's profitable businesses to Lehman's more vulnerable businesses, which had large risks and faced huge challenges.[2628] Curl stated that he told Fuld that he did not believe the deal would work but that he would pass it on to Lewis.[2629] According to Fuld, Curl was quite receptive to the idea, expressing concern only about BofA not being in control of the resultant entity, which Fuld thought could be worked out.[2630]

Curl told the Examiner that he presented the idea to Lewis but, like Curl, Lewis was not in favor of the deal because the logistics of the transaction would be quite

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[2623] *Id*.
[2624] *Id*. at p. 6.
[2625] *Id*.
[2626] *Id*.
[2627] *Id*.
[2628] *Id*.
[2629] *Id*.
[2630] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 4.

difficult and BofA would not be in control of the resultant entity.[2631] Lewis told the Examiner that he was not in favor of the deal because it did not make sense financially for BofA.[2632] Fuld recalled being informed that Lewis was not in favor of the deal.[2633]

(ii) Talks Resume in September

Talks between Lehman and BofA resumed in late August or early September. On or about August 26, 2008, Fuld had a conversation with Lewis about SpinCo.[2634] Not long after that, Fuld met with Lewis following a dinner at the FRBNY.[2635] During that meeting, Fuld explained SpinCo and Lehman's plans.[2636] Lewis, Fuld, and Geithner all were aware beforehand that Fuld would meet with Lewis, but the meeting was arranged in such a fashion as to avoid signaling to other attendees that they were meeting.[2637] Lewis recalled that Fuld gave him a "heavy" sales pitch at this meeting but does not remember what they specifically discussed.[2638] Lewis told Fuld that he was reluctant to proceed because BofA had been pursuing Merrill Lynch for some time.[2639] Fuld emphasized that BofA needed bankers to cover retail clients, which Lehman could

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[2631] Examiner's Interview of Gregory L. Curl, Sept. 17, 2009, at p. 6; Examiner's Interview of Kenneth D. Lewis, Sept. 24, 2009, at p. 3.

[2632] Examiner's Interview of Kenneth D. Lewis, Sept. 24, 2009, at p. 3.

[2633] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 4.

[2634] *Id*. at p. 5. Fuld was uncertain of the date of the conversation but Fuld's call logs indicate that on August 26, 2008, he had a telephone call with Lewis accompanied by the description "proposed deal." Richard S. Fuld, Jr., Lehman, Call Logs (Aug. 26, 2008), at p. 63 [LBHI_SEC07940_016973].

[2635] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 5; Examiner's Interview of Kenneth D. Lewis, Sept. 24, 2009, at p. 4.

[2636] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 5.

[2637] Examiner's Interview of Kenneth D. Lewis, Sept. 24, 2009, at p. 4.

[2638] *Id*.

[2639] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 5.

provide.[2640] According to Fuld, Lewis was interested and told Fuld that he would speak with Curl about putting together a team for negotiations.[2641]

Sometime after September 1, 2008, Paulson contacted Curl to express his concern that Lehman could become a serious problem and to ask Curl to look into Lehman and see if there was any way BofA could help.[2642] Curl responded that he was unsure of whether BofA could help because, without knowing the specifics of the situation, the transaction sounded difficult.[2643] Even in the face of Paulson's request, BofA remained reluctant to look into Lehman.[2644] Paulson stated to the Examiner that he told Lewis to buy Lehman.[2645] Paulson also told the Examiner that he warned Fuld in September 2008 that Lehman could not afford the luxury of finding the best "fit" in a buyer as Lehman's survival was at stake.[2646]

[2640] *Id*.

[2641] *Id*.

[2642] Examiner's Interview of Gregory L. Curl, Sept. 17, 2009, at p. 7. Paulson described his "job" during this time period as, among other things, working with FRBNY president Timothy Geithner to finalize a deal to sell Lehman to Bank of America or Barclays. Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 17.

[2643] Examiner's Interview of Gregory L. Curl, Sept. 17, 2009, at p. 7.

[2644] *Id*.

[2645] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 19.

[2646] *Id.* In John Mack's October 14, 2009 speech at Wharton School of Business, Mack said that Paulson urged Mack to sell Morgan Stanley to J.P. Morgan for $1 per share in the week following Lehman's bankruptcy. Mack refused. John Mack, Leadership in Crisis, speech at Wharton School of Business (Oct. 14, 2009), *available at* http://knowledge.wharton.upenn.edu/article.cfm?articleid=2357.

[2646] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 16.

Government officials continued to call Curl, saying the situation at Lehman was not improving and asking BofA to look at Lehman.[2647] On September 8 or 9, 2008, Curl contacted Cohen, who previously had served as the intermediary in negotiations between BofA and Lehman, asking him to begin the process of looking into Lehman.[2648] Curl told the Examiner that BofA began its due diligence of Lehman on September 9 or 10, 2008.[2649]

According to Fuld, he called Lewis again on September 9, 2008 after the news broke that Lehman would not be doing a deal with KDB.[2650] During that conversation, Fuld informed Lewis that Lehman was planning to pre-announce its quarterly earnings and advised Lewis that the rating agencies were discussing possibly taking action regarding Lehman.[2651] Lewis told Fuld to keep him apprised of any developments going forward.[2652] Fuld called Lewis again on September 11, 2008, informing him that the rating agencies were comforted by hearing that Lehman was negotiating with a major bank.[2653] Fuld told the Examiner that, during the September 11, 2008 conversation, he remarked to Lewis, "You know we're going to do this deal, don't you,

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[2647] Examiner's Interview of Gregory L. Curl, Sept. 17, 2009, at p. 7. Curl also stated that Lewis was called repeatedly with requests to look into Lehman, but Lewis disavowed any knowledge of pressure by Paulson or any other Government official to look into Lehman. *Id.;* Examiner's Interview of Kenneth D. Lewis, Sept. 24, 2009, at p. 6. See Appendix 15 to this Report, which provides a day-by-day discussion of developments with BofA.

[2648] Examiner's Interview of Gregory L. Curl, Sept. 17, 2009, at p. 7.

[2649] *Id.*

[2650] *Id.*

[2651] *Id.*

[2652] *Id.*

[2653] *Id.*

Ken?" to which Lewis responded, "Yes, I do, Dick."[2654] Lewis said he never indicated to Fuld that a deal would get done; Lewis said he was noncommittal.[2655]

Lewis told the Examiner that he knew from the outset that he would agree to a deal only if it was highly beneficial financially for BofA, because BofA would gain little strategic advantage from a transaction with Lehman.[2656] By the end of Friday, September 12, 2008, BofA was finishing due diligence,[2657] concluding that Lehman's valuations of its commercial real estate positions were too high.[2658] Moreover, BofA had uncovered approximately $65 - $67 billion worth of Lehman assets that BofA said it did not want at any price.[2659] Consequently, Lewis felt that any deal with Lehman would not be financially advantageous for BofA,[2660] and BofA was not willing to go forward with Lehman without Government assistance.[2661] Some members of the Bank of America due diligence team apparently thought a deal could be profitable for Bank of America but they did not share that opinion with BofA senior management.[2662]

[2654] *Id*.

[2655] Examiner's Interview of Kenneth D. Lewis, Sept. 24, 2009, at pp. 5-6.

[2656] *Id*. at p. 4.

[2657] *See* e-mail from David Belk, BofA, to Walter Muller, BofA, *et. al.* (Sept. 12, 2008) [BofA-SEC-00003515].

[2658] *See* e-mail from Don Benningfield, BofA, to Rochelle Dobbs, BofA, *et al.* (Sept. 12, 2008) [BofA-SEC-00002774].

[2659] Examiner's Interview of Kenneth D. Lewis, Sept. 24, 2009, at p. 5.

[2660] *Id*.

[2661] *Id*. at p. 6.

[2662] *See, e.g.*, e-mail from Rochelle Dobbs, BofA, to Nigel Milner, BofA, (Sept. 13, 2008) [BofA-SEC-00003525]. Both Curl and Lewis denied that any members of the due diligence team had indicated to them that they felt the deal would be financially advantageous for BofA. Examiner's Interview of Gregory L. Curl, Sept. 17, 2009, at p. 10; Examiner's Interview of Kenneth D. Lewis, Sept. 24, 2009, at p. 5.

According to Lewis, he had heard prior to the morning of Saturday, September 13, 2008, that the Government would be unwilling to intervene to save Lehman.[2663] Nonetheless, Lewis contacted Paulson to inform him that without sufficient Government assistance to balance out the unwanted assets, BofA could not do a deal for Lehman.[2664] Paulson was unwilling to offer such assistance to Lewis.[2665] Although Paulson told Lewis that the Government would not provide taxpayer money, Paulson wanted to reconvene with BofA later in the day to discuss other options.[2666]

On the night of Friday, September 12, 2008, Fuld's calls to Lewis to discuss the status of the transaction began going unanswered.[2667] Fuld told the Examiner that, as of Friday evening, he did not yet suspect anything was awry.[2668]

On the afternoon of Saturday, September 13, 2008, BofA began talks with Merrill Lynch without informing anyone at Lehman.[2669] According to Lewis, BofA had been interested in Merrill Lynch for years and, once it became evident that Merrill Lynch was looking for a strategic partner, BofA pursued a deal.[2670] According to Lewis, the deal between BofA and Merrill Lynch did not interfere with a deal for Lehman.[2671] Lewis

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[2663] Examiner's Interview of Kenneth D. Lewis, Sept. 24, 2009, at p. 6.
[2664] *Id*.
[2665] *Id*.
[2666] Examiner's Interview of Gregory L. Curl, Sept. 17, 2009, at p. 11.
[2667] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 6.
[2668] *Id*.
[2669] Examiner's Interview of Kenneth D. Lewis, Sept. 24, 2009, at p. 7.
[2670] *Id*.
[2671] *Id*.

told the Examiner that by the time Merrill Lynch approached BofA about a potential transaction, it was already apparent that a deal with Lehman probably would not happen.[2672] BofA already had brought home its due diligence team.[2673]

Throughout the day on Saturday, September 13, 2008, Fuld continued to call Lewis without getting a response.[2674] Lewis' wife eventually answered the phone and said that if her husband wanted to talk to Fuld, he would return the call.[2675] Lewis told the Examiner that he did not answer Fuld's calls because he did not think Fuld was in a position to help move the transaction forward.[2676] According to Lewis, the only way that a transaction could have happened would have been for the Government to provide the assistance requested.[2677] Therefore, Lewis said, any conversations or negotiations with Fuld would have been a distraction.[2678]

Fuld told the Examiner that he believes Lewis was using Lehman as a bargaining chip with the FRBNY regarding assistance the Federal Reserve had apparently promised but never delivered in connection with Bank of America's purchase of Countrywide.[2679] Curl told the Examiner that when Paulson contacted him in early

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[2672] *Id.*

[2673] *Id.*

[2674] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 7.

[2675] *Id.*

[2676] Examiner's Interview of Kenneth D. Lewis, Sept. 24, 2009, at p. 6.

[2677] *Id.*

[2678] *Id.*

[2679] Fuld told the Lehman Board of Directors on September 13, 2008, when it appeared that no deal with BofA would happen, that BofA appeared to be playing a "game of chicken" with the Fed and the

September 2008 to request that Bank of America look into Lehman, Curl mentioned the Countrywide deal to Paulson.[2680] Curl had expressed frustration to Paulson over the fact that the Government had approved the Countrywide deal but later required remedial steps to be taken regarding capital that negatively affected Bank of America.[2681] According to Curl, Paulson said he believed that, if Curl's account were correct, the Government's actions had been inappropriate.[2682] Paulson promised that the Government would look into that issue.[2683]

On September 15, 2008, the Financial Times reported that Lewis "declined to comment on whether Bank of America had ever entertained any real interest in acquiring Lehman Brothers."[2684] When interviewed by the Examiner, Lewis stated unequivocally that there was no quid pro quo regarding Bank of America's concerns related to Countrywide when BofA looked into Lehman.[2685] Lewis said that BofA would not have done any deal with Lehman that was not in BofA's interests financially.[2686] In any event, after BofA had looked into Lehman, the Countrywide deal was not

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Treasury. Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 13, 2008), at p. 1 [LBEX-AM 003927]; Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at pp. 6-7.

[2680] Examiner's Interview of Gregory L. Curl, Sept. 17, 2009, at p. 7.

[2681] *Id.*

[2682] *Id.*

[2683] *Id.*

[2684] Greg Farrell, *BofA Corrals the "Thundering Herd," The Financial Times*, Sept. 15, 2008.

[2685] Examiner's Interview of Kenneth D. Lewis, Sept. 24, 2009, at p. 7. Lewis explained that the issue in the Countrywide deal was between Bank of America and the Federal Reserve anyway and therefore Paulson and the Treasury would not have had the power to reopen it even if such a bargain had been struck. *Id.*

[2686] *Id.* at pp. 6-7.

reopened.[2687] Neither Curl nor Lewis indicated that he felt any undue pressure to consummate a deal with Lehman.[2688]

(f) Barclays

On September 10, 2008, John Varley, Chief Executive Officer of Barclays, contacted Hector Sants, Chief Executive of the Financial Services Authority ("FSA"), the United Kingdom's equivalent of the SEC.[2689] Varley advised Sants that Barclays was considering a bid for Lehman.[2690] The FSA did not object to the idea but stressed the importance of Barclays keeping the FSA informed of the details and developments of any proposed transaction.[2691]

On Thursday, September 11, 2008, Fuld informed the Board that he had "not heard from Barclays directly, but had been advised of its potential interest by the Firm's regulators."[2692] Fuld told the Examiner that, prior to that point, Fuld had at least two conversations with Robert E. Diamond, president of Barclays.[2693] During those conversations, Diamond told Fuld that there was too much overlap to do a deal.[2694] Sometime during the first two weeks of September, Terrence J. Checki, an Executive

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[2687] *Id*. at p. 7

[2688] *Id*. at pp. 6-7; Examiner's Interview of Gregory L. Curl, Sept. 17, 2009, at p. 7.

[2689] FSA, Statement of the FSA (Jan. 20, 2010), ¶ 7. See Appendix 15 to this Report, which provides a discussion of developments with Barclays by the day.

[2690] *Id*.

[2691] *Id*.

[2692] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 11, 2008), at p. 2 [LBEX-AM 003918].

[2693] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 7.

[2694] *Id*.

Vice President at the FRBNY, told Fuld that Barclays was interested in Lehman.[2695] Fuld called Diamond and was again told there was too much overlap.[2696]

Also on September 11, 2008, Varley informed the FSA that the Barclays board would meet that day to consider whether Barclays should approach Lehman about a possible deal.[2697] Varley told Sants that Barclays would bid for Lehman if three conditions were met: (1) there was a high degree of confidence that a deal could be completed "with the necessary support of the Federal Reserve to ensure this;" (2) there was liquidity support from the Federal Reserve; and (3) there was a discount on Lehman's net asset values.[2698] Sants responded that the FSA's review would focus on the impact any transaction structure would have on Barclays' liquidity and capital, warning that the FSA would not approve any core Tier 1 number below the minimum requirement.[2699] Later that day, Callum McCarthy, the chairman of the FSA, contacted Geithner to discuss Lehman.[2700] According to the FSA, Geithner left open the possibility of federal assistance for Lehman.[2701]

On September 12, 2008, at 9:00 a.m. in New York, the Barclays board of directors authorized its management to undertake due diligence to determine if there was an

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[2695] *Id*.
[2696] *Id*.
[2697] FSA, Statement of the FSA (Jan. 20, 2010), ¶ 8.
[2698] *Id.* ¶ 8.
[2699] *Id.* ¶ 9.
[2700] *Id.* ¶ 10.
[2701] *Id*.

opportunity for a transaction with Lehman.[2702] Barclays' management presented its board two possible acquisition scenarios; both involved transactions that valued Lehman's stock at $5 per share.[2703] Varley informed Paulson that the Barclays board was prepared to consider a possible bid for Lehman.[2704]

Paulson spoke to Alistair Darling, Chancellor of the Exchequer, on September 12, 2008.[2705] During that conversation, Paulson told Darling that the FRBNY might provide Barclays with regulatory assistance to support a transaction.[2706] During the day, discussions between the FSA and Barclays focused on quantifying the size and nature of Lehman's assets and their impact on Barclays' capital ratios.[2707] Barclays advised the FSA that it continued to seek unlimited access to the FRBNY discount window although there remained debate within the Treasury as to who should provide the funding.[2708]

On September 12, 2008, Fuld met with Diamond.[2709] At that meeting, Fuld told Diamond that Fuld would step aside if they did a deal.[2710] Barclays expressed two areas of concern about any potential deal with Lehman: long term funding and certain risky

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[2702] Transcript of deposition testimony of Robert E. Diamond, *In re Lehman Brothers Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y. Sept. 11, 2009, at p. 24:9-22.

[2703] Barclays, Long Island Transaction Overview (Sept. 12, 2008), at p. 3 [BCI-EX-(S)-00053306_000001], attached to e-mail from Richard Haworth, Barclays, to John Varley, Barclays, *et al.* (Sept. 12, 2008) [BCI-EX-(S)-00053305].

[2704] FSA, Statement of the FSA (Jan. 20, 2010), ¶ 8.

[2705] *Id.* ¶ 23.

[2706] *Id*.

[2707] *Id.* ¶ 27.

[2708] *Id*.

[2709] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 7. *See* Tom Junod, *The Deal of the Century*, Esquire Magazine, Oct. 2009, at p. 157 (placing the meeting on Friday, Sept. 12, 2008).

[2710] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 8.

assets.[2711] Barclays anticipated that the FSA would share its concerns.[2712] Between 5:10 p.m. and 6:00 p.m., Varley and Diamond had a call with Paulson and Geithner to discuss the potential deal.[2713]

Early that evening, Fuld informed the Board that Barclays recently had begun due diligence, although there had not yet been any discussion of structure or price.[2714] Fuld also informed the Board that Barclays would need stockholder approval for a transaction.[2715]

On Saturday, September 13, 2008, Lehman and Barclays discussed a potential deal that Fuld described as "life after SpinCo" because the contemplated purchase did not include Lehman's commercial real estate assets.[2716] Barclays' board had set as a condition precedent to any deal that Barclays would not take on any asset Lehman planned to put in SpinCo.[2717] Barclays' board also conditioned any deal on the FRBNY's agreement to continue to make the Primary Dealer Credit Facility ("PDCF") available to Lehman after a takeover. [2718] During the afternoon, Barclays advised the FSA that the FRBNY had asked Barclays to guarantee Lehman's obligations during the period prior

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[2711] *See* e-mail from John Varley, Barclays, to Robert E. Diamond, Barclays, *et al.* (Sept. 12, 2008) [BCI-EX-00078748].

[2712] *Id*.

[2713] *See* Henry M. Paulson Jr., Call Logs (Sept. 2008), *available at* http://www.scribd.com/doc/21221123/Too-Big-To-Fail-Paulson-Call-Logs-and-Calendar-Sept-2008.

[2714] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 12, 2008), at p. 1 [LBEX-AM 003920].

[2715] *Id*.

[2716] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 8.

[2717] FSA, Statement of the FSA (Jan. 20, 2010), ¶ 32.

[2718] *Id.* ¶ 33.

to the closing of the transaction.[2719] That guaranty would make Barclays responsible for Lehman's existing and new business even if the transaction failed.[2720] The FSA's Listing Rules required the guaranty to be approved by Barclays' shareholders.[2721] Late in the day in the United Kingdom, Varley advised Sants that because of the guaranty, it was unlikely that a deal structure could be found that would satisfy Barclays' board.[2722]

On Saturday in New York, however, Cohen, McDade and Kirk told Fuld that the approval of the FSA would not be an issue.[2723] Fuld reported to the Board on Saturday afternoon that Barclays offered to purchase the operating subsidiaries of Lehman for $3 billion and that Barclays would guarantee Lehman's debt.[2724] Lehman would receive the cash and would retain its commercial real estate assets, minority investments in hedge fund managers and limited partnership interests in Lehman-sponsored private equity funds.[2725] On Saturday night, Fuld went home thinking that Lehman had a deal with Barclays.[2726] Cleary Gottlieb Stein & Hamilton ("Cleary Gottlieb") attorney Robert Davis, who represented Barclays during the negotiations, told the Examiner that he too thought that Lehman and Barclays had reached an agreement in principle on Saturday

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[2719] *Id.* ¶ 39.
[2720] *Id*.
[2721] *Id*.
[2722] *Id*. ¶ 40.
[2723] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 8.
[2724] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 12, 2008), at p. 1 [LBEX-AM 003920].
[2725] *Id.*
[2726] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 9.

night.[2727] However, William Schlich, the audit partner for Ernst & Young, noted that as of late Saturday night, there was no deal.[2728] Schlich did not think a deal could get done absent "drastic changes" because "[t]he buyer's expectations and the resulting need of financing from the street" were too high.[2729]

On Saturday, September 13, 2008, Barclays reached out to Buffett to ask whether Buffett would guarantee Lehman's operations until a Lehman-Barclays deal closed.[2730] Barclays and Buffett discussed a scenario in which Buffett would provide $5 billion of protection. Buffett expressed interest in that possibility, but Barclays did not pursue it.[2731]

On Sunday morning in the United Kingdom, the FSA and Barclays discussed the FRBNY's requirement that Barclays guarantee Lehman's obligation.[2732] The FSA acknowledged that theoretically it could waive the shareholder approval requirement, but the FSA concluded that because no precedent existed, granting a waiver would "represent a compromise of one of the fundamental principles of the FSA's Listing Regime."[2733] During the early afternoon in the United Kingdom, Geithner called FSA

[2727] Examiner's Interview of Lindsee Granfield and Robert Davis, Mar. 10, 2009, at pp. 2-3; Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Brothers Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y. Sept. 2, 2009, at p. 14:10-15:5.

[2728] E-mail from William Schlich, Ernst & Young, to Carmine DiSibio, Ernst & Young, *et al.* (Sept. 14, 2008) [EY-LE-LBHI-KEYPERS 4908879] (updating on the status of negotiations).

[2729] *Id.*

[2730] Examiner's Interview of Warren E. Buffett, Sept. 22, 2009, at pp. 4-5.

[2731] *Id*.

[2732] FSA, Statement of the FSA (Jan. 20, 2010), ¶ 43.

[2733] *Id*.

Chairman McCarthy. Geithner reiterated the FRBNY's requirement of a guaranty and suggested that the urgency of the situation required a waiver of the shareholder approval requirement.[2734] Later that afternoon, Cox also contacted McCarthy to discuss waiving the shareholder requirement. McCarthy cited the lack of precedent for such a waiver and noted that Barclays had yet to submit a formal proposal for the FSA's review of the deal.[2735] By 4:00 p.m. in the United Kingdom, Varley informed the FSA that discussions had ceased.[2736]

Lehman's management had scheduled a Board meeting for noon on Sunday, September 14, 2008, but delayed the meeting until 5:00 p.m. in order to try to come to some resolution at the FRBNY meetings.[2737] At some point on Sunday, Fuld was told that the FSA would not waive the requirement that a guaranty of Lehman's obligations required the approval of Barclays' shareholders, and therefore the FSA would not approve the Barclays deal.[2738] Fuld asked Paulson to call Prime Minister Gordon Brown, but Paulson said he could not do that.[2739] Fuld asked Paulson to ask President Bush to call Brown, but Paulson said he was working on other ideas.[2740] From that, Fuld inferred that Paulson was going to call Buffett, although Paulson never mentioned

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[2734] *Id.* ¶ 47.
[2735] *Id.* ¶ 54.
[2736] *Id.*
[2737] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 9.
[2738] *Id.*
[2739] *Id.*
[2740] *Id.*

Buffett's name.[2741] Fuld brainstormed about other means to contact and convince the FSA to permit the deal, including having Jeb Bush, a Lehman advisor, ask President Bush to call the Prime Minister.[2742]

Paulson believed that Barclays wanted to do a deal with Lehman.[2743] Indeed, Paulson noted that Barclays had asked him to speak to Alistair Darling, the United Kingdom's Chancellor of the Exchequer.[2744] Paulson placed the call on Friday, September 12, 2008. During the call, Paulson said Chancellor Darling did not mention the need for a guaranty of Lehman's debts, but said that the FSA would not reject or approve the deal. Paulson described Chancellor Darling's statement as a particularly British way of saying no.[2745]

Fuld told the Examiner that in 2009, Fuld had a conversation with Riccardo Banchetti, who had been joint-CEO of Lehman Europe.[2746] During that conversation, Banchetti told Fuld that "everyone knew that the FSA had no role in this at all" and would not have been in a position to grant an exemption.[2747]

[2741] *Id*.
[2742] *Id*. at 10.
[2743] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 20.
[2744] *Id*.
[2745] *Id*.
[2746] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 10.
[2747] *Id*.

(6) Government Communications

Between the time of Bear Stearns' near collapse in March and the end of May 2008, Fuld was in regular contact with both Paulson and Geithner. Fuld spoke with Paulson no fewer than ten times during that period.[2748] Similarly, Fuld spoke with Geithner at least eighteen times during that same period.[2749] The conversations covered numerous topics. For example, Fuld apprised Paulson of market rumors, potential transactions Lehman explored, and other general market updates.[2750] Fuld's conversations with Geithner included market updates but also addressed Lehman's capital raises, market rumors and Lehman's liquidity.[2751] Between June and the first week of September 2008 — the final week before Lehman's bankruptcy — Fuld's call logs indicate that he updated Geithner at least 23 times, and Paulson 24 times, on various issues, such as potential strategic partners, SpinCo and the market.[2752] Paulson told the Examiner that during August 2008, Paulson delegated contact with Lehman and Fuld to his deputy, Ken Wilson, so that Paulson could focus on Fannie Mae and Freddie Mac.[2753] In addition, Lehman communicated with representatives of the SEC regarding issues such as short-sellers and SpinCo.[2754]

[2748] Richard S. Fuld, Jr., Lehman, Call Logs (Mar. 15 - Sept. 15, 2008) [LBHI_SEC07940_016911].
[2749] *Id.*
[2750] *Id.*
[2751] *Id.*
[2752] *Id.*
[2753] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 15.
[2754] See *supra* Section III.A.3.c and *infra* Section III.A.3.c.6. of this Report, which discuss Lehman's communications with the Government regarding SpinCo and short sellers in greater detail.

(a) Treasury Dinner

On April 11, 2008, Fuld and Paulson both attended a G-7 dinner in Washington, D.C., and Fuld and Paulson conversed at the dinner.[2755] As Fuld left the dinner, he sent an e-mail to Russo, reporting that Fuld thought Lehman had a "huge brand with [T]reasury" and that Treasury "loved [Lehman's] capital raise."[2756] Fuld told the Examiner that he believed his e-mail accurately reflected his view of his conversations with Paulson that night.[2757] Paulson told the Examiner that he assumed that he gave Fuld "a big pat on the back" for raising capital. Paulson did not recall discussing the capital raise with Fuld at that public dinner.[2758] Fuld also walked away from the dinner believing that Paulson had a "worried view" of Merrill Lynch, implying that Paulson remained confident of Lehman.[2759] On the other hand, Paulson told the Examiner that he had become concerned about Lehman when he heard about the Archstone transaction in 2007 and that his concerns intensified after Bear Stearns' near collapse.[2760]

[2755] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 17.

[2756] E-mail from Richard S. Fuld, Jr., Lehman, to Thomas A. Russo, Lehman (Apr. 12, 2008) [LBHI_SEC07940_033997].

[2757] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 17.

[2758] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 13.

[2759] E-mail from Richard S. Fuld, Jr., Lehman, to Thomas A. Russo, Lehman (Apr. 12, 2008) [LBHI_SEC07940_033997].

[2760] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at pp. 9-10.

(b) Short Sales

Short selling is frequently mentioned as a factor in the near collapse of Bear Stearns.[2761] On March 17, 2008, the SEC proposed a "naked" short selling anti-fraud rule, Rule 10b-21.[2762] The SEC noted that although naked short selling as part of a manipulative scheme already was illegal, commentary to the proposed Rule stated that the Rule "would highlight the specific liability" of people whose deception relates to their intention or ability to deliver shares in time for settlement.[2763] The SEC sought comments to its proposed rule by May 20, 2008.

After Bear Stearns nearly collapsed, short sellers began to focus on Lehman and other banks. On March 20, 2008, Russo contacted Linda Thomsen, the SEC's Head of Enforcement, regarding rumors of hedge funds "taking another run at Lehman."[2764] On April 1, 2008, at Lehman's prompting, Erik R. Sirri, head of the SEC's CSE program, made a statement at an annual conference regarding the SEC's view of the seriousness of rumors and stock manipulation in the context of short sales.[2765] At the April 15, 2008 Board meeting, Lehman's management discussed Lehman's concerns regarding short

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[2761] *See, e.g.*, Matt Taibbi, *Wall Street's Naked Swindle*, Rolling Stone, Oct. 14, 2009.

[2762] "Naked" Short-Selling Anti-fraud Rule, 73 Fed. Reg. 15376 (proposed Mar. 17, 2008) (to be codified at 17 C.F. R. § 240), *available at* http://www.sec.gov/rules/proposed/2008/34-57511.pdf.

[2763] *Id*.

[2764] E-mail from Thomas A. Russo, Lehman, to Richard S. Fuld, Jr., Lehman, *et al.* (Mar. 20, 2008) [LBHI_SEC07940_212208] (forwarding discussion with SEC regarding short sellers).

[2765] *See* e-mail from Thomas A. Russo, Lehman, to Richard S. Fuld, Jr., Lehman, *et al.* (Apr. 1, 2008) [LBHI_SEC07940_033699] (reporting Erik Sirri's statement regarding the SEC's view of short selling in the context of market manipulation).

selling.[2766] On May 21, 2008, at the Ira Sohn Conference, one day after the comment period for the SEC's proposed rule concluded, Einhorn gave a presentation on Lehman, analyzing Lehman's Form 10-Q, filed April 9, 2008.[2767] Einhorn announced that he was shorting Lehman's stock based on his belief that the stock was over-valued.[2768]

Before that presentation, Einhorn had corresponded with Callan in mid-May 2008, as part of what he described as fact-checking in advance of his presentation at the Ira Sohn Conference.[2769] Einhorn focused on four major issues in his correspondence with Callan and in his May 21, 2008 speech: (1) Lehman's disclosures regarding CDO exposure and related write-downs; (2) the difference between the amount of Level III assets disclosed in the Form 10-Q filed in February 2008 and during Lehman's first quarter 2008 earnings call; (3) Lehman's disclosure and valuation of its stake in KSK Energy; and (4) Lehman's write downs of its CMBS assets.[2770] On the day of Einhorn's speech, Lehman's stock closed down $2.44, with its highest volume of the entire month

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[2766] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Apr. 15, 2008), at p. 8 [LBEX-AM 003654].

[2767] David Einhorn, Greenlight Capital, Accounting Ingenuity, speech at Ira W. Sohn Investment Research Conference (May 21, 2008) [LBHI_SEC07940_336846].

[2768] *Id*.

[2769] *See* e-mail from David Einhorn, Greenlight Capital, to Erin M. Callan, Lehman (May 20, 2008) [LBHI_SEC07940_098608].

[2770] *Id.*; *see also* e-mail from Eric Felder, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (May 21, 2008) [LBHI_SEC07940_336795] (Felder e-mail reporting on Einhorn's speech).

of May 2008. Einhorn's criticism of Lehman and Callan is commonly cited as the reason for Callan's replacement less than three weeks later.[2771]

Following the near collapse of Bear Stearns, Einhorn published a book, *Fooling Some of the People All of the Time*, which focused on Allied Capital. Thomas C. Baxter, Jr., General Counsel to the FRBNY, said that reading Einhorn's book made him think that the FRBNY should pay more attention to short sellers' concerns.[2772] However, Baxter did not reach that conclusion for the reason that Lehman would have wanted, namely to persuade the Government to regulate short sellers, but rather because it appeared to Baxter that Einhorn may have been shorting Lehman for good cause. Baxter was unable to say, however, whether anyone at the Federal Reserve followed up on Einhorn's criticism of Lehman in his speech.[2773]

Between March 20, 2008 and July 17, 2008, Lehman sent the SEC, as well as the FRBNY, more than twenty complaints about rumors and short sellers.[2774] On July 15, 2008, the SEC issued a short-term rule prohibiting short sales. That rule expired on July

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[2771] Examiner's Interview of John F. Akers, Apr. 22, 2009, at p. 8; Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 9; Examiner's Interview of Michael L. Ainslie, Sept. 22, 2009, at p. 5.

[2772] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at pp. 7-8.

[2773] *Id*.

[2774] *See, e.g.*, e-mail from Thomas A. Russo, Lehman, to Terrence J. Checki, FRBNY (July 17, 2008) [LBEX-AM 057718]; e-mail from Beth Rudofker, Lehman, to Israel Friedman, SEC, *et al.* (June 17, 2008) [LBEX-WGM 1142544]; e-mail from Beth Rudofker, Lehman, to Laura Vecchio, Lehman (May 27, 2008) [LBEX-WGM 648855] (forwarding e-mail sent to the SEC regarding Einhorn and rumors); e-mail from Thomas A. Russo, Lehman, to Richard S. Fuld, Jr., Lehman, *et al.* (Mar. 20, 2008) [LBHI_SEC07940_212208] (forwarding discussion with SEC regarding short sellers); e-mail from William Brodows, FRBNY, to Timothy F. Geithner, FRBNY, *et al.* (July 10, 2008) [FRBNY to Exam. 026728]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (July 14, 2008), at p. 2 [LBEX-AM 003837].

29, 2008.[2775] More than two months later, the SEC responded to the massive disruptions in the market by issuing Rule 10b-21, which became effective on October 17, 2008.[2776] The rule specifically prohibited traders from deceiving brokers about the source of shares that would be used to repurchase shares sold short, if the trader failed to deliver the security when due.[2777]

(c) Possibility of Federal Assistance

Since Lehman's bankruptcy, Paulson repeatedly has said that he never gave Lehman reason to believe that it would receive a bailout in the event it became necessary. In a July 2, 2008 speech at Chatham House in London, titled "The U.S., The World Economy and Markets," Paulson noted that "[b]ankruptcy [can] impose[] market discipline on creditors" but that "in a time of crisis, [bankruptcy] could involve undue market disruption."[2778] After reviewing Paulson's remarks, Felder remarked in a contemporaneous e-mail that it appeared that Paulson was "trying to set the stage" to close the PDCF but wanted to "have a plan in place in case there is an investment bank that fails" after the PCDF closed.[2779] Paulson told the Examiner that he believed that he

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[2775] SEC, Press Release, *SEC Enhances Investor Protections Against Naked Short Selling* (July 15, 2008), *available at* http://sec.gov/news/press/2008/2008-143.htm.

[2776] SEC, "Naked" Short Selling Antifraud Rule (Oct. 14, 2008) (codifying 17 C.F.R. § 242.10b-21), *available at* http://sec.gov/rules/final/2008/34-58774.pdf.

[2777] *Id*.

[2778] U.S. Department of Treasury, Henry M. Paulson, Jr., Remarks by U.S. Treasury Secretary on the U.S. The World Economy and Markets speech before the Chatham House (July 2, 2008), *available at* http://www.treas.gov/press/releases/ht1064.htm.

[2779] E-mail from Eric Felder, Lehman, to Ian T. Lowitt, Lehman, *et al.* (July 2, 2008) [LBEX-DOCID 067106].

may have discussed the possibility of bankruptcy with Fuld in July 2008.[2780] Paulson told the Examiner that, at the very least, he made clear to Fuld that the Government would not provide a bailout for Lehman.[2781] On the other hand, Fuld told the Examiner that while Paulson never gave him any assurance or reason to believe that the Government would provide assistance, Paulson also never said anything that ruled out the possibility of Government assistance.[2782]

A September 11, 2008 discussion between Geithner and Fuld may have played a role in leading Fuld to believe that a federal bailout was possible. On Thursday, September 11, Baxter called Russo and suggested that Fuld step down from the Board of the FRBNY.[2783] Fuld told the Examiner that after Russo told Fuld about the conversation, Fuld called Geithner.[2784] Geithner asked Fuld to step down from the Board "in case we have to do something for you or with you this weekend."[2785] Geithner told the Examiner that he could not recall making the statement, but he was certain he was careful not to imply that Lehman could expect the Federal Reserve's support.[2786] Fuld reported that he walked away from his conversation with Geithner

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[2780] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at pp. 14-15.

[2781] *Id*.

[2782] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 11; Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 21.

[2783] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 11; Examiner's Interview of Thomas Baxter, Jr., Aug. 31, 2009.

[2784] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 11.

[2785] *Id*.

[2786] Examiner's Interview of Treasury Secretary Timothy F. Geithner, Nov. 24, 2009, at p. 9.

with the feeling that, if it came down to it, the FRBNY and Geithner would be there for Lehman.[2787] A FRBNY meeting agenda dated September 10, 2008 also suggests that a FRBNY representative was contemplating providing public funds for Lehman at the time of the September 11, 2008 conversation between Geithner and Fuld.[2788]

(7) Lehman's Bankruptcy Planning

In August 2008, as the magnitude of third quarter losses became clear, Steven Berkenfeld, Head of Lehman's Legal, Compliance and Audit Division, became concerned about the possibility of a Lehman bankruptcy.[2789] Berkenfeld spoke to Russo about hiring bankruptcy counsel to begin initial preparations as a precaution.[2790] Russo refused that suggestion because he worried that a leak would turn bankruptcy planning into a self-fulfilling prophecy.[2791]

Public reports imply that no bankruptcy work was done prior to September 14, 2008. That is not accurate. On September 10, 2008, after Fannie Mae and Freddie Mac failed, Berkenfeld called Stephen J. Dannhauser, the chairman of Weil, Gotshal &

[2787] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 11.

[2788] *See* FRBNY, Liquidation Consortium (Sept. 10, 2008) [FRBNY to Exam. 003517], attached to e-mail from Michael Nelson, FRBNY, to Christine Cumming, FRBNY, *et al.* (Sept. 10, 2008) [FRBNY to Exam 003516]. *Accord* Examiner's Interview of William Brodows, Aug. 20, 2009, at p. 6; Examiner's Interview of Jan H. Voigts, Aug. 25, 2009.

[2789] Examiner's Interviews of Steven Berkenfeld, Oct. 5 and 7, 2009, at p. 21. See Appendix 15 to the Report which provides a chronological discussion of Lehman's pre-bankruptcy planning.

[2790] *Id*.

[2791] *Id*.

Manges LLP ("Weil"), to begin work toward a possible bankruptcy filing.[2792] Berkenfeld had not obtained any internal authorization to make that call.[2793] Russo was not pleased to hear about Berkenfeld's call to Weil, because Russo was concerned about a leak and believed that bankruptcy was not a possibility.[2794] Harvey R. Miller, the chairman of Weil's bankruptcy department, first billed time to Lehman bankruptcy preparation on September 10, 2008.[2795]

On Thursday, September 11, 2008, Weil attorneys began preparing the documents necessary to file a Chapter 11 petition, including attendant motions, resolutions, and affidavits.[2796] Weil's work continued through the weekend.[2797]

On Friday, September 12, 2008, published reports cited an anonymous Treasury source as saying that Paulson had ruled out the possibility of any Government financial assistance to Lehman.[2798] Paulson confirmed to the Examiner that, as of September 12, 2008, the Treasury did not plan to offer support to Lehman.[2799] That same day, Mark J. Shapiro, Lehman's co-head of restructuring, approached Russo about establishing a

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[2792] *See* Weil, Gotshal & Manges LLP, Time Records (Sept. 10, 2008), at p. 1 [LBEX-WGM 1146447]. *Accord* Examiner's Interviews of Steven Berkenfeld, Oct. 5 and 7, 2009, at p. 21.
[2793] Examiner's Interviews of Steven Berkenfeld, Oct. 5 and 7, 2009, at p. 21.
[2794] Examiner's Interview of Thomas A. Russo, May 11, 2009, at pp. 9-10.
[2795] Weil, Gotshal & Manges LLP, Time Records (Sept. 10, 2008), at p. 1 [LBEX-WGM 1146447].
[2796] *Id*. at pp. 1, 5, 7, 10, 14, 15, 17 and 19.
[2797] *Id.* at pp. 1-20.
[2798] *See, e.g.*, Anita Raghavan, *Paulson Brothers on Either Side of Lehman Divide*, Forbes, Sept. 12, 2008.
[2799] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 16.

bankruptcy-remote trust for employee medical costs and taxes.[2800] Russo was hesitant, again due to a concern that any preparations for a bankruptcy would become a self-fulfilling prophecy, but Russo deferred to experts such as Shapiro, who were familiar with bankruptcy-related issues.[2801] As soon as Russo became aware of Weil's work, he informed the Board.[2802] As a result, Miller was invited to make a presentation at the telephonic September 12, 2008 Board meeting.[2803] Although Miller does not recall being physically present at a Board meeting until Sunday, September 14, 2008, Lehman's Board minutes indicate that Miller advised the Board on Friday, September 12, 2008, that "bankruptcy would be a very bad option" under the circumstances.[2804]

At a late afternoon meeting on September 12, 2008, Russo reported to the Board that "the Federal Reserve is interested in helping to facilitate an orderly wind-down and *avoid a bankruptcy*."[2805] Grundhofer and Kaufman told the Examiner that they were concerned about the systemic risk if the Government allowed Lehman to fail.[2806] Grundhofer believed that Lehman was too big and systemically important to fail and

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[2800] *See* Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 13, 2008), at p. 2 [LBEX-AM 003927-28]. *Accord* Examiner's Interview of Thomas A. Russo, May 11, 2009, at p. 10.

[2801] Examiner's Interview of Thomas A. Russo, May 11, 2009, at p. 10.

[2802] *Id*.

[2803] *See* Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 12, 2008), at p. 2 [LBEX-AM 003920].

[2804] *Id*.; Examiner's Interview of Harvey R. Miller, Apr. 23, 2009, at p. 5.

[2805] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 12, 2008), at p. 2 [LBEX-AM 003920] (emphasis added).

[2806] Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 15; Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at p. 20.

that Lehman's failure would have global consequences.[2807] Akers did not expect the Federal Reserve to abandon Lehman, because, according to Akers, Fuld had told the Board that the Federal Reserve would assist Lehman.[2808]

On Friday evening, Miller received a call from James L. Bromley, an attorney at the law firm Cleary Gottlieb, which represented the Federal Reserve, requesting a meeting.[2809] Bromley expressed no urgency to meet that night. [2810]

At the noon Saturday, September 13, 2008 Board meeting, Russo stated that "the Federal Reserve believes that any bankruptcy filing by the Firm would be extremely disruptive."[2811] Late Saturday morning or early that afternoon, Weil attorneys Miller, Lori R. Fife and Shai Y. Waisman met with six or seven Federal Reserve officials and Bromley.[2812]

By the morning of Sunday, September 14, 2008, the FSA made clear that it would not waive the shareholder vote requirement, killing the Barclays deal.[2813] After the Barclays deal fell apart, Paulson told Fuld that Paulson was continuing to work on some other things.[2814] By the early afternoon of Sunday, September 14, 2008, Miller learned

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[2807] Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 15.
[2808] Examiner's Interview of John F. Akers, Apr. 22, 2009, at p. 12.
[2809] Examiner's Interview of Harvey R. Miller, Apr. 23, 2009, at p. 6.
[2810] *Id*.
[2811] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 13, 2008), at p. 2 [LBEX-AM 003927].
[2812] Examiner's Interview of Harvey R. Miller, Apr. 23, 2009, at p. 6.
[2813] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at pp. 9-10.
[2814] *Id.* at p. 9.

that things were not going well for Lehman at the FRBNY.[2815] Weil attorneys Miller, Fife, Dannhauser and Thomas A. Roberts went to the FRBNY to represent Lehman.[2816] On the way to the FRBNY meeting, Roberts received a call from another Weil partner saying that Citibank had been told that Lehman was being liquidated and was requesting that Weil represent Citibank.[2817]

On September 14, 2008, the Federal Reserve issued a press release stating that "[t]he collateral eligible to be pledged at the Primary Dealer Credit Facility ("PDCF") has been broadened to closely match the types of collateral that can be pledged in the tri-party repo systems of the two major clearing banks."[2818] Upon learning of the expansion of the PDCF window, Lowitt and Fuld initially believed that Lehman's problem was solved and that Lehman would be able to open in Europe by borrowing from the PDCF.[2819] However, Lehman soon learned that it was not eligible to use the window.[2820] The FRBNY limited the collateral LBI could use for overnight financing to the collateral that was in LBI's box at JPMorgan as of Friday, September 12, 2008.[2821] That restriction was referred to as the "Friday criteri[on]."[2822]

[2815] Examiner's Interview of Harvey R. Miller, Apr. 23, 2009, at p. 7.

[2816] *Id*.

[2817] *Id*.

[2818] Federal Reserve, Press Release (Sept. 14, 2008), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20080914a.htm, Sept. 14, 2008, last visited, May 26, 2009.

[2819] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 13.

[2820] *Id*.

[2821] Examiner's Interview of Robert Azerad, Apr. 20, 2009, at p. 5; Examiner's Interview of Christopher Burke, July 7, 2009, at p. 3. An experimental allocation by Lehman to the PDCF on Monday morning

Fuld told the Examiner that on Sunday afternoon, Sirri, head of the SEC's Trading and Markets Division, called Fuld and asked him to "promise [Sirri] one thing," which was that Lehman would not file for bankruptcy protection.[2823] Not long after that conversation with Sirri, McDade called Fuld from the meeting at the FRBNY to tell him that "the Fed has just mandated that we file for bankruptcy."[2824] At the FRBNY, Baxter said that Lehman needed to file by midnight that night.[2825] Miller asked why and objected that it could not happen by midnight.[2826] He said that a Lehman bankruptcy would "bring great destabilization in the market," "bring trading to a halt," and result in "Armageddon."[2827] In response, the Government representatives told the Lehman representatives that it was decided and there were cars available to return them to Lehman's building.[2828]

After Lehman's executives returned from the meeting at the Federal Reserve, the Board meeting resumed and discussed "the Fed's direct and authoritative statements

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showed at least $72 billion of eligible Lehman securities being swept into the PDCF system. *See* e-mail from John N. Palchynsky, Lehman, to Craig L. Jones, Lehman *et al.* (Sept. 15, 2008) [LBEX-DOCID 076981]; s*ee also* Lehman, PDCF Schedule of Eligible Securities (Sept. 14, 2008) [LBEX-DOCID 405695].

[2822] Examiner's Interview of Robert Azerad, Apr. 20, 2009, at p. 5; Examiner's Interview of Christopher Burke, July 7, 2009, at p. 3. According to Azerad, this restriction prevented Lehman from posting the range of collateral to the PDCF that other firms were allowed to post after September 15, 2008. Examiner's Interview of Robert Azerad, Apr. 20, 2009, at p. 5; s*ee also* e-mail from Timothy Lyons, Lehman, to Ian T. Lowitt, Lehman (Sept. 14, 2008) [LBEX-DOCID 070210] (stating "the fed is letting the other eighteen broker dealers fund a much broader range of collateral than us").

[2823] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 12.

[2824] *Id*. at p. 13.

[2825] Examiner's Interview of Harvey R. Miller, Apr. 23, 2009, at p. 7.

[2826] *Id*.

[2827] *Id*.

[2828] *Id.* at p. 8.

that they wanted the Corporation to file under Chapter 11 that evening."[2829] During the meeting, Cox, Baxter, Brian G. Cartwright (SEC General Counsel) and Alan L. Beller (a Cleary Gottlieb partner who represented the Federal Reserve and SEC) called in and asked to speak with the Board.[2830] In response to questions from Board members regarding the necessity of filing, "Mr. Beller stated that the view of the regulators as to the appropriateness of a bankruptcy filing was expressed at the meeting with the Federal Reserve that afternoon, but that the callers did not want to influence the Board's exercise of its fiduciary duties."[2831] According to Baxter, the purpose of the call was to emphasize that a bankruptcy filing by LBHI "made sense" but that the ultimate decision was for the Board.[2832] Further, Baxter told the Examiner that he made the point "that opening on Monday was not an option because of the chaos in the markets."[2833]

The Board's initial reaction to the Government's call was "anger."[2834] Nonetheless, the Board discussed the advantages and disadvantages of a bankruptcy filing.[2835] The Board discussed whether a delay in filing would allow time better to plan

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[2829] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 14, 2008), at p. 3 [LBEX-AM 003932].
[2830] *Id.* at p. 4.
[2831] *Id*. at pp. 4-5.
[2832] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 11.
[2833] *Id*.
[2834] Examiner's Interview of John F. Akers, Apr. 22, 2009, at pp. 13-14; Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 16.
[2835] *See* Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 14, 2008), at p. 5 [LBEX-AM 003932].

and prepare Lehman to operate under Chapter 11 and prepare a more complete filing.[2836]

Lehman's bankruptcy counsel, Miller, said that he did not think the rushed filing had an adverse impact on the estate.[2837] On the other hand, Alvarez and Marsal later asserted that as much as $75 billion in value was destroyed by the form of Lehman's bankruptcy.[2838] For example, Bryan P. Marsal told the Examiner that the bankruptcy resulted in the loss of 70% of $48 billion of receivables from derivatives that could otherwise have been unwound.[2839]

One important consideration for the Board was the anticipated difficulty Lehman would have meeting payment obligations on Monday.[2840] The Board questioned whether a substantial amount of the collateral pledged to JPMorgan could be recovered prior to filing.[2841] The Board also noted the clear preference of the Government that Lehman file that night, the Federal Reserve's unwillingness to finance Lehman and the ultimate inevitability of a bankruptcy filing under the circumstances.[2842] Kaufman was a

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[2836] *Id.*

[2837] Examiner's Interview of Harvey R. Miller, Apr. 23, 2009, at p. 9. Miller did concede that more advance notice and planning could have avoided JPMorgan taking approximately $500 million in collateral. Miller also said that more value could have been received by liquidating contracts in a more orderly fashion. *Id.*

[2838] Jeffrey McCracken, *Lehman's Chaotic Bankruptcy Filing Destroyed Billions in Value*, Wall St. J. (Dec. 29, 2008), at A10.

[2839] Examiner's Interview of Bryan P. Marsal, Dec. 14, 2009, at p. 2.

[2840] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 14, 2008), at p. 5 [LBEX-AM 003932].

[2841] *Id.*

[2842] *Id.*

proponent of "calling the Government's bluff" by opening on Monday,[2843] but the Board concluded that filing for bankruptcy immediately was the appropriate course of action.[2844]

After discussion, the Board unanimously resolved to file for bankruptcy protection under Chapter 11 of the Bankruptcy Code.[2845] Weil began filing around 1:30 a.m. on Monday, September 15, 2008.[2846]

[2843] Examiner's Interview of Henry Kaufman, Sept. 2, 2009, at p. 19; Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 16.

[2844] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 14, 2008), at p. 5 [LBEX-AM 003932].

[2845] *Id.*

[2846] Examiner's Interview of Harvey R. Miller, Apr. 23, 2009, at p. 9.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	Chapter 11 Case No.
LEHMAN BROTHERS HOLDINGS INC., *et al.*,	:	08-13555 (JMP)
	:	(Jointly Administered)
Debtors.	:	

REPORT OF ANTON R. VALUKAS, EXAMINER

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March 11, 2010

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Section III.A.4: Repo 105

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4. Repo 105

a) Repo 105 – Executive Summary

Lehman employed off-balance sheet devices, known within Lehman as "Repo 105" and "Repo 108" transactions, to temporarily remove securities inventory from its balance sheet, usually for a period of seven to ten days, and to create a materially misleading picture of the firm's financial condition in late 2007 and 2008.[2847] Repo 105 transactions were nearly identical to standard repurchase and resale ("repo") transactions that Lehman (and other investment banks) used to secure short-term financing, with a critical difference: Lehman accounted for Repo 105 transactions as "sales" as opposed to financing transactions based upon the overcollateralization or higher than normal haircut in a Repo 105 transaction.[2848] By recharacterizing the Repo 105 transaction as a "sale," Lehman removed the inventory from its balance sheet.[2849]

[2847] Unless otherwise noted, the Report uses the term "Repo 105" to refer to both Repo 105 and Repo 108 transactions. Lehman treated the two transactions identically under the same internal accounting policy and both transactions shared the same anatomy. They differed only in that Repo 105 transactions utilized fixed income securities and required a minimum five percent overcollateralization amount (*i.e.*, a minimum of $105 worth of securities in exchange for $100 cash borrowed) while Repo 108 transactions utilized equities securities and required a minimum eight percent overcollateralization amount (*i.e.*, a minimum of $108 worth of securities in exchange for $100 cash borrowed).

[2848] Sale and repurchase agreements ("repos") are agreements where one party transfers an asset or security to another party as collateral for a short-term borrowing of cash, while simultaneously agreeing to repay the cash and take back the collateral at a specific point in time. When the repo transaction matures, the borrower repays the funds plus an agreed upon interest rate and takes back its collateral. As explained in Section III.A.4.d.2.c of the Report, overcollateralization amounts, or haircuts, in Repo 105 transactions were higher than the typical haircut applied to ordinary repos using similar securities.

[2849] Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Feb. 13, 2008), at p. 2 [LBEX-DOCID 3213297]; ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Financial Accounting Standards No. 140, ¶¶ 2, 98 (Fin. Accounting Standards Bd. 2000) ("SFAS 140"). The accounting for a Repo 105 transaction began with the

Lehman regularly increased its use of Repo 105 transactions in the days prior to reporting periods to reduce its publicly reported net leverage and balance sheet.[2850] Lehman's periodic reports did not disclose the cash borrowing from the Repo 105 transaction – *i.e.*, although Lehman had in effect borrowed tens of billions of dollars in these transactions, Lehman did not disclose the known obligation to repay the debt.[2851] Lehman used the cash from the Repo 105 transaction to pay down other liabilities, thereby reducing both the total liabilities and the total assets reported on its balance sheet and lowering its leverage ratios.[2852] Thus, Lehman's Repo 105 practice consisted of a two-step process: (1) undertaking Repo 105 transactions followed by (2) the use of

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same entries as an ordinary repo; additional entries were then made to recharacterize the Repo 105 from a secured financing to a sale of an inventory security.

[2850] *See* Sections III.A.4.f.2–4 and III.A.4.g.2 of this Report.

[2851] *See* Sections III.A.4.d.2.d and III.A.4.j.2.c of this Report.

[2852] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 7 (stating that incoming cash from Repo 105 transactions was used to pay business expenses); Examiner's Interview of Edward Grieb, Oct. 2, 2009, at pp. 13-14 (stating that cash received in Repo 105 transactions was used to pay off other liabilities); Examiner's Interview of Matthew Lee, July 1, 2009, at p. 14 (explaining that in order for Lehman to realize the benefit to its leverage ratios as a result of Repo 105 transactions, the firm had to use the cash received to pay off a different liability); e-mail from Anuraj Bismal, Lehman, to Marie Stewart, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223384] (stating the effect of Repo 105 on net leverage ratio, which could only be impacted if Lehman used Repo 105 cash to pay down different liabilities). Given that Lehman undertook $38.6 billion, $49.1 billion, and $50.38 billion of Repo 105 transactions at quarter-end fourth quarter 2007, first quarter 2008, and second quarter 2008, respectively, Lehman's disclosures of its cash holdings at each quarter-end further strengthens the witness statements and other evidence that Lehman used the Repo 105 cash borrowing for other business purposes, including to pay down other short-term liabilities. *See* Lehman Brothers Holdings Inc., Annual Report for 2007 as of Nov. 30, 2007 (Form 10-K) (filed on Jan. 29, 2008), at p. 86 ("LBHI 2007 10-K") (reporting that Lehman had $7.286 billion in cash and cash equivalents on November 30, 2007); Lehman Brothers Holdings Inc., Quarterly Report as of Feb. 29, 2008 (Form 10-Q) (filed on Apr. 9, 2008), at p. 5 ("LBHI 10-Q (filed Apr. 9, 2008)") (reporting that Lehman had $7.564 billion in cash and cash equivalents on February 29, 2008); Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2008 (Form 10-Q) (filed on July 10, 2008), at p. 5 ("LBHI 10-Q (filed July 10, 2008)") (reporting that Lehman had $6.513 billion in cash and cash equivalents on May 31, 2008). While Lehman's Repo 105 transactions spiked at quarter-ends, Lehman's ordinary repo balances dropped off significantly during the same time periods. *See* Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 5.

Repo 105 cash borrowings to pay down liabilities, thereby reducing leverage. A few days after the new quarter began, Lehman would borrow the necessary funds to repay the cash borrowing plus interest, repurchase the securities, and restore the assets to its balance sheet.[2853]

Lehman never publicly disclosed its use of Repo 105 transactions, its accounting treatment for these transactions, the considerable escalation of its total Repo 105 usage in late 2007 and into 2008, or the material impact these transactions had on the firm's publicly reported net leverage ratio.[2854] According to former Global Financial Controller Martin Kelly, a careful review of Lehman's Forms 10-K and 10-Q would not reveal

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[2853] Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 4; *see also* Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Feb. 13, 2008), at p. 2 [LBEX-DOCID 3213297].

[2854] Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 15; Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 9; Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 14; Examiner's Interview of Matthew Lee, July 1, 2009, at p. 15; *see also* Sections III.A.4.f.1 and III.A.4.j.2.c–d of this Report (discussing Lehman's Forms 10-K and 10-Q). In its Forms 10-K and 10-Q, Lehman defined its "net leverage ratio" as net assets divided by tangible equity capital. Lehman defined net assets as total assets excluding: (1) cash and securities segregated and on deposit for regulatory and other purposes; (2) securities received as collateral; (3) securities purchases under agreements to resell; (4) securities borrowed; and (5) identifiable intangible assets and goodwill. LBHI 2007 10-K, at p. 63; LBHI 10-Q (filed Apr. 9, 2008), at p. 72; LBHI 10-Q (filed July 10, 2008), at p. 88. Lehman calculated tangible equity capital by including stockholders' equity and junior subordinated notes and excluding identifiable intangible assets and goodwill. *See* LBHI 2007 10-K (Nov. 30, 2007), at p. 63; LBHI 10-Q (filed Apr. 9, 2008), at p. 72; LBHI 10-Q (filed July 10, 2008), at p. 88. In contrast, Lehman's "leverage ratio" was generally computed by simply dividing total assets by stockholders' equity. The Examiner's conclusion that Lehman never disclosed its Repo 105 practice was confirmed by several Lehman witnesses, including two former Global Financial Controllers who oversaw the preparation of the Forms 10-K and 10-Q. Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 9; Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 14.; *see also* Section III.A.4.j.2 of this Report, *infra* (containing Examiner's analysis of Lehman's Form 10-K and Form 10-Q disclosures). This Report does not reach the question whether Lehman's Repo 105 transactions technically complied with the relevant financial accounting standard, SFAS 140. As set forth below, the answer to that question does not impact whether there is sufficient evidence to support a colorable claim regarding Lehman's failure to disclose its Repo 105 practice and whether that failure rendered the firm's periodic reports materially misleading.

Lehman's use of Repo 105 transactions.[2855] Lehman failed to disclose its Repo 105 practice even though Kelly believed "that the only purpose or motive for the transactions was reduction in balance sheet;" felt that "there was no substance to the transactions;" and expressed concerns with Lehman's Repo 105 program to two consecutive Lehman Chief Financial Officers – Erin Callan and Ian Lowitt – advising them that the lack of economic substance to Repo 105 transactions meant "reputational risk" to Lehman if the firm's use of the transactions became known to the public.[2856] In addition to its material omissions, Lehman affirmatively misrepresented in its financial statements that the firm treated all repo transactions as financing transactions – *i.e.*, not sales – for financial reporting purposes.[2857]

Starting in mid-2007, Lehman faced a crisis: market observers began demanding that investment banks reduce their leverage.[2858] The inability to reduce leverage could lead to a ratings downgrade, which would have had an immediate, tangible monetary impact on Lehman.[2859] In a September 2007 e-mail comparing Lehman's net leverage

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[2855] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 9.

[2856] *Id.* at pp. 7-10.

[2857] The Notes to Lehman's Consolidated Financial Statements for each period stated that Lehman treated "[r]epurchase and resale agreements" as "collateralized agreements and financings for financial reporting purposes." *See* LBHI 2007 10-K, at p. 97; LBHI 10-Q (filed Apr. 9, 2008), at p. 13; LBHI 10-Q (filed July 10, 2008), at p. 16. The Notes further stated that "Other secured borrowings principally reflect transfers accounted for as financings rather than sales under SFAS 140." LBHI 2007 10-K, at p. 97; LBHI 10-Q (filed Apr. 9, 2008), at p. 13; LBHI 10-Q (filed July 10, 2008), at p. 16.

[2858] Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at pp. 5-6; Mark Jickling, Averting Financial Crisis, CRS Report for Congress, at 7-9 (Mar. 10, 2008, updated on Oct. 8, 2008).

[2859] A downgrade in an issuer's credit rating has a significant negative impact on the financial position of a company like Lehman. *See*, *e.g.*, e-mail from Ian T. Lowitt, Lehman, to Herbert H. (Bart) McDade III,

ratio to Bear Stearns', Paolo Tonucci, Lehman's Global Treasurer, wrote that Lehman's net leverage calculation "was intended to reflect the methodology employed by S&P who were most interested and focused on leverage."[2860] In mid-to-late 2007, top Lehman executives from across the firm felt pressure to reduce the firm's leverage for quarterly and annual reports.[2861] In response to Tonucci's September 2007 e-mail, Ryan Traversari, Senior Vice President for External Reporting, wrote that the "question" of net leverage ratio "has come up multiple times in the 20 seconds that I've been here – largely from [then-CFO] O'Meara, Freidheim, Lowitt, Corporate Strategy, Investor Relations and the like."[2862]

By January 2008, Lehman CEO Fuld ordered a firm-wide deleveraging strategy, hoping to reduce the firm's positions in commercial and residential real estate and

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Lehman (June 30, 2008) [LBHI_SEC07940_643543] ("One notch downgrade requires 1.7 bn; and 2 notch requires 3.4 bn of additional margin posting."). Counterparties may respond to a downgrade by demanding that the issuer post additional cash collateral to secure its obligations. *See* Amadou N.R. Sy, The Systemic Regulation of Credit Rating Agencies and Rated Markets 8-9 (Int'l Monetary Fund, Working Paper, 2009) (noting that broker-dealers may use credit ratings to determine acceptable counterparties, as well as collateral levels for outstanding credit exposure); e-mail from Ian T. Lowitt, Lehman, to Eric Felder, Lehman (July 5, 2008) [LBEX-DOCID 071263] (stating that a downgrade "will affect lines and willingness of counterparties to fund secured"). Some of Lehman's derivative contracts had built-in "triggers" permitting counterparties to require additional cash collateral in the event of a downgrade. *See also* Lehman, Global Treasury Downgrade Effect on Cash Capital Facilities (June 3, 2008) [LBHI_SEC07940_513314] (attached to e-mail from Amberish Ratanghayra, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (June 3, 2008) [LBHI_SEC07940_513312]); *see also* Appendix 13, Survival, at pp. 1-3.

[2860] E-mail from Paolo R. Tonucci, Lehman, to Marie Stewart, Lehman, *et al.* (Sept. 10, 2007) [LBEX-DOCID 1695576].

[2861] E-mail from Ian T. Lowitt, Lehman, to Gerard Reilly, Lehman, *et al.* (Sept. 7, 2007) [LBEX-DOCID 1357178]; e-mail from Ryan Traversari, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Sept. 11, 2007) [LBEX-DOCID 1695576]; *see* Sections III.A.4.e.1–3, 6 of this Report (discussing importance of net leverage for public perception of Lehman and for reporting purposes)

[2862] E-mail from Ryan Traversari, Lehman, to Paolo R. Tonucci, Lehman (Sept. 11, 2007) [LBEX-DOCID 1695576].

leveraged loans in particular by half.[2863] In the words of one internal Lehman presentation, "Reducing leverage is necessary to remove refinancing risk and win back the confidence of the market, lenders, and investors."[2864]

Fuld recalled that Lehman had to improve its net leverage ratio by selling inventory because "there was a perception issue" with raising equity.[2865] Selling inventory, however, proved difficult in late 2007 and into 2008 because, starting in mid-2007, many of Lehman's inventory positions had grown increasingly "sticky" – *i.e.*, difficult to sell without incurring substantial losses. Moreover, selling sticky inventory at reduced prices could have led to a loss of market confidence in Lehman's valuations for inventory remaining on the firm's balance sheet since fire-sale pricing would reveal that Lehman "had a lot of air in [its] marks."[2866]

In light of these factors, Lehman relied at an increasing pace on Repo 105 transactions at each quarter-end in late 2007 and early 2008. Lehman's expansion of its Repo 105 program mitigated, in part, the adverse impact its increasingly "sticky"/illiquid inventory – comprised mostly of the leveraged loans and residential and commercial real estate positions Fuld wanted to exit – was having on the firm's

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[2863] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at pp. 26-27.

[2864] Erin Callan, Lehman, Lehman Brothers Leverage Analysis (Apr. 7, 2008), at p. 1 [LBEX-DOCID 1401225].

[2865] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 27. According to Fuld, if Lehman had raised equity, it would have improved net leverage, but would not have fixed Lehman's underlying problem. *Id.* Fuld stated that he wanted Lehman to improve its net leverage by selling assets. *Id.*

[2866] Examiner's Interview of Treasury Secretary Timothy F. Geithner, Nov. 24, 2009, at pp. 7-8.

publicly reported net leverage and net balance sheet.[2867] An early 2007 document from Lehman's archives concluding that "Repo 105 offers a low cost way to offset the balance sheet and leverage impact of current market conditions," further stated that "[e]xiting large CMBS positions in Real Estate and sub prime loans in Mortgages before quarter end would incur large losses due to the steep discounts that they would have to be offered at and carry substantial reputation risk in the market. . . . A Repo 105 increase would help avoid this without negatively impacting our leverage ratios."[2868] While Lehman did not utilize Repo 105 transactions for selling sticky inventory, the firm's expanded use of Repo 105 transactions at quarter-end impacted Lehman's publicly reported net leverage ratio.[2869]

[2867] *See* Section III.A.4.e.4 of this Report (discussing sticky inventory). The concept of "net balance sheet" is used interchangeably with "net assets" in this Report. The "net asset" calculation begins with "total assets" as reported for GAAP purposes in Lehman's Forms 10-K and 10-Q. From there, Lehman subtracted certain assets to arrive at "net assets": (i) cash and securities segregated and on deposit for regulatory and other purposes; (ii) collateralized lending agreements (*e.g.*, securities Lehman is holding as collateral for a loan made to a third-party); and (iii) identifiable intangible assets and goodwill. *See* LBHI 2007 10-K, at pp. 30, 61.

[2868] Joseph Gentile, Lehman, Proposed Repo 105/108 Target Increase for 2007 (Feb. 10, 2007), at p. 1 [LBEX-DOCID 2489498] (attached to e-mail from Joseph Gentile, Lehman, to Edward Grieb, Lehman (Feb. 10, 2007) [LBEX-DOCID 2600714]).

[2869] As discussed *infra* at pp. 843-46, Lehman attempted to move less liquid inventory into the Repo 105 program, but was unable to find willing counterparties. As discussed in Section III.A.4.d.2.a of this Report, *at the moment of* a Repo 105 transaction, Lehman reduced its inventory assets but received cash, thereby having a net neutral effect on total assets. Because Lehman did not reflect the cash borrowing on its balance sheet as a liability (as it did in ordinary repo transactions), *at the moment of* a Repo 105 transaction, the transaction also had a net neutral effect on total liabilities. Lehman, however, used the cash borrowing in Repo 105 transactions to pay different short-term liabilities, thereby reducing both total assets and total liabilities. By engaging in Repo 105 transactions and using the cash borrowings, Lehman reduced its reported leverage ratios.

In this way, 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. Notably, during Lehman's 2008 earnings calls in which it touted its leverage reduction, analysts frequently inquired about *the means* by which Lehman was reducing its leverage.[2870] Although CFO Callan told analysts that Lehman was "trying to give the group a great amount of transparency on the balance sheet," she reported that Lehman was reducing its leverage through the sale of less liquid asset categories but said nothing about the firm's use of Repo 105 transactions.[2871]

Despite the belief of Lehman personnel that none of the firm's peer investment banks still used similar accounting methods for repo transactions to arrive at their leverage numbers, *to which Lehman's reported net leverage was compared*, Lehman temporarily reduced its net balance sheet at quarter-end through its Repo 105 practice by approximately $38.6 billion in fourth quarter 2007, $49.1 billion in first quarter 2008, and $50.38 billion in second quarter 2008.[2872]

[2870] *See* Section III.A.4.e.6 of this Report.

[2871] *See* Final Transcript of Lehman Brothers Holdings Inc. First Quarter 2008 Earnings Call (Mar. 18, 2008), at p. 13 [LBHI_SEC07940_7277784]; *see also* Final Transcript of Lehman Brothers Holdings Inc. Fourth Quarter 2007 Earnings Call (Dec. 13, 2007), at p. 7 [LBHI_SEC07940_7222291]; Transcript of Lehman Brothers Holdings Inc. Preliminary Second Quarter 2008 Earnings Call (June 9, 2008), at pp. 3-4, 12 [LBHI_SEC07940_2554480].

[2872] Numerous Lehman witnesses and internal Lehman e-mails stated that by December 2007, Lehman personnel believed that Lehman was the last of its peer investment banks to use Repo 105-type transactions. The Examiner has not verified whether other CSE firms at one time used this type of transaction but later ceased. Martin Kelly (former Global Financial Controller), Anuraj Bismal (former Senior Vice President Balance Sheet Group), Marie Stewart (former Global Head of Accounting Policy), and Michael McGarvey (FID Finance) said that they believed Lehman was the only CSE firm engaging in

Lehman first introduced its Repo 105 program in approximately 2001.[2873] Unable to find a United States law firm that would provide it with an opinion letter permitting the true sale accounting treatment under United States law, Lehman conducted its Repo 105 program under the aegis of an opinion letter the Linklaters law firm in London wrote for LBIE, Lehman's European broker-dealer in London, under English law.[2874] Accordingly, if United States-based Lehman entities such as LBI and LBSF wished to engage in a Repo 105 transaction, they transferred their securities inventory to LBIE in order for LBIE to conduct the transaction on their behalf.[2875]

While not referenced or incorporated into Lehman's internal Repo 105 Accounting Policy, senior Lehman management set limits on the total amount by which

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Repo 105-type transactions by late 2007. Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 14; Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 11; Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 7; Examiner's Interview of Martin Kelly, Oct. 2, 2009, at p. 8. In a December 2007 e-mail, Bismal wrote: "[W]as chatting with ex-lehman employee [Carlos Lo] at Merrill yesterday - he is in their balance sheet group - he told me that they do not use repo 105," to which Marie Stewart replied, "Then that means we are the only one left who does." E-mail from Marie Stewart, Lehman, to Anuraj Bismal, Lehman, *et al*. (Dec. 5, 2007) [LBEX-DOCID 3223386]. In a January 2008 e-mail, McGarvey wrote: "By the way we are now the only large firm on the street that uses Repo 105." E-mail from Michael McGarvey, Lehman, to Clement Bernard, Lehman (Jan. 30, 2008) [LBEX-DOCID 2796630]. In a May 2008 e-mail to O'Meara (then-Chief Risk Officer), Ryan Traversari (Senior Vice President External Reporting) reported that Citigroup and JPMorgan "likely do not do Repo 105 and Repo 108 which are UK-based specific transactions on opinions received by LEH from Linklaters. This would be another reason why LEH's daily balance sheet is larger intra-month then at month-end." E-mail from Ryan Traversari, Lehman, to Christopher M. O'Meara, Lehman, *et al*. (May 16, 2008) [LBEX-DOCID 574498]. In sum, it was widely believed within Lehman by late 2007 that it was the only firm using Repo 105-type transactions to reduce balance sheet and impact the firm's net leverage ratio.

[2873] *See* Section III.A.4.d.1 of this Report.

[2874] *See* Section III.A.4.d.3 of this Report and Appendix 17, Repo 105 Appendix.

[2875] As explained in Section III.A.4.d.3 of this Report, United States-based Lehman entities engaged only in Repo 105, and not in Repo 108 transactions. Regardless of which Lehman entity transferred securities in either a Repo 105 or Repo 108 transaction, the balance sheet and leverage reduction benefit was firm-wide, as Lehman ran its business on a consolidated basis.

the firm could reduce its balance sheet on any given day using Repo 105 transactions.[2876] In July 2006, the limit was set at "1x leverage" for Repo 105 transactions, or $17 billion.[2877] Combined with a $5 billion limit for Repo 108 transactions, Lehman's firm-wide cap on combined Repo 105/108 transactions was $22 billion in the summer of 2006.[2878] As of January 2008, the firm-wide cap on combined Repo 105/108 transactions at quarter-end was $25 billion, though in fact, Lehman exceeded the cap by approximately $25 billion in first and second quarter 2008.[2879] Beginning in mid-2007 – the very time that the market began to particularly focus on investment banks' leverage – Lehman breached its internal limit on Repo 105 activity at every quarter-end,

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[2876] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 27; Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 8.

[2877] Lehman, Global Balance Sheet, Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 2 [LBEX-WGM 748489]. When questioned about the calculation of the Repo 105 limit set out in the Global Balance Sheet Overview Presentation, former Lehman Financial Controller Ed Grieb could not recall the calculation of the limit or whether the "1x leverage or $17 billion" definition referred to one of Lehman's leverage ratios or, rather, to tangible equity capital. Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 9. Lehman's Form 10-Q from the same period as the Global Balance Sheet Overview Presentation shows that Lehman's tangible equity capital was $17.4 billion and that the firm's net leverage ratio was 13.8, suggesting that the setting of Lehman's Repo 105 limit may have been tied to tangible equity capital. Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2006 (Form 10-Q) (filed on July 10, 2006), at p. 58 ("LBHI 10-Q (filed July 10, 2006)"). The Global Balance Sheet Overview Presentation itself suggested that tangible equity is the appropriate measure of leverage. Lehman, Global Balance Sheet, Overview of Repo 105 (FID)/Repo 108 Equities (July 2006), at p. 5 [LBEX-WGM 748489]; *see also* Duff & Phelps, Repo 105/108 Usage vs. Limit Comment (Oct. 16, 2009), at p. 1. The conclusion that "1 x leverage" means that the Repo 105 limit was 1 x the tangible equity metric is also supported by the fact that the denominator of Lehman's net leverage ratio is tangible equity. Duff & Phelps, Repo 105/108 Usage vs. Limit Comment (Oct. 16, 2009), at p. 1 & n. 4. The setting of the Repo 105 limit at 1 x tangible equity implies that Lehman management authorized Repo 105 usage to reduce Lehman's net leverage ratio by up to one multiple, or 1.0. *Id.* at p. 2.

[2878] Lehman, Global Balance Sheet, Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 2 [LBEX-WGM 748489].

[2879] E-mail from Sigrid Stabenow, Lehman, to Clement Bernard, Lehman, *et al*. (Jan. 25, 2008) [LBEX-DOCID 1853428] (requesting that Repo 105 limit of $20 billion be expanded to $23 billion).

temporarily removing as much as $50.38 billion in securities inventory from its balance sheet in second quarter 2008.[2880]

Lehman dramatically ramped up its use of Repo 105 transactions in late 2007 and early 2008 despite concerns about the practice expressed by Lehman officers and personnel. In an April 2008 e-mail asking if he was familiar with the use of Repo 105 transactions to reduce net balance sheet, Bart McDade, Lehman's former Head of Equities (2005–2008) and President and Chief Operating Officer (June–September 2008), replied: "I am very aware . . . it is another drug we r on."[2881] A week earlier, McDade had recommended to Lehman's Executive Committee that the firm set a cap on the use of Repo 105 transactions.[2882] A senior member of Lehman's Finance Group considered Lehman's Repo 105 program to be balance sheet "window-dressing" that was "based on legal technicalities."[2883] Other former Lehman employees characterized Repo 105

[2880] Lehman, Total Repo 105/108 Trend (Feb. 20, 2008) [LBHI_SEC07940_1957956] (stating total Repo 105 usage for August 30, 2007, close of third quarter 2007, was $36.4 billion); Lehman, Total Repo 105 & Repo 108 Report (Dec. 5, 2007) [LBEX-DOCID 3219746] (attached to e-mail from Anuraj Bismal, Lehman, to Marie Stewart, Lehman, *et al*. (Dec. 5, 2007) [LBEX-DOCID 3223384] and stating that total firm-wide Repo 105 usage on Nov. 30, 2007 was $38.634 billion); Lehman, Total Repo 105 & Repo 108 Report (June 11, 2008) [LBEX-DOCID 2078195] (attached to e-mail from Kristie Wong, Lehman, to Martin Kelly, Lehman (June 11, 2008) [LBEX-DOCID 2325872] and stating that total firm-wide Repo 105 usage on Feb. 29, 2008 was $49.102 billion and on May 30, 2008 was $50.383 billion). Note that in 2008, May 31 was a Saturday. As set forth below, the Examiner concludes that the evidence supports the existence of colorable claims arising from Lehman's *failure to disclose* its Repo 105 practice and the impact these transactions had on Lehman's publicly reported net leverage and balance sheet.

[2881] E-mail from Herbert H. (Bart) McDade III, Lehman, to Hyung Lee, Lehman (Apr. 3, 2008) [LBEX-DOCID 1570783].

[2882] Examiner's Interview of Herbert H. (Bart) McDade III, Jan. 28, 2010, at pp. 3-4.

[2883] E-mail from Michael McGarvey, Lehman, to Jormen Vallecillo, Lehman (July 2, 2008) [LBEX-DOCID 3379145].

transactions as an "accounting gimmick" and a "lazy way of managing the balance sheet."[2884]

In addition to the firm-wide cap on total Repo 105 usage, management created two related rules loosely known within Lehman as (1) the "80/20" or "continual use" rule and (2) the "120%" rule.[2885] These rules prescribed, respectively, a minimal level of continual use of Repo 105 transactions throughout the quarter and a maximum volume of Repo 105 transactions at quarter-end.[2886] Former Financial Controller Ed Grieb described the purpose of the rules: "to make sure there was a legitimate business purpose" for Repo 105 transactions.[2887]

Lehman did not actually follow these self-imposed rules. That is not surprising, since no witness was able to provide a rational business explanation for the arbitrary 1x leverage, continual use, and 120% rules. If Repo 105 transactions made good business

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[2884] Examiner's Interview of Murtaza Bhallo, Sept. 14, 2009; Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 7.

[2885] Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 13; Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 2 [LBEX-WGM 748489] ("Repo 105 transactions must be executed on a continual basis and remain in force throughout the month. To meet this requirement, the amount outstanding at any time should be maintained at approximately 80% of the amount at month-end. [per Chris O'Meara and Ed Grieb.]"); e-mail from Michael McGarvey, Lehman, to Kentaro Umezaki, Lehman, *et al.* (Aug. 17, 2007) [LBEX-DOCID 1635769] ("The guide line for month end usage of repo 105 is that it should not exceed 120% of your daily average.").

[2886] *See* Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 2 [LBEX-WGM 748489] ("Repo 105 transactions must be executed on a continual basis and remain in force throughout the month. To meet this requirement, the amount outstanding at any time should be maintained at approximately 80% of the amount at month-end. [per Chris O'Meara and Ed Grieb.]"); e-mail from Michael McGarvey, Lehman, to Kentaro Umezaki, Lehman, *et al.* (Aug. 17, 2007) [LBEX-DOCID 1635769] ("The guide line for month end usage of repo 105 is that it should not exceed 120% of your daily average.").

[2887] Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 13.

sense on their own, there would be no apparent reason to arbitrarily restrict the amount of such transactions to 1x leverage or to impose intra-month limits to ensure that the amount of the transactions at reporting periods did not spike to more than 120% of average usage. No reason, that is, except to keep the transactions under the radar, by limiting their total and the amount of a quarter-end spike.

Lehman's Fixed Income Division ("FID"), in particular, employed Repo 105 transactions to reach quarter-end balance sheet targets set by senior Lehman management in connection with the firm-wide effort to reduce net leverage. For example, four days prior to the close of fiscal year 2007, Jerry Rizzieri was in search of a way to meet his balance sheet target and wrote to Mitchell King: "Can you imagine what this would be like without 105?"[2888] When FID's balance sheet was above target in the days leading up to the close of the first quarter 2008, a senior financial officer within that division warned that the division was "looking at selling what ever we can and also doing some more repo 105."[2889] Similarly, the head of the Liquid Markets group within FID wrote at the same quarter-end regarding the group's balance sheet: "We

[2888] E-mail from Jerry Rizzieri, Lehman, to Mitchell King, Lehman (Nov. 26, 2007) [LBEX-DOCID 3232804].

[2889] E-mail from Clement Bernard, Lehman, to Martin Potts, Lehman, *et al.* (Feb. 28, 2008) [LBEX-DOCID 1854189].

have a desperate situation and I need another 2 billion from you, either through Repo 105 or outright sales. Cost is irrelevant, we need to do it."[2890]

Lehman's reliance upon Repo 105 transactions for quarter-end balance sheet relief continued into Lehman's second quarter 2008. In an e-mail titled "Q2 balance sheet" and dated May 21, 2008 – ten days before Lehman's second quarter close – the head of the Liquid Markets group wrote: "Do as much as you can in Repo 105" in response to the question "Do u thk we can be flexible beyond $3bn in 105?"[2891] In another May 21, 2008 e-mail, the head of Liquid Markets asked: "Are we going to make the FID Europe [balance sheet] target," which elicited the response: "V close . . . anything that moves is getting 105'd."[2892]

Several additional contemporaneous e-mails retrieved from Lehman archives succinctly set forth Lehman's purpose for undertaking Repo 105 transactions:

- "[T]he firm has a function called repo 105 whereby you can repo a position for a week and it is regarded as a true sale to get rid of net balance sheet."[2893]
- "We have been using Repo 105 in the past to reduce balance sheet at the quarter-end."[2894]

[2890] E-mail from Kaushik Amin, Lehman, to Kieran Higgins, Lehman (Feb. 28, 2008) [LBEX-DOCID 3234351].

[2891] E-mail from Kaushik Amin, Lehman, to Thomas Siegmund, Lehman (May 21, 2008) [LBEX-DOCID 756545].

[2892] E-mail from Kieran Higgins, Lehman, to Kaushik Amin, Lehman (May 21, 2008) [LBEX-DOCID 3234382].

[2893] E-mail from Anthony Jawad, Lehman, to Andrea Leonardelli, Lehman (Feb. 29, 2008) [LBEX-DOCID 224902].

[2894] E-mail from Raymond Chan, Lehman, to Paul Mitrokostas, Lehman, *et al.* (July 15, 2008) [LBEX-DOCID 3384937].

When pressed to identify any legitimate business purpose for Lehman's use of Repo 105 transactions, certain witnesses noted the secured short-term financing afforded by the transactions. While one outcome of Repo 105 transactions was that Lehman received financing in exchange for collateral – which was not reflected in Lehman's periodic reports as a borrowing or liability – a Repo 105 transaction was a more expensive way for Lehman to secure such short-term financing as compared to an ordinary repo transaction. Lehman had the ability to conduct an ordinary repo transaction using the same securities and with substantially the same counterparties as in Repo 105 transactions, at a lower cost.[2895] As such, the same witnesses who identified a financing purpose for Repo 105 transactions, as well as several other former Lehman personnel, uniformly acknowledged that the overarching goal of Repo 105 transactions was to meet net balance sheet targets – *i.e.*, reduce the net asset component (the numerator) of the net leverage ratio calculation – in connection with the filing of Lehman's financial statements. While the Examiner found a large number of contemporaneous documents that talk about the use of Repo 105 transactions to manage the balance sheet and meet leverage targets, few, if any, contemporaneous documents describe any other purpose for those transactions. Repo 105 transactions were not used for a business purpose, but instead for an accounting purpose: to reduce Lehman's publicly reported net leverage and net balance sheet.

[2895] Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 6.

As set forth more fully below, the Examiner concludes that a fact finder could find that Lehman's *failure to disclose* its use of Repo 105 transactions to impact its balance sheet at a time when both the market and senior Lehman management were keenly focused on the reduction of Lehman's firm-wide net leverage and balance sheet, and particularly in light of the specific volumes at which Lehman undertook Repo 105 transactions at quarter-end in fourth quarter 2007, first quarter 2008, and second quarter 2008, materially misrepresented Lehman's true financial condition.

A trier of fact could find that Lehman's use of tens of billions of dollars of Repo 105 transactions at quarter-end in late 2007 and early 2008 rendered the firm's financial statements and related disclosures materially misleading. Indeed, audit walk-through papers prepared by Lehman's outside auditor, Ernst & Young,[2896] regarding the process for reopening or adjusting a closed balance sheet stated: "Materiality is usually defined as any item individually, or in the aggregate, that moves net leverage by 0.1 or more (typically $1.8 billion)."[2897] Repo 105 moved net leverage not by tenths, but by whole points.[2898]

[2896] Ernst & Young refers only to Ernst & Young LLP (*i.e.*, Ernst & Young North America) unless stated otherwise.

[2897] Ernst & Young, LBHI/LBI Walkthrough Template for Balance Sheet Close Process (Nov. 30, 2007), at p. 14 [EY-LE-LBHI-CORP-GAMX-07-033384]; *see also* Section III.A.4.g, which discusses and analyzes the materiality of Repo 105 transactions.

[2898] *See* Section III.A.4.g.2 of this Report; e-mail from Anuraj Bismal, Lehman, to Marie Stewart, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223384] (stating that Lehman "would be at net leverage of 18.0x [vs say 16.3x] without repo 105/8").

Lehman's publicly reported net leverage ratio for November 30, 2007 (fourth quarter 2007), February 29, 2008 (first quarter 2008), and May 31, 2008 (second quarter 2008) was 16.1x, 15.4x and 12.1x, respectively.[2899] Without the balance sheet benefit of Repo 105 transactions, Lehman's net leverage ratios for the same periods would have been 17.8x, 17.3x and 13.9x, respectively:[2900]

Date	Repo 105 Usage	Reported Net Leverage	Leverage Without Repo 105	Difference
Q4 2007	$38.6 B[2901]	16.1[2902]	17.8[2903]	1.7
Q1 2008	$49.1 B[2904]	15.4[2905]	17.3[2906]	1.9
Q2 2008	$50.38 B[2907]	12.1[2908]	13.9[2909]	1.8

[2899] LBHI 2007 10-K, at p. 64; LBHI 10-Q (filed Apr. 9, 2008), at p. 72; LBHI 10-Q (filed July 10, 2008), at p. 89.

[2900] Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 8; *see also* Section III.A.4.g.2 of the Report (discussing impact of Lehman's Repo 105 practice on Lehman's net leverage ratio).

[2901] Lehman, Total Repo 105/108 Trend (Feb. 20, 2008) [LBHI_SEC07940_1957956] (stating that fourth quarter 2007 Repo 105 usage was $38.634 billion); *see also* Lehman, Global Consolidated Balance Sheet (Final) (Nov. 30, 2007) [LBEX-DOCID 3439086] (stating that fourth quarter 2007 Repo 105 usage was $38.634 billion). Note that many internal Lehman documents, such as the Global Consolidated Balance Sheet, used a "Repo 105" heading to refer to both Repo 105 and Repo 108 usage. In such documents, Repo 108 usage may be disaggregated from the Repo 105 usage by identifying the line item for Equities. "Repo 105" transactions using Equities inventory were actually "Repo 108" transactions.

[2902] *See* LBHI 2007 10-K, at pp. 29, 64.

[2903] Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 8.

[2904] Lehman, Total Repo 105 & Repo 108 Report (June 11, 2008) [LBEX-DOCID 2078195] (stating that firm-wide Repo 105 usage was $49.102 billion at close of first quarter 2008, Feb. 29, 2008).

[2905] *See* LBHI 10-Q (filed Apr. 9, 2008), at p. 72.

[2906] Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 8.

[2907] Lehman, Total Repo 105 & Repo 108 Report (June 11, 2008) [LBEX-DOCID 2078195] (stating that firm-wide Repo 105 usage was $50.3834 billion at close of second quarter 2008, May 30, 2008). Note that May 31 in 2008 was a Saturday.

[2908] *See* LBHI 10-Q (filed July 10, 2008), at p. 89.

[2909] Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 8.

Lehman's directors, the rating agencies, and Government regulators – all of whom were unaware of Lehman's use of Repo 105 transactions – have advised the Examiner that Lehman's Repo 105 usage was material or significant information that they would have wanted to know.[2910] The Examiner concludes that sufficient evidence exists for a trier of fact to find that Lehman's quarter-end Repo 105 practice was material and should have been disclosed.[2911]

Because Lehman treated Repo 105 transactions as sales rather than financing transactions, accounting rules did not require Lehman to record the liabilities arising from the cash borrowings in Repo 105 transactions. Nevertheless, there is sufficient evidence to support a determination that disclosure of the obligation to repurchase the securities and repay the cash borrowing was required in the Management's Discussion and Analysis ("MD&A") section of Lehman's publicly filed financial statements because the repurchase was a known event that was reasonably likely to occur and would have had a material effect on the company's financial condition or results of operations.[2912] A trier of fact could further find that by failing to disclose the tens of billions of dollars of Repo 105 transactions and cash borrowings, Lehman's disclosures in the Liquidity and

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[2910] *See* Sections III.A.4.g.4–5 and III.A.4.h.3 of this Report (discussing rating agencies, Government regulators and Lehman Board of Directors).

[2911] *See* Sections III.A.4.j.2.a–d of this Report (explaining disclosure requirements and providing Examiner's conclusions regarding Lehman's disclosures).

[2912] *See* Section III.A.4.j.2 of this Report (discussing and analyzing disclosure requirements).

Capital Resources Section of the MD&A were deficient.[2913] In addition, Lehman's description of its net leverage was misleading because it omitted disclosing that the ratio was reduced by means of temporary, accounting-motivated transactions.[2914]

The Examiner concludes that there is sufficient evidence to support a colorable claim that: (1) certain of Lehman's officers breached their fiduciary duties by exposing Lehman to potential liability for filing materially misleading periodic reports and (2) Ernst & Young, the firm's outside auditor, was professionally negligent in allowing those reports to go unchallenged. The Examiner concludes that colorable claims of breach of fiduciary duty exist against Richard Fuld, Chris O'Meara, Erin Callan, and Ian Lowitt, and that a colorable claim of professional malpractice exists against Ernst & Young.[2915]

b) Introduction

Sale and repurchase agreements ("repos") are agreements in which one party transfers assets to another party as collateral for a short-term borrowing of cash, while simultaneously agreeing to repay the cash and take back the collateral at a specific point in time.[2916] When the repo transaction matures, the borrower repays the funds plus an

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[2913] *See* Section III.A.4.j.2 of this Report (discussing and analyzing disclosure requirements).

[2914] *See* Sections 4.g.2 and 4.j.2.c of the Report (discussing impact of Repo 105 practice on net leverage ratio and Lehman's public filings, respectively).

[2915] *See* Sections III.A.4.j.4.b and III.A.4.j.5 of this Report (discussing evidence supporting colorable claims against certain Lehman officers and Ernst & Young).

[2916] *See* ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Financial Accounting Standards No. 140, ¶ 96 (Fin. Accounting Standards Bd. 2000) ("Government securities dealers, banks, other financial institutions and corporate investors

agreed upon interest rate or other charge and takes back its collateral. Repo transactions are widely used by financial institutions and are a legitimate tool for raising short-term funding.

Like other large investment banks, Lehman engaged, on a daily basis, in tens of billions of dollars of repo transactions in its normal course of business for financing purposes ("ordinary repo" or "traditional repo" transactions). Lehman accounted for these ordinary repo transactions as financing transactions.[2917] Accordingly, in Lehman's traditional repo transactions:

- The transferred securities inventory remained on Lehman's balance sheet during the term of the repo.
- Because the inventory remained on Lehman's balance sheet, the incoming borrowed cash increased Lehman's total assets.
- Total liabilities also increased because Lehman recorded a corresponding liability representing its obligation to repay the borrowed cash.

While simplified and for illustrative purposes only, the five illustrations that follow demonstrate the impact of an ordinary repo transaction and a Repo 105 transaction on Lehman's balance sheet and leverage ratios.

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commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ('repo party') transfers a security to a transferee ('repo counterparty' or 'reverse party') in exchange for cash and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated 'interest' factor.").

[2917] Lehman reported in its Forms 10-Q and 10-K that it treated repurchase (repo) transactions as financing transactions for accounting and reporting purposes. *See* LBHI 2007 10-K, at p. 97; LBHI 10-Q (filed Apr. 9, 2008), at p. 13; LBHI 10-Q (filed July 10, 2008), at p. 16.

Illustration 1

Assume this simplified balance sheet for Lehman:

Assets (in millions)		**Liabilities**	
Cash	7,500	Short Term Borrowings	200,000
Financial Instruments	350,000	Collateralized Financings	325,000
Collateralized Agreements	350,000	Long Term Borrowings	150,000
Receivables	20,000	Payables	98,000
Other	72,500	Stockholders' Equity	27,000
Total	800,000		800,000
Gross Leverage[2918]	30		
Net Leverage[2919]	17		

Illustration 2, *below*, shows the impact of an ordinary repo on Lehman's balance sheet and leverage ratios.

[2918] Gross leverage, *for illustrative purposes in this set of examples only*, is calculated as total assets divided by stockholders' equity.

[2919] *For illustrative purposes in this set of examples only*, a simplified definition of net leverage is used: net leverage = (total assets – collateralized agreements) divided by stockholders' equity.

Illustration 2

If Lehman executes $50 billion of typical repo transactions with $50 billion of its financial instruments, those instruments remain on the balance sheet; Lehman receives a $50 billion cash borrowing, increasing its cash position; and Lehman records $50 billion of additional collateralized financing liabilities; at the moment of the repo transactions, total balance sheet and leverage increase:

Assets (in millions)		**Liabilities**	
Cash	***57,500***	Short Term Borrowings	200,000
Financial Instruments	350,000	Collateralized Financings	***375,000***
Collateralized Agreements	350,000	Long Term Borrowings	150,000
Receivables	20,000	Payables	98,000
Other	72,500	Stockholders' Equity	27,000
Total	***850,000***		***850,000***
Gross Leverage	***31***		
Net Leverage	***19***		

Illustration 3, *below*, shows the impact of an ordinary repo followed by the use of the cash borrowing to pay down liabilities.

Illustration 3

Assuming Lehman were to use the $50 billion cash borrowing from typical repo transactions to pay off current liabilities, the effect on the balance sheet would be neutral – no net increase in total assets/liabilities, and no effect upon leverage:[2920]

Assets (in millions)		**Liabilities**	
Cash	7,500	Short Term Borrowings	200,000
Financial Instruments	350,000	Collateralized Financings	***325,000***
Collateralized Agreements	350,000	Long Term Borrowings	150,000
Receivables	20,000	Payables	98,000
Other	72,500	Stockholders' Equity	27,000
Total	800,000		***800,000***
Gross Leverage	30		
Net Leverage	17		

Although Lehman publicly reported that it treated all repo transactions as financing transactions for accounting purposes,[2921] Lehman booked "Repo 105" transactions as sales under the Financial Accounting Standards Board's Statement of

[2920] This is not to suggest that Lehman regularly used the funds received in a typical repo transaction to pay down liabilities. In the Notes to its Consolidated Financial Statements, for example, Lehman stated "We enter secured borrowing and lending transactions to finance inventory positions, obtain securities for settlement and meet clients' needs." *See* LBHI 2007 10-K, at p. 110.

[2921] *See* LBHI 2007 10-K, at p. 97 (stating that Lehman treats repo transactions as financing transactions for reporting purposes); LBHI 10-Q (filed Apr. 9, 2008), at p. 13 (same); LBHI 10-Q (filed July 10, 2008), at p. 16 (same); *see also* Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 1 [LBEX-WGM 748489] ("Repo transactions are normally recorded on the balance sheet as financings.").

Financial Accounting Standards No. 140 ("SFAS 140"), *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.[2922]

SFAS 140 governs, in part, when to recognize a transfer of assets as a financing transaction or, alternatively, as a sale.[2923] Although SFAS 140 more often is discussed in the context of securitization transactions, a particular provision of SFAS 140 – specifically SFAS 140.98 – permits the transferor of assets in a repo agreement to account for the repo transaction as a "sale" with a forward purchase commitment if the transaction satisfies certain criteria.[2924] As an accounting matter, and consistent with Lehman's publicly reported statements, the vast majority of repo transactions do *not* satisfy SFAS 140's criteria to recharacterize the repo transaction as a sale and thereby move the transferred inventory "off balance sheet."[2925]

[2922] As discussed more fully at Section III.A.4.d.2.c of the Report, the "105" and "108" descriptions refer to the "haircut" necessary for Lehman to account for the transaction as a "sale" under SFAS 140. Lehman utilized treasuries, agencies, and other government securities in "Repo 105" transactions and utilized equities securities in "Repo 108" transactions. *See* Section III.A.4.d.4 of this Report.

[2923] ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Financial Accounting Standards No. 140, ¶¶ 2, 98 (Fin. Accounting Standards Bd. 2000) ("SFAS 140"). Issued in June 2009 and effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, SFAS 160 and SFAS 167 amended certain aspects of SFAS 140. *See* ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS, AN AMENDMENT OF FASB STATEMENT NO. 140, Statement of Financial Accounting Standards No. 166 (Fin. Accounting Standards Bd. 2009); AMENDMENTS TO FASB INTERPRETATION NO. 46(R), Statement of Financial Accounting Standards No. 167 (Fin. Accounting Standards Bd. 2009).

[2924] *See* SFAS 140, ¶ 98; *see also* Section III.A.4.j.2.c.ii.a of this Report (discussing Lehman's disclosures regarding securitization activities and SFAS 140).

[2925] Paragraph 208 of SFAS 140 notes that sale treatment for repo transactions is unusual. Specifically, Paragraph 208 provides, "[P]articipants in the very large markets for repurchase agreements and securities lending transactions are, for the most part, unaccustomed to treating those transactions as sales, and a change to sale treatment would have a substantial impact on their reported financial position." SFAS 140, ¶ 208.

The recharacterization of a repo transaction from a financing or "borrowing" transaction to a "sale" transaction pursuant to SFAS 140 leads to several consequences:

- The transferred securities inventory are derecognized, *i.e.*, considered sold and removed from the transferor's/seller's balance sheet during the term of the repo even though the transferor/seller is required to repurchase the inventory at a future date.[2926]
- Additionally, when a repo transaction is recharacterized as a sale, the transferor/seller does not record a liability representing its obligation to repay the borrowed funds.[2927] In other words, the "borrowing" is not reflected on the balance sheet, even though the economic substance of the transaction is a borrowing, and thus, the transferor's total liabilities do not increase.[2928]
- Although the transferor's inventory decreases, *at the moment* of the transaction the transferor's total assets remain unchanged because the transferor receives cash borrowings in exchange for the securities inventory.

Consequently, Lehman's Repo 105 transactions removed securities inventory from Lehman's balance sheet for the duration of the repo – typically seven to ten days.[2929] At the moment of the Repo 105 transaction, Lehman received cash.[2930] Thus,

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[2926] *See* SFAS 140, ¶ 11.a ("Upon completion of a transfer of financial assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor shall: a. Derecognize all assets sold."); *see also* Appendix E: Glossary of SFAS 140 ("Derecognize**:** Remove previously recognized assets or liabilities from the statement of financial position.").

[2927] *See* SFAS 140, ¶ 98 ("If the criteria in paragraph 9 are met, including the criterion in paragraph 9(c)(1), the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment.").

[2928] *Id.*

[2929] Examiner's Interview of Tejal Joshi, Sept. 15, 2009, at p. 4; Examiner's Interview of Mark Gavin, Sept. 24, 2009, at p. 4; Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 5; Examiner's Interview of Matthew Lee, July 1, 2009, at p. 13.

[2930] Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 1 [LBEX-WGM 748489]; Examiner's Interview of Edward Grieb, Oct. 2, 2009, at pp. 13-14 (stating that cash received in Repo 105 transactions was used to pay off other liabilities); Examiner's Interview of Matthew Lee, July 1, 2009, at p. 14 (explaining that in order for Lehman to realize the benefit to its leverage ratios as

although Lehman reduced its inventory, the incoming cash resulted in no change to the volume of Lehman's total assets.[2931] Because Lehman booked Repo 105 transactions as sales under SFAS 140, rather than as financings, it did not record any liabilities arising from the obligation to repay the short-term funding secured by a Repo 105 transaction.[2932] Consequently, as demonstrated in Illustration 4, *below*, Lehman was also able to borrow tens of billions of dollars without disclosing the borrowing.

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a result of Repo 105 transactions, the firm had to use the cash received to pay off a different liability); Duff & Phelps, Explanation of Repo 105 Accounting Ledger Entries and Trading System Output (Jan. 5, 2010), at p. 2. In addition, as explained in Letter from Linklaters, to Lehman Brothers International (Europe), re: Repurchase Transactions under a Global Master Repurchase Agreement (May 21, 2006), §2.4 [LBEX-LBIE 000001], Section III.A.4.d.2.a of this Report and Appendix 17, Repo 105 Appendix, during the term of the Repo 105 transaction – as in a typical repo transaction – Lehman continued to receive the income stream arising from the transferred securities during the term of the transaction.

[2931] Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 3; Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 13-14 (stating Lehman used Repo 105 cash borrowing to pay other liabilities); Examiner's Interview of Matthew Lee, July 1, 2009, at p. 14 (explaining that in order for Lehman to realize the benefit to its leverage ratios as a result of Repo 105 transactions, the firm had to use the cash received to pay off a different liability).

[2932] Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at pp. 3-4.

Illustration 4

If Lehman executes $50 billion of Repo 105 transactions, rather than typical repos, the transaction is recharacterized as a sale and $50 billion of financial instruments, considered sold, are removed from the balance sheet;[2933] Lehman receives $50 billion in cash, exchanging one form of asset for another, so total assets are unchanged; Lehman records no liability to return the cash borrowing so liabilities likewise remain unchanged; at the moment of the Repo 105 transactions, leverage is unaffected:

Assets (in millions)		**Liabilities**	
Cash	***57,500***	Short Term Borrowings	200,000
Financial Instruments	***300,000***	Collateralized Financings	325,000
Collateralized Agreements	350,000	Long Term Borrowings	150,000
Receivables	20,000	Payables	98,000
Other	72,500	Stockholders' Equity	27,000
Total	800,000		800,000
Gross Leverage	30		
Net Leverage	17		

[2933] As discussed in greater detail in Section III.A.4.d.2.d of this Report, Lehman created a $5 derivative asset for every $105 worth of securities removed from its balance sheet in a Repo 105 transaction. For the sake of simplification, Illustrations 3 and 4 do *not* include the $5 derivative.

Lehman used the borrowed funds from Repo 105 transactions to pay down short-term liabilities such as ordinary repo transactions, as in Illustration 5, *below*.[2934] By doing so, Lehman reduced its total assets, thereby reducing its leverage ratios.

[2934] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 7 (stating that incoming cash from Repo 105 transactions was used to pay business expenses); Examiner's Interview of Edward Grieb, Oct. 2, 2009, at pp. 13-14 (stating that cash received in Repo 105 transactions was used to pay off other liabilities); Examiner's Interview of Matthew Lee, July 1, 2009, at p. 14 (explaining that in order for Lehman to realize the benefit to its leverage ratios as a result of Repo 105 transactions, the firm had to use the cash received to pay off a different liability); *see* e-mail from Anuraj Bismal, Lehman, to Marie Stewart, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223384] (stating that Lehman would have a net leverage of 18.0x instead of 16.3x without Repo 105, which indicates that Lehman used Repo 105 cash to pay down different liabilities). Given that Lehman undertook $38.6 billion, $49.1 billion, and $50.38 billion of Repo 105 transactions at quarter-end fourth quarter 2007, first quarter 2008, and second quarter 2008, respectively, Lehman's disclosures of its cash holdings at each quarter-end further strengthens the testimony and other evidence that Lehman used the cash borrowing from Repo 105 transactions to pay down short-term liabilities. *See* LBHI 2007 10-K, at p. 86 (reporting that Lehman had $7.286 billion in cash and cash equivalents on November 30, 2007); LBHI 10-Q (filed Apr. 9, 2008), at p. 5 (reporting that Lehman had $7.564 billion in cash and cash equivalents on February 29, 2008); LBHI 10-Q (filed July 10, 2008), at p. 5 (reporting that Lehman had $6.513 billion in cash and cash equivalents on May 31, 2008). While Lehman's Repo 105 transactions spiked at quarter-ends, Lehman's ordinary repo balances dropped off significantly during the same time periods. Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 5.

Illustration 5

In a Repo 105 transaction, Lehman uses the cash it generates to reduce traditional borrowings, such as ordinary repos ("collateralized financings" in the example below). By applying the cash from a Repo 105 transaction to pay down liabilities such as ordinary repos, Lehman reduces its balance sheet and leverage.

Assets (in millions)		**Liabilities**	
Cash	7,500	Short Term Borrowings	200,000
Financial Instruments	***300,000***	Collateralized Financings	***275,000***
Collateralized Agreements	350,000	Long Term Borrowings	150,000
Receivables	20,000	Payables	98,000
Other	72,500	Stockholders' Equity	27,000
Total	***750,000***		***750,000***
Gross Leverage	***28***		
Net Leverage	***15***		

When the Repo 105 transaction matured, Lehman borrowed funds to repay the Repo 105 cash borrowing plus interest and the previously transferred securities inventory returned to Lehman's balance sheet as securities inventory.[2935] Accordingly, total assets and total liabilities increased.

Although it is undisputed that Lehman received cash as part of Repo 105 transactions, the documents and witness testimony reveal that the financing Lehman

[2935] Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 1 [LBEX-WGM 748489]; Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 4; Duff & Phelps, Explanation of Repo 105 Accounting Ledger Entries and Trading System Output (Jan. 5, 2010), at p. 5.

received under a Repo 105 transaction was not the real or primary purpose for entering into Repo 105 transactions. Lehman could have obtained the same financing at a lower cost by engaging in ordinary repo transactions with substantially the same counterparties using the same assets involved in Repo 105 transactions.[2936]

Lehman's primary motive for undertaking tens of billions of dollars in Repo 105 transactions at or near each quarter-end in late 2007 and 2008 was to temporarily remove the securities inventory involved from its balance sheet in order to report lower leverage and net leverage ratios than Lehman actually had.[2937] Numerous witnesses told the Examiner that Lehman's motive for undertaking a Repo 105 transaction, as opposed to an ordinary repo, turned solely on Lehman's need to manage the firm-wide balance sheet and effect the publicly disclosed leverage.[2938]

[2936] Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 6.

[2937] Leverage is the relationship of a company's total assets to stockholders' equity. LBHI 2007 10-K, at p. 30. Lehman believed that "net leverage based on net assets and tangible equity capital" was "a more meaningful measure of leverage." *See* LBHI 2007 10-K, at pp. 30, 63. Lehman defined "net leverage ratio" as "net assets divided by tangible equity capital." *Id.* Lehman's "net asset" calculation begins with "total assets" as reported for GAAP purposes in Lehman's Forms 10-K and 10-Q. From there, Lehman subtracted certain assets in order to arrive at "net assets": (i) cash and securities segregated and on deposit for regulatory and other purposes; (ii) collateralized lending agreements (i.e., securities Lehman is holding as collateral for a loan made to a third-party); and (iii) identifiable intangible assets and goodwill. *See id.* at p. 30.

[2938] Examiner's Interview of Tejal Joshi, Sept. 15, 2009, at pp. 4, 6 (stating that Repo 105 "allowed us to treat trades of positions that would be financing trades as true sales instead" and that at quarter-end there was a mad scramble to meet balance sheet targets through use of Repo 105); Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 27 (stating that at the end of reporting periods, Lehman deployed Repo 105 transactions to net down its balance sheet); Examiner's Interview of Mark Gavin, Sept. 24, 2009, at p. 4 (stating purpose of Repo 105 transactions was "balance sheet management"); Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 7 ("[T]he only purpose or motive for the [Repo 105 transactions] was reduction in balance sheet."); Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 11 (stating Repo 105 transactions were used to bring balance sheet in line with targets); Examiner's Interview of John Feraca, Oct. 9, 2009, at pp. 6, 10 ("It was universally accepted throughout the entire institution that Repo

From 2001, when Lehman first began using Repo 105 transactions,[2939] until early-to-mid-2007, Lehman engaged in a relatively consistent volume of Repo 105 transactions, including at quarter-end, generally within a range of between $20 and $25 billion.[2940] Lehman also maintained internal rules – based on senior management's judgment, rather than any accounting requirement – limiting the total firm-wide use of Repo 105 transactions to $22 billion, later increased to $25 billion.[2941]

In mid-to-late 2007, however, Lehman increased dramatically the volume of firm-wide Repo 105 transactions at quarter-end. By first quarter 2008, the dollar value

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105 was used for balance sheet relief at quarter end"); Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 6 (stating that Repo 105 was a balance sheet management mechanism, "a tool that could be used to reduce Lehman's net balance sheet"); Examiner's Interview of Clement Bernard, Oct. 23, 2009, at p. 7 ("Repo 105 was a mechanism FID relied on to get its balance sheet down"); Examiner's Interview of Matthew Lee, July 1, 2009, at p. 15 (stating Repo 105 transactions driven by management's imperative to reverse-engineer leverage ratio).

[2939] Though Repo 105 started in 2001, Lehman did not initiate Repo 108 transactions, used for equities securities, until May 2006. *See* Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 4 [LBEX-WGM 748489].

[2940] *Id.* (showing Repo 105 month-end trend between January 2005 and May 2006 of between approximately $11 billion and $21 billion); Joseph Gentile, Lehman, Proposed Repo 105/108 Target Increase for 2007 (Feb. 10, 2007), at p. 1 [LBEX-DOCID 2489498] (attached to e-mail from Joseph Gentile, Lehman, to Edward Grieb, Lehman (Feb. 10, 2007) [LBEX-DOCID 2600714] and showing daily total Repo 105 usage for December 1, 2006 through February 2, 2007 remained between approximately $14 billion and $24 billion).

[2941] *See, e.g.*, Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 2 [LBEX-WGM 748489] (setting Repo 105 limit at $17 billion and Repo 108 limit at $5 billion); Joseph Gentile, Lehman, Proposed Repo 105/108 Target Increase for 2007 (Feb. 10, 2007), at p. 1 [LBEX-DOCID 2489498] (attached to e-mail from Joseph Gentile, Lehman, to Edward Grieb, Lehman (Feb. 10, 2007) [LBEX-DOCID 2600714] and proposing to increase $22 billion combined Repo 105/108 limit to $25 billion); e-mail from Sigrid Stabenow, Lehman, to Clement Bernard, Lehman, *et al.* (Jan. 25, 2008) [LBEX-DOCID 1853428] (requesting that Repo 105 limit of $20 billion be expanded to $23 billion); Examiner's Interview of Andrew J. Morton, Sept. 21, 2009, at pp. 4, 22 (stating Repo 105 limits established at inception of program in 2001); Examiner's Interview of Edward Grieb, Oct. 2, 2009, at pp. 9-10; Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 10; Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 7. The Repo 105 limit was a management decision, was not based on accounting rules, and was not part of Lehman's internal Repo 105 Accounting Policy.

of assets that Lehman temporarily removed from its balance sheet at quarter-end through Repo 105 transactions was $49 billion.[2942] Lehman escalated its Repo 105 activity despite its understanding that its peer investment banks – to whom Lehman's leverage was compared – did not use similar devices.[2943]

Lehman greatly expanded its Repo 105 program at a time when market observers increased their focus on the leverage of investment banks and Lehman management placed increased pressure on the businesses within the firm to reduce their net assets. CEO Fuld noted that marketplace perceptions of Lehman precluded Lehman from improving its net leverage ratio by means of raising equity.[2944] Moreover, as Lehman's inventory grew increasingly illiquid, it became difficult to sell without reducing prices and incurring losses or calling into question Lehman's marks for inventory remaining on its balance sheet.[2945]

[2942] *See* Lehman, Total Repo 105 & Repo 108 Report (June 11, 2008) [LBEX-DOCID 2078195] (attached to e-mail from Kristie Wong, Lehman, to Martin Kelly, Lehman (June 11, 2008) [LBEX-DOCID 2325872] and showing total firm-wide Repo 105 usage at May 30, 2008).

[2943] Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 14; Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 11; Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 7; Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 7; Examiner's Interview of Matthew Lee, July 1, 2009, at p. 14; *see also* e-mail from Anuraj Bismal, Lehman, to Marie Stewart, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223386]; e-mail from Michael McGarvey, Lehman, to Clement Bernard, Lehman (Jan. 30, 2008) [LBEX-DOCID 2796630]; e-mail from Ryan Traversari, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (May 16, 2008) [LBEX-DOCID 574498]; e-mail from Michael McGarvey, Lehman, to Jormen Vallecillo, Lehman (July 2, 2008) [LBEX-DOCID 3379145].

[2944] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 27.

[2945] *See* Section III.A.4.e.3–4 of this Report.

c) Why the Examiner Investigated Lehman's Use of Repo 105 Transactions

As part of the Examiner's investigation of internal Lehman audits of risk management controls, the Examiner became aware of Lehman's Repo 105 off-balance sheet effect. As the Examiner obtained a critical mass of information regarding Lehman's use of these transactions and the firm's motive in undertaking them at increasing volumes in late 2007 and 2008, it became apparent that Lehman's use of Repo 105 transactions intersected with several issues involved in the Examiner's investigation, including the directive that the Examiner investigate whether there are colorable claims for breach of fiduciary duties by officers and directors.[2946] As described *infra*, the Examiner concludes that a colorable claim of breach of fiduciary duty exists against certain Lehman officers – namely, Richard Fuld, Chris O'Meara, Erin Callan, and Ian Lowitt.

The Examiner further concludes that a colorable claim of professional malpractice exists against Ernst & Young.[2947]

[2946] Order Directing Appointment of an Examiner Pursuant to Section 1104(c)(2) of the Bankruptcy Code, Docket No. 08-13555 (JMP), *In re Lehman Brothers Holdings Inc.*, No. 08-13555, at p. 3 (Bankr. S.D.N.Y. Jan. 16, 2009).

[2947] Ernst & Young's conduct in connection with Lehman's failure to disclose its use of Repo 105 transactions falls within the Court's January 16, 2009 directive that the Examiner "perform the duties specified in sections 1106(a)(3) and (4) of the Bankruptcy Code." *Id.* at 5. Sections 1106(a)(3) and (4) of the Bankruptcy Code provide that the Examiner shall "investigate the acts, conduct, assets, liabilities and financial condition of the debtor [and] the operation of the debtor's business" and "file a statement of any investigation . . . including any fact ascertained pertaining to fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor, or to a cause of action available to the estate." 11 U.S.C. § 1106 (2006).

d) A Typical Repo 105 Transaction

(1) The Genesis of Lehman's Repo 105 Program in 2001

Lehman initiated its Repo 105 program sometime in 2001, soon after SFAS 140 took effect in September 2000.[2948] At that time, heads of various Lehman business units from New York and London, and representing several of the firm's business divisions and groups, including Credit, Treasury, Product Control, Accounting Policy, Legal, and Compliance, convened to assess how Lehman could use SFAS 140 to manage its balance sheet.[2949] Lehman's outside auditors and lawyers participated in the firm's review of SFAS 140.[2950] Indeed, Lehman vetted the concept of a SFAS 140 repo transaction with its outside auditor, before the firm formalized a Repo 105 accounting policy and approved Repo 105 transactions for use by firm personnel.[2951]

[2948] Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 7; Examiner's Interview of John Coghlan, Nov. 11, 2009, at p 5. Lehman added Repo 108 transactions to the program in May 2006. *See* Lehman, Global Balance Sheet, Lehman, Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 4 [LBEX-WGM 748489] ("Repo 108 for equity securities was introduced as at May 2006 [$0.6B].").

[2949] Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 7. While he did not dispute Feraca's recollection, John Coghlan, former Head of Prime Services to whom Feraca directly reported, recalled that Lehman developed its Repo 105 policy and began engaging in Repo 105 transactions in approximately 2001, after senior management at the firm had grown aware that other peer Consolidated Supervised Entities ("CSE") firms were undertaking similar off-balance sheet repo transactions. Examiner's Interview of John Coghlan, Nov. 11, 2009, at p. 5.

[2950] Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 7. Asked directly to name the auditors and lawyers, Feraca did not recall the specific identities of the firms or individuals. Although Lehman acquired true sale opinion letters, as required by SFAS 140, from the Linklaters law firm (discussed more fully below), the evidence referencing Linklaters' opinion letters is silent on the issue of Linklaters' involvement at the development stage of Lehman's Repo 105 program.

[2951] *Id.*

Several months of internal meetings and discussions occurred before Lehman finalized the structure of its Repo 105 program.[2952] Ultimately, Lehman designed the model structure for a Repo 105 transaction and drafted an official, internal Lehman Accounting Policy that covered what became known at the firm as "Repo 105," and eventually included "Repo 108," transactions.[2953] Lehman's Accounting Policy Manual for Repo 105 transactions was distributed to all "business people" within the firm.[2954] Repo 105 transactions firm-wide had to comply with this policy.

(2) Repo 105 Transactions Versus Ordinary Repo Transactions[2955]

Generally, "[r]epurchase Agreements, or repos, are the primary instruments used by [United States] broker-dealers to finance their inventory positions."[2956] Repo

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[2952] Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 7.

[2953] *Id.* Lehman's Accounting Policy Manual for Repo 105 and Repo 108 is reprinted in its entirety in Appendix 17, Repo 105 Appendix.

[2954] Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 8; Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 7; Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 7.

[2955] Repo transactions are characterized differently under bankruptcy, tax, insurance, and securities law. That is, some bodies of law characterize repo transactions as sales, while others characterize repo transactions as loans or secured transactions. For example, in bankruptcy disputes between creditors and debtors where a claim involves an alleged breach of the duty to liquidate the securities transferred in a repo transaction in a commercially reasonable manner, the Southern District of New York held that a repo transaction was a sale rather than a secured loan, thereby suggesting that a repo transaction should be governed by Article 8 of the Uniform Commercial Code (the "UCC") as opposed to Article 9 of the UCC. *Granite Partners, L.P v. Bear, Stearns & Co.*, Inc., 17 F. Supp.2d 275, 302 (S.D.N.Y. 1998). On the other hand, for purposes of tax law, the United States Supreme Court has held that repo transactions are secured loans rather than sales. *Nebraska Dep't of Revenue v. Loewenstein*, 513 U.S. 123, 130-31 (1994). An analysis of the characterization of repo transactions under law is beyond the scope of this Report, which, with respect to Lehman's Repo 105 program, focuses on the accounting treatment of Repo 105 transactions, the treatment of Repo 105 transactions for financial reporting purposes, and Lehman's disclosure obligations.

[2956] Lehman, Repo Manual (Nov. 8, 2005), at p. 6 [LBEX-LL 1175483]. The Repo Manual was an internal Lehman publication intended as a reference guide for sales people engaging in repo transactions.

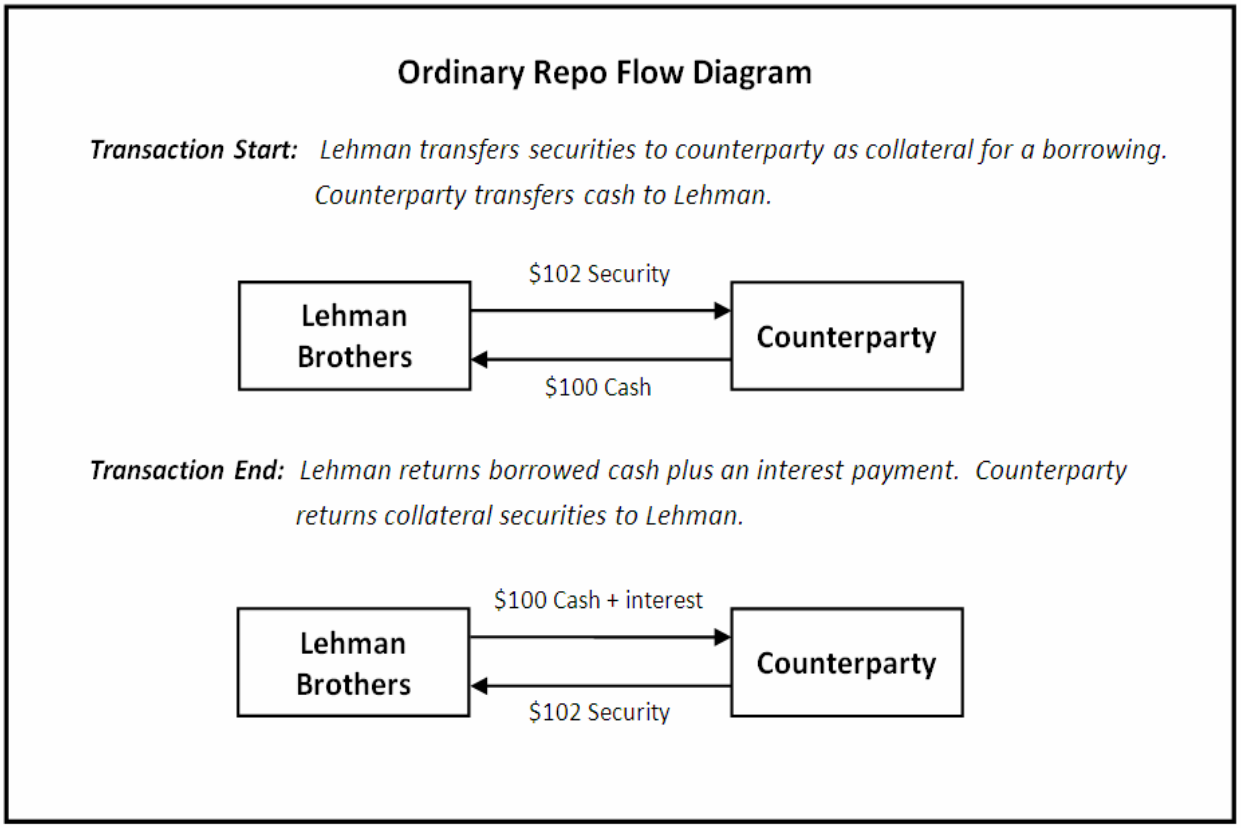
transactions consist of two legs.[2957] In the first leg, Lehman would transfer securities inventory to a repo lender in return for cash.[2958] In the second leg, Lehman would repay the cash amount plus interest, and the repo lender would return the securities inventory.[2959] The difference between the value of the securities inventory transferred and the cash received is referred to as the "haircut" on the repo transaction. As explained in detail below, in an ordinary repo transaction involving liquid securities during the late 2007 and 2008 time period, the haircut third parties typically required was approximately 2% while in a Repo 105 or Repo 108 transaction, the haircut involved was required to be at least five percent or eight percent, respectively, and was often more.[2960]

[2957] *See* Lehman, Repo Manual (Nov. 8, 2005), at p. 7 [LBEX-LL 1175483].

[2958] *See* Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 8; Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 7.

[2959] *See* Lehman, Repo Manual (Nov. 8, 2005), at p. 7 [LBEX-LL 1175483].

[2960] Examiner's Interview of Mark Gavin, Sept. 24, 2009, at p. 7; Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 6; *see* Lehman, Global Balance Sheet, Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 2 [LBEX-WGM 748489].



(a) Lehman's Accounting Treatment of Repo 105 Transactions Versus Ordinary Repo Transactions

For accounting and financial reporting purposes – consistent with Lehman's policy as disclosed in its publicly filed statements – the substance of an ordinary repo transaction is a short-term borrowing or financing transaction.[2961] The transferor in an ordinary repo transaction, also known as the "repo borrower," receives cash, but the ordinary repo transaction also creates a liability for the transferor to repay the amount

[2961] *See* Lehman, Global Balance Sheet, Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 1 [LBEX-WGM 748489] ("Repo transactions are normally recorded on the balance sheet as financings."); *see also* Section III.A.4.j.2.c.ii.a of the Report (discussing Lehman's characterization of repo transactions for purposes of financial reporting in Forms 10-K and 10-Q).

of cash borrowed.[2962] Accordingly, the accounting impact of an ordinary repo on the transferor's balance sheet is to increase both: (1) total assets, as a result of the incoming cash, and (2) total liabilities, by an amount corresponding to the obligation to repay the cash.[2963] Typically the repo borrower in an ordinary repo continues to receive the income from the coupon payments of the securities that serve as collateral for the borrowing of cash from the transferee.[2964]

When an ordinary repo transaction matures, that is, the term of the transaction expires, the transferor repays the cash to the transferee and the transferee, also known as a "repo lender," returns to the transferor the securities held as collateral.[2965] The effect of the maturing of the ordinary repo transaction on the transferor's balance sheet

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[2962] *See* Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 2.

[2963] *Id.*; *see also* SFAS 140 ¶ 100 ("Repurchase agreements that do not meet all the criteria in paragraph 9 shall be treated as secured borrowings.").

[2964] *See, e.g.*, Master Repurchase Agreement (September 1996 Version) between Lehman Brothers Inc., Lehman Commercial Paper Inc. and Lehman Brothers International (Europe) (Oct. 6, 1998), ¶ 5 Income Payment [LBEX-AM 333493] (stating that repo seller is entitled to receive all income paid or distributed on or in respect of the transferred securities to the full extent it would be so entitled if the securities had not been sold); Master Repurchase Agreement (September 1996 Version) between Dresdner Bank AG, New York Branch and Lehman Brothers Inc., Lehman Commercial Paper Inc. (July 19, 2002, 1998), ¶ 5 Income Payment [LBEX-AM 334017] (same); Master Repurchase Agreement (September 1996 Version) between Lehman Brothers Inc. and Bank for International Settlements (Aug. 14, 1998), ¶ 5 Income Payment [LBEX-AM 333532] (same). *cf.* Lehman Brothers, Repo Manual (Nov. 8, 2005), at p. 15 [LBEX-LL 1175483] (stating that for its standard repo transactions, Lehman uses BMA Master Repurchase Agreement, which includes interest payment terms). The Supreme Court's decision in *Nebraska Dep't of Revenue v. Loewenstein*, in which the Court held that repo transactions were secured loans rather than sales, noted that the interest charged by the repo lender bears no relation to the coupon interest paid or accruing on the securities during the term of the repo. 513 U.S. 123, 131 (1994). The fact that the coupon interest on the securities continued to flow to the repo borrower was one factor the Court considered in holding that repo transactions were secured loans rather than sales under tax law. *Id.* at 130.

[2965] Lehman, Repo Manual (Nov. 8, 2005), at p. 7 [LBEX-LL 1175483].

is to reduce both: (1) total assets, as a result of the repayment of the borrowed cash, and (2) total liabilities, because the obligation to repay has been extinguished.[2966]

Consistent with the firm's disclosures in its financial statements, Lehman recorded ordinary repo transactions as secured lending or financing transactions.[2967] Accordingly, when Lehman engaged in an ordinary repo transaction as transferor, the securities that Lehman transferred remained on Lehman's balance sheet as inventory, a subset of total assets.[2968]

Repo 105 transactions were structurally and substantively identical to ordinary repo transactions; indeed, Lehman used the same documentation to execute both Repo 105 and ordinary repo transactions, and these transactions were conducted with the same collateral and substantially the same counterparties.[2969] Specifically, in a Repo 105

[2966] *See* Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 2.

[2967] Lehman, Global Balance Sheet, Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 1 [LBEX-WGM 748489] ("Repo transactions are normally recorded on the balance sheet as financings."); LBHI 2007 10-K, at p. 97 (stating that Lehman treats repo transactions as collateralized agreements and financings for financial reporting purposes); LBHI 10-Q (filed Apr. 9, 2008), at p. 13 (same); LBHI 10-Q (filed July 10, 2008), at p. 16 (same); *see also* Duff & Phelps, Explanation of Repo 105 Accounting Ledger Entries and Trading System Output (Jan. 5, 2010), at p. 3 (stating that Lehman's accounting systems recorded repo transactions as financing transactions and that manual intervention required to recharacterize the repo as a sale (*i.e.*, a Repo 105)).

[2968] *See* SFAS 140, ¶ 100 ("Repurchase agreements that do not meet all the criteria in paragraph 9 shall be treated as secured borrowings.").

[2969] John Feraca, who ran Lehman's Secured Funding Desk which was responsible for executing ordinary repo and Repo 105 transactions, stated that with most counterparties, Lehman had capacity to do either an ordinary repo or a Repo 105 transaction; that nothing prevented Lehman from engaging in a standard, overnight repo transaction using the same assets with the same counterparty but at a lower haircut; and that Lehman used the same GMRA for ordinary repo and Repo 105 transactions with the same counterparty. Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 6 Mark Gavin, who worked for LBIE's Secured Financing Desk believed that a single GMRA, which governed both ordinary repo and

transaction, just as in an ordinary repo transaction, Lehman would transfer securities to a repo lender in exchange for short-term financing.[2970] Additionally, in a Repo 105 transaction, just as in an ordinary repo transaction, Lehman, as the borrower, was obligated to "repurchase" the securities posted as collateral (stated differently, to repay the cash borrowing) upon maturation of the repo.[2971]

During the term of a Repo 105 transaction, as with a typical ordinary repo transaction, Lehman continued to receive the stream of income (the coupon payments) from the securities transferred in a Repo 105 transaction.[2972] As in an ordinary repo transaction, Lehman was charged interest on the cash borrowing in a Repo 105 transaction.[2973] Lehman paid the repo interest separately upon the completion of a Repo

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Repo 105 transactions, was in place for many of Lehman's counterparties. Examiner's Interview of Mark Gavin, Sept. 24, 2009, at p. 6.

[2970] *See* Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 3.

[2971] Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 9; Examiner's Interview of Matthew Lee, July 1, 2009, at p. 10 (stating that Lehman repurchased the inventory approximately 4 to 5 days after new quarter began).

[2972] The May 2001 Linklaters true sale opinion letter, discussed in greater detail below, makes clear that in the transactions contemplated under the letter, income received during the transaction period by the repo buyer (i.e., Lehman's United Kingdom counterparty in the case of Repo 105 transactions) from the transferred securities would be paid or otherwise credited to the repo seller's (*i.e.*, LBIE) account by the buyer. Letter from Linklaters, to Lehman Brothers International (Europe), re: Repurchase Transactions under a Global Master Repurchase Agreement (May 21, 2006), §2.4 [LBEX-LBIE 000001]. The Global Master Repurchase Agreements, upon which the Linklaters letter is based, also contain wording to this effect. *See, e.g.*, Global Master Repurchase Agreement (2000 Version) between Lehman Brothers International (Europe) and Barclays Bank PLC (May 4, 2006), ¶ 5 Interest Payment [LBEX-AM 333643]; Global Master Repurchase Agreement (2000 Version) between Lehman Brothers International (Europe) and Fortis Bank NV/SA (July 16, 2004), ¶ 5 Interest Payment [LBEX-AM 334046]; Global Master Repurchase Agreement (1995 Version) between CS First Boston Limited and Lehman Brothers International (Europe) (Jan. 3, 1996), ¶ 5 Interest Payment [LBEX-AM 333769].

[2973] *See* SFAS 140 ¶ 96 ("Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those

105 transaction (*i.e.*, when the term expired), just as Lehman would on all ordinary repo transactions.[2974] Accordingly, Lehman would debit an "interest expense" income statement item.[2975]

Despite the identical structure and substance of ordinary repos and Repo 105 transactions, the latter received critically different accounting treatment: Lehman treated Repo 105 transactions as "sales" of financial assets for accounting purposes under SFAS 140, which in effect enabled Lehman to move the securities inventory off its balance sheet during the term of the Repo 105 transaction; with the reduction in inventory, the net impact of the incoming cash from a Repo 105 transaction was that total assets remained unchanged.[2976]

Under SFAS 140, "A transfer of financial assets . . . in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the

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agreements, the transferor ('repo party') transfers a security to a transferee ('repo counterparty' or 'reverse party') in exchange for cash and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated 'interest' factor."); *see also* Duff & Phelps, Explanation of Repo 105 Accounting Ledger Entries and Trading System Output (Jan. 5, 2010), at p. 5.

[2974] Duff & Phelps, Explanation of Repo 105 Accounting Ledger Entries and Trading System Output (Jan. 5, 2010), at p. 5.

[2975] *Id.* At the transactional level, each repo – ordinary or Repo 105 – had a specific interest rate charge. But, all the interest charges were rolled up into one number ("interest expense") that appeared in the income statement of Lehman's reported financials.

[2976] Lehman Brothers Holdings Inc., Accounting Policy Memo, Repo 105 and Repo 108 (Feb. 13, 2008), at pp. 1-2 [LBEX-DOCID 3213297] (attached to e-mail from Marie Stewart, Lehman, to Martin Kelly, Lehman (Apr. 10, 2008) [LBEX-DOCID 3223687]; Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at pp. 1-2 [LBEX-DOCID 3213286] (attached to e-mail from Marie Stewart, Lehman, to Martin Kelly, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223386]; Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 (Dec. 1, 2004), at pp. 1-2 [LBEX-DOCID 647239] (attached to e-mail from Kieran Higgins, Lehman, to Kaushik Amin, Lehman (Nov. 21, 2007) [LBEX-DOCID 738606]).

extent that consideration other than beneficial interests in the transferred assets is received in exchange."[2977] SFAS 140 also states that "The transferor has surrendered control over transferred assets if and only if all of the following conditions are met":

- The transferred assets have been isolated from the transferor – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
- Each transferee has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.
- The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.[2978]

If a repo transaction satisfies each of these three criteria, the repo transferor is deemed to have surrendered control of the transferred collateral, and consequently, SFAS 140 permits the transferor to account for the transaction as a "sale" of financial

[2977] ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Financial Accounting Standards No. 140, ¶ 9 (Fin. Accounting Standards Bd. 2000) ("SFAS 140").
[2978] SFAS 140, ¶ 9.

assets and a forward purchase commitment.[2979] Lehman determined that its Repo 105 transactions met these criteria and accounted for them accordingly.[2980]

Consequently, recharacterizing a Repo 105 transaction as a sale had the following immediate consequences:

- Unlike in an ordinary repo transaction, the securities that Lehman transferred in a Repo 105 transaction to the repo lender did not remain on Lehman's balance sheet as securities inventory during the term of the repo. Instead, Lehman removed the securities from its balance sheet, thereby reducing securities inventory (one class of asset) on its balance sheet.[2981]

- Although there was a reduction in inventory, total assets remained the same as a result of the incoming cash.[2982] Thus, unlike an ordinary repo transaction, in which both total assets and total liabilities increase, Lehman's total assets and total liabilities did not increase as the result of a Repo 105 transaction.[2983]

- At the moment of a Repo 105 transaction, because total assets and total liabilities were unchanged, Lehman's leverage ratios also remained unaffected even though Lehman had borrowed, in the aggregate, billions of dollars.

[2979] SFAS 140, ¶ 11; Lehman, Global Balance Sheet, Overview of Repo 105 (FID)/108 (Equities) (July 2006), p. 1 [LBEX-WGM 748489]; Lehman Brothers Holdings Inc., Accounting Policy Manual, Repo 105 and Repo 108 (Sept. 9, 2006), at p. 1 [LBEX-DOCID 3213293] (attached to e-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Mar. 6, 2008) [LBEX-DOCID 3223442].

[2980] Lehman Brothers Holdings Inc., Accounting Policy Manual, Repo 105 and Repo 108 (Sept. 9, 2006), at pp. 1-2 [LBEX-DOCID 3213293] (attached to e-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Mar. 6, 2008) [LBEX-DOCID 3223442].

[2981] *Id.*; *see also* Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at pp. 3-4.

[2982] Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 3.

[2983] Lehman's total assets were reduced when Lehman engaged in a Repo 105 transaction because Lehman both removed the inventory from the balance sheet and used the incoming Repo 105 cash for other business purposes, including to pay off other liabilities (rather than having the cash remain on the firm's balance sheet).

- Moreover, unlike in an ordinary repo transaction where liabilities increased because Lehman recorded the obligation to repay the cash borrowing, in a Repo 105 transaction, Lehman did not record any obligation to repay the cash borrowing.[2984]

But Lehman's Repo 105 practice had two steps. While the first step had no impact upon net leverage, in step two Lehman used the cash borrowing from Repo 105 transactions to pay down different liabilities and thereby reduce the firm's reported leverage ratios.[2985]

(b) Lehman's Accounting Policy for Repo 105 Transactions

After Lehman established its Repo 105 program in 2001, the firm published an internal Repo 105 Accounting Policy.[2986] All Repo 105 transactions firm-wide were required to comply with this policy.[2987]

[2984] *See* Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 3.

[2985] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 7; Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 9; Examiner's Interview of Matthew Lee, July 1, 2009, at p. 14; *see also* e-mail from Anuraj Bismal, Lehman, to Marie Stewart, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223384] (stating Repo 105's effect on net leverage ratio, which can only be impacted if Lehman used Repo 105 cash to pay down different liabilities); Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at pp. 4-5. In addition, Lehman's public disclosures state that it held between approximately $6 to $7 billion cash at quarter-ends when Lehman undertook $38.6 billion, $49.1 billion, and $50.38 billion of Repo 105 transactions in fourth quarter 2007, first quarter 2008, and second quarter 2008, respectively, also demonstrating that Lehman did not hold the incoming Repo 105 cash borrowing but used it for other business purposes, including to pay down liabilities. *See* LBHI 2007 10-K, at p. 86 (reporting that Lehman had $7.286 billion in cash and cash equivalents on November 30, 2007); LBHI 10-Q (filed Apr. 9, 2008), at p. 5 (reporting that Lehman had $7.564 billion in cash and cash equivalents on February 29, 2008); LBHI 10-Q (filed July 10, 2008), at p. 5 (reporting that Lehman had $6.513 billion in cash and cash equivalents on May 31, 2008).

[2986] Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006) [LBEX-DOCID 3213286] (attached to e-mail from Marie Stewart, Lehman, to Martin Kelly, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223386]).

[2987] The Examiner has reproduced Lehman's Repo 105 Accounting Policy in its entirety in Appendix 17, Repo 105 Appendix.

Excerpted here is certain of the policy's more pertinent language:

- The Policy acknowledged that Lehman treated ordinary repo transactions as "secured financing transactions" but treated Repo 105 transactions as "sales of inventory and forward agreements to repurchase."[2988]

- "Repo 105 and Repo 108 transactions refer to repos with a counterparty in which we sell securities valued at a minimum of 105% (for fixed income securities) or 108% (for equity securities) of the cash received. That is, we sell fixed income securities with a fair value of at least $105 in exchange for $100 of cash for Repo 105, and equity securities with a fair value of at least $108 in exchange for $100 of cash for Repo 108."[2989]

- "Repo 105 and Repo 108 contracts typically are executed by Lehman Brothers International (Europe) ('LBIE') because true sale opinions can be obtained under English law. We generally cannot obtain a true sale opinion under U.S. law."[2990]

- "Re-characterization of a repo from a secured financing transaction to a sale of inventory and a forward to repurchase assets is allowed only if we can demonstrate we have relinquished control of the transferred assets."[2991]

- "When [certain identified] criteria are met, the assets transferred are removed from our balance sheet and an asset under a derivative contract is

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[2988] Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at p. 1 [LBEX-DOCID 3213286].

[2989] *Id.* Although Lehman's Accounting Policy required an 8% haircut for a Repo 108 transaction, Ed Grieb (former Lehman Global Financial Controller) had approved as a general matter a 7% haircut for Repo 108 transactions. *See* e-mail from Marie Stewart, Lehman, to Christopher McEwan, Lehman, *et al.* (July 13, 2006) [LBEX-DOCID 3234337] ("[B]ack in May we had agreed that it was OK to do Repo 108 at 107. . . . I have re-cleared 107 with Ed Grieb and he is fine.").

[2990] Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at p. 1 [LBEX-DOCID 3213290] (attached to e-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223389]); *cf.* e-mail from John Feraca, Lehman, to Michael McGarvey, Lehman (Apr. 17, 2008) [LBEX-DOCID 3213321] (stating that in order to proceed with a Repo 105 transaction, "[y]ou have to get approval from both Finance and Legal" and that "you need a true sale legal opinion for the repo agreement and the entity you operate from and affirmation that your counterpart operates in an enforceable legal jurisdiction. . . .").

[2991] Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at p. 2 [LBEX-DOCID 3213290].

recorded to reflect that we will repurchase, under a forward contract, the transferred assets."[2992]

(c) The Accounting Purpose of the Larger Haircut

The labels "Repo 105" and "Repo 108" referred to Lehman's "haircut" on the transaction. A haircut in a repo transaction is the difference between the value of the collateral used to secure a borrowing and the amount of cash that is borrowed.[2993]

The five percent minimum required haircut in a Repo 105 transaction (or eight percent minimum in a Repo 108 transaction) was greater than the haircut Lehman faced in an ordinary repo transaction involving treasury-type securities, which witnesses indicated was typically approximately 2%.[2994] However, the larger haircut in Repo 105 transactions was an essential component for Lehman to avail itself of SFAS 140 accounting treatment.

Under SFAS 140, recharacterizing a repo from a financing transaction to a sale of inventory requires the transferor to demonstrate that it has relinquished control over

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[2992] *Id.*

[2993] *See* Business Definition for "Haircut," *available at* http://www.allbusiness.com/glossaries/haircut/4948623-1.html (last visited Jan. 3, 2010).

For each $100 Lehman borrowed in a Repo 105 transaction it needed to transfer $105 of collateral to its counterparty (lender), *i.e.*, it over collateralized the borrowing by five percent. As such, in a Repo 105 transaction in which Lehman borrowed $100 and posted $105, the "haircut" was actually ($105 - $100)/ $105 = 4.76%. However, for purposes of discussion in this Report, we refer to the five percent overcollateralization as a five percent "haircut." Similarly, the "haircut" on a Repo 108 transaction was actually ($108 - $100)/$108 = 7.4%, but for purposes of this discussion, we refer to the eight percent overcollateralization as an eight percent haircut.

[2994] Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 6; *see also* Agreement between Lehman, FRBNY and JP Morgan re: Custodial Undertaking in Connection with Master Open Market Agreement, Schedule of Eligible Securities, Margin Percentage column (Sept. 14, 2008) [JPM-2004 0055343] (showing repo collateral haircuts at the time).

the transferred assets.[2995] Paragraphs 47 through 49, 217, and 218 of SFAS 140 contain the relevant discussion of "control."[2996] The FASB determined that "to maintain effective control, the transferor must have *both* the contractual right and the contractual obligation to reacquire securities that are identical to or substantially the same as those concurrently transferred."[2997] "[T]he transferor's right to repurchase is not assured unless it is protected by obtaining collateral sufficient to fund substantially all of the cost of purchasing identical replacement securities during the term of the contract."[2998]

Paragraph 218 of SFAS 140 further provided:

> Judgment is needed to interpret the term *substantially all* and other aspects of the criterion that the terms of a repurchase agreement do not maintain effective control over the transferred asset. However, arrangements to repurchase or lend readily obtainable securities, typically with as much as 98 percent collateralization (for entities agreeing to repurchase) or as little as 102 percent overcollateralization (for securities lenders), valued daily and adjusted up or down frequently for changes in the market price of the securities transferred and with clear powers to use that collateral quickly in the event of default, typically fall clearly within that guideline. The Board believes that other collateral arrangements typically fall well outside that guideline.[2999]

[2995] ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Financial Accounting Standards No. 140 (Fin. Accounting Standards Bd. 2000) ("SFAS 140").

[2996] SFAS 140, ¶¶ 47-49, 217-218.

[2997] SFAS 140, ¶ 217 (emphasis in original).

[2998] SFAS 140, ¶ 218.

[2999] *Id.* (emphasis in original). In other words, the FASB believed that when the collateralization was between 98% and 102%, a repo borrower maintained effective control over transferred assets and consequently the assets could not be moved off the borrower's balance sheet.

Like ordinary repos, Repo 105 transactions included a commitment from Lehman to repurchase the assets/securities upon the maturation of the repo.[3000] But a general repurchase commitment is not dispositive of "control" for purposes of a SFAS 140 analysis. Consistent with SFAS 140 and FASB's implementation guide for SFAS 140, Lehman interpreted SFAS 140 to mean that the greater haircuts Lehman applied to Repo 105 transactions established the requisite relinquishment of control of the assets involved in the transactions.[3001]

Specifically, if Lehman had the ability to "fund substantially all of the cost of purchasing the same or substantially the same replacement assets," Lehman would be "viewed as having the means to replace the assets" and was therefore "considered not to have relinquished control of the assets."[3002] Lehman determined, however, that under the rule, it did not have the ability to fund substantially all of the cost of repurchasing the assets because of the difference – via the larger haircut – between the value of the assets/securities transferred and the funding Lehman borrowed in a Repo 105

[3000] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at pp. 10-11; Examiner's Interview of Matthew Lee, July 1, 2009, at p. 14. The boilerplate contract used in Repo 105 transactions – the GMRA – could also be used in ordinary repo transactions.

[3001] SFAS 140 ¶ 218. *See also* FASB Staff Implementation Guidance, Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, questions 45 and 46 (issued February 2001, last revised March 2006).

[3002] *See* Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at p. 2 [LBEX-DOCID 3213286] (attached to e-mail from Marie Stewart, Lehman, to Martin Kelly, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223386]).

transaction. Therefore, Lehman effectively relinquished "control" of the assets for purposes of a SFAS 140 analysis.[3003]

At bottom, Lehman applied a higher haircut to what otherwise could be an ordinary repo transaction in order to avail itself of the accounting classification under SFAS 140.[3004] Thus, Lehman's use of Repo 105 transactions "clearly . . . was an effort to reduce balance sheet. Traders had balance sheet limits and this was one way they could meet them."[3005] Counterparties to Lehman's Repo 105 transactions did not necessarily – or even usually – require or ask for a higher five percent or eight percent haircut on a Repo 105 or Repo 108 transaction.[3006] Lehman posted more collateral in a Repo 105 transaction for the same loan it could acquire through an ordinary repo in order to achieve the off-balance sheet treatment for the collateral.[3007]

[3003] Lehman's internal Repo 105 Accounting Policy provided, "[W]e have retained control of the transferred assets if a fixed income security is margined at less than 105% of the cash received or an equity security is margined at less than 107% of the cash received." Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at p. 2 [LBEX-DOCID 3213293] (attached to e-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Mar. 6, 2008) [LBEX-DOCID 3223442]). It continued: "Transfers in which we transfer fixed income securities valued at a minimum of 105% of the cash received and equity securities at a minimum of 107% of the cash received are considered to be sales and a forward to repurchase rather than secured financing transactions." *Id.*

[3004] Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 6. In both an ordinary repo transaction and a Repo 105 transaction: (1) the collateral used eventually returned to Lehman; (2) the same assets could be used for either an ordinary repo transaction or a Repo 105 transaction; and (3) with most counterparties, Lehman had capacity to do either an ordinary repo transaction or a Repo 105 transaction. *Id.*

[3005] *Id.*

[3006] *Id.*

[3007] *Id.* (stating that Lehman offered the five percent or eight percent haircut to its counterparties because Lehman wanted to remove the securities from its balance sheet).

(d) Lehman Did Not Record a Cash Borrowing but Recorded a Derivative Asset in a Repo 105 Transaction

Unlike an ordinary repo transaction, Lehman did not record the borrowing of cash from a Repo 105 transaction even though Lehman was obliged to repay the borrowing.[3008] Instead, Lehman established a long inventory derivative asset representing the obligation under a forward contract to repurchase the full amount of securities "sold."[3009] As Lehman's internal Repo 105 Accounting Policy explained, assuming Lehman borrowed $100 cash in exchange for a pledge of $105 of fixed income collateral, Lehman booked a $5 derivative, which represented Lehman's obligation to repurchase the securities at the end of the term of the repo transaction.[3010] The $5 arose

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[3008] *See* SFAS 140 ¶ 98 ("If the criteria in paragraph 9 are met, including the criterion in paragraph 9(c)(1), the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment."). As discussed above, ordinary repo transactions are considered financing or borrowing transactions. *See* Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 1 [LBEX-WGM 748489]. In addition to the incoming cash (an asset), in an ordinary repo transaction, the repo borrower also records a liability (the obligation to repay the borrowed cash). *See* SFAS 140 ¶ 100 ("Repurchase agreements that do not meet all the criteria in paragraph 9 shall be treated as secured borrowings."). If the Repo 105 transaction technically qualified for true sale accounting under SFAS 140, Lehman was not required for accounting purposes to record a liability, although the economic reality was that Lehman had borrowed cash it had to repay. Instead, Lehman recorded the cash proceeds of the Repo 105 transaction as an asset (cash), but re-characterized this secured financing as a sale of the securities used as collateral for the borrowing, resulting in a reduction to its Securities Inventory balance. Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at p. 2 [LBEX-DOCID 3213293] (attached to e-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Mar. 6, 2008) [LBEX-DOCID 3223442]). Thus, the Repo 105 device allowed Lehman to borrow tens of billions of dollars in cash without reflecting the borrowing on its balance sheet.

[3009] Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at p. 2 [LBEX-DOCID 3213293], at p. 3 (attached to e-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Mar. 6, 2008) [LBEX-DOCID 3223442]) ("We have a receivable under a derivative contract because we are *required* to repurchase under a forward contract $105 worth of securities for payment of only $100.") (emphasis added).

[3010] *Id.*

from the fact that when it came time to repurchase the pledged securities, Lehman paid $100 cash for $105 worth of securities.[3011] The transaction therefore had a $5 value to Lehman reflecting the market value of the "overcollateralization" amount of the Repo 105 transaction.[3012] Because it had a positive fair value of $5, the derivative was recorded as an asset under SFAS 133.[3013]

(3) Anatomy of Repo 105 Transactions and the Linklaters True Sale Opinion Letter

In addition to the required haircut, Lehman had to take one additional step to qualify Repo 105 transactions as "sales" and enjoy the balance sheet and leverage relief afforded by that classification. Lehman had to either originate these transactions or conduct them through Lehman Brothers International (Europe) ("LBIE") in London.

Broadly speaking, Lehman effected Repo 105 transactions through LBIE employing two alternative structures (depending upon the origin of the securities that Lehman ultimately transferred to the counterparty).[3014] To understand the reason for

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[3011] *Id.*

[3012] *Id.*

[3013] Ernst & Young work papers from Lehman's second quarter 2008 show that Ernst & Young reviewed the value of Lehman's Repo 105 derivatives. *See* Ernst & Young, Fair Value of OTC Derivative Contracts by Maturity as of May 31, 2008 (July 8, 2008) [EY-SEC-LBHI-WP-2Q08-000535]; *see also* e-mail from Jared Pedowitz, Ernst & Young, to James Billingham, Ernst & Young (Apr. 24, 2008), at p. 4 [EY-LE-LBHI-KEYPERS 0373642–0373645] ("I am currently working on the Q1 Fair Value of OTC Derivative Contracts in the MD&A. . . . [W]e need to verify. . . the Repo 105 population . . . .[W]ould you be able to confirm the $4.818 bn balance is consistent with your teams review of this area?"); Ernst & Young, Repo 105 Pivot Table [EY-LE-LBHI-KEYPERS 0373646] (showing total value of Repo 105/108 derivatives was $4.818 billion). *See* Section III.A.4.j.2.c.ii.c of this Report for discussion of Lehman's deficient disclosures regarding the Repo 105 derivative.

[3014] This discussion is limited to Repo 105 transactions, and does not include Repo 108 transactions.

Lehman's alternative structures requires a brief detour back through the requirements of SFAS 140.

In order for a repo transferor to be deemed to have surrendered control of an asset under SFAS 140 – so as to achieve "true sale" treatment under SFAS 140 and remove the transferred securities from the transferor's balance sheet – the transferred assets must be *isolated* from the transferor, that is, put presumptively beyond the reach of the transferor and its creditors, even in the event of the transferor's bankruptcy.[3015] To be isolated under SFAS 140, there must have been a true sale *at law*.[3016] Typically, to meet this requirement, the transferor obtains a true sale opinion letter.[3017]

Lehman's internal Repo 105 Accounting Policy echoed the SFAS 140 requirement that the "transaction [be] a true sale at law."[3018] The problem was that Lehman was unable to obtain a true sale opinion from a United States lawyer. Lehman's Repo 105 Accounting Policy states: "We generally cannot obtain a true sale opinion under U.S.

[3015] ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Financial Accounting Standards No. 140, ¶ 9.a. (Fin. Accounting Standards Bd. 2000) ("SFAS 140").

[3016] Auditing guidance provides that "A determination about whether the isolation criterion has been met to support a conclusion regarding surrender of control is largely a matter of law. This aspect of surrender of control, therefore, is assessed primarily from a legal perspective." Using the Work of a Specialist: Auditing Interpretations of Section 336, AU § 9336.01, The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion that a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of SFAS 140 (Pub. Co. Accounting Oversight Bd. 2001) ["Using the Work of a Specialist: Auditing Interpretations of Section 336, AU § 9336"].

[3017] "[S]ince the isolation aspect of surrender of control is assessed primarily from a legal perspective, the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion." Using the Work of a Specialist: Auditing Interpretations of Section 336, AU § 9336.21.

[3018] Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at p. 1 [LBEX-DOCID 3213293] (attached to e-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Mar. 6, 2008) [LBEX-DOCID 3223442]).

law;" "Repos generally cannot be treated as sales in the United States because lawyers cannot provide a true sale opinion under U.S. law."[3019] Lehman was able to get a true sale opinion from the Linklaters law firm in London, in several iterations, under the laws of the United Kingdom.[3020]

The Linklaters letter was addressed to LBIE, and analyzes repo transactions executed under a 1995 or 2000 version of a Global Master Repurchase Agreement under English law, as applied by English courts.[3021] The Linklaters letter provides "[t]his

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[3019] *Id.* Several witnesses similarly recalled that Lehman was unable to obtain a true sale opinion from a law firm based in the United States related to Lehman's Repo 105 transactions. Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 13; Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 7; Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 8; Examiner's Interview of John Coghlan, Nov. 11, 2009, at p. 9; Examiner's Interview of Matthew Lee, July 1, 2009, at p. 15.

[3020] *See generally* Letter from Linklaters, to Lehman Brothers International (Europe), re: Repurchase Transactions under a Global Master Repurchase Agreement (May 31, 2006) [LBEX-LBIE 000001]. Lehman's internal Repo 105 Accounting Policy and an internal PowerPoint presentation referenced several iterations of the Linklaters opinion letter and witnesses state that Lehman refreshed the Linklaters letter on more than one occasion. *See* Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 3 [LBEX-WGM 748489] (stating that true sale opinion letter for GMRA was first obtained in May 2001, updated in September 2004, and further updated in May 2006); Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at p. 1 [LBEX-DOCID 3213293] (stating that Linklaters has issued opinions under a GMRA); Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 8 (stating that Ed Grieb refreshed the Linklaters letter). Though Lehman refreshed the letter several times, the Examiner has been able to locate only one version of the Linklaters letter, dated May 31, 2006. The May 2006 Linklaters Letter is reproduced at Appendix 17, Repo 105 Appendix.

[3021] Letter from Linklaters, to Lehman Brothers International (Europe), re: Repurchase Transactions under a Global Master Repurchase Agreement (May 31, 2006) [LBEX-LBIE 000001]; *see also* Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at p. 1 [LBEX-DOCID 3213293] ("This policy addresses repo transactions executed in the UK under a Global Master Repurchase Agreement ('GMRA') provided the counterparty resides in a jurisdiction covered under English law…. The UK law firm of Linklaters has issues us true sale opinions covering Repo 105 and Repo 108 transactions documented under a GMRA under English law."); Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 1 [LBEX-WGM 748489] ("A repo under a Global Master Repurchase Agreement [GMRA] is a 'true sale'"); *id*., at 3 (stating legal opinion in place for GMRA). Lehman's internal Repo 105 Accounting Policy likewise stated that "Repo 105 and Repo 108 contracts are typically executed by Lehman Brothers International (Europe) ('LBIE') because true sale opinions can be

opinion is addressed to you [LBIE] solely for your benefit" and that "[i]t is not to be transmitted to anyone else, nor is it to be relied upon by anyone else or for any other purpose. . . ."[3022] The letter stated, however, that "a copy of this opinion may be

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obtained under English law." Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at p. 1 [LBEX-DOCID 3213293]. Lehman acquired legal opinions from Linklaters covering other forms of contracts – the OSLA (Overseas Securities Lending Agreement), GESLA (Master Gilt Edged Stock Lending Agreement) and GMSLA (Global Master Securities Lending Agreement) – but these were never used. Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 3 [LBEX-WGM 748489]; Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at p. 1 [LBEX-DOCID 3213293]. The requirement of a true sale opinion letter was well known throughout the firm. *See* e-mail from John Feraca, Lehman, to Annie Lin, Lehman (Apr. 17, 2008) [LBEX-DOCID 3347035] ("You have to get approval from both Finance and Legal locally before you proceed on this. If they need assistance, they can work with their respective counterparts in London and NY. Effectively you need a true sale legal opinion for the repo agreement and the entity you operate from and affirmation that your counterpart operates in an enforceable legal jurisdiction. Doubt we have one from LBAU. Then you need to get approval from Finance. As such, I know LBIE and the GMRA agreement used by it are ok. You can do back to back repos with LBIE who can in turn repo to third parties. Not ideal though."); *see also* e-mail from Brett Beldner, Lehman, to Jignesh Doshi, Lehman, *et al.* (Dec. 13, 2007) [LBEX-DOCID 3383368] (transmitting Repo 105 Accounting Policy and stating "beside getting in contact with Europe legal to make sure you can get the true sale opinion, you also should probably get John Feraca and Mike McGarvey into the loop. They deal with Repo 105 from both a structure/capacity side (John) and the Product Control side (Mike) and can probably direct you to the proper contacts to address any legal/operational questions."). All Repo 105 transactions were undertaken pursuant to a "GMRA" or Global Master Repurchase Agreement, which is published by PSA and the International Securities Market Association, used for international repo agreements, and governed by English law, though parties may modify the governing law. *See* Appendix 17, Repo 105 Appendix (discussing GMRA in contrast to MRA, or Master Repurchase Agreement).

[3022] Letter from Linklaters, to Lehman Brothers International (Europe), re: Repurchase Transactions under a Global Master Repurchase Agreement (May 31, 2006), at p. 8 [LBEX-LBIE 000001]. Despite that express condition and the express acknowledgement in Lehman's Repo 105 Accounting Policy that Lehman was unable to obtain a true sale opinion under United States law, Lehman's financial officers were unconcerned that a significant portion of Lehman's firm-wide Repo 105 transactions utilized securities/assets that were owned by and originated from United States-based Lehman entities. John Feraca recalled "indifference" among Lehman mid-level management to the divergence between English and American law that prevented a United States law firm from issuing Lehman a true sale opinion for Repo 105 transactions. Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 8 (stating "there was never any angst about it"). Feraca recalled that Lehman's inability to get a true sale opinion under United States law was discussed as early as 2001, when Lehman first designed its Repo 105 program. *Id.* Feraca did not recall any Lehman employee undertaking an analysis of whether an intercompany repo between a United States-based Lehman entity and LBIE, conducted solely for purposes of executing a Repo 105 transaction, complied with Lehman's internal Repo 105 Accounting Policy. *Id.* Ed Grieb, former Global Financial Controller, was aware that Lehman was unable to get a United States true sale opinion to

provided by Lehman Brothers to its auditors for the purpose of preparing the firm's balance sheets."[3023] The Linklaters letter did not contain any reference to United States GAAP or SFAS 140.[3024]

Although the Linklaters letter was written for the exclusive benefit of LBIE, a significant volume of Lehman's Repo 105 transactions was executed for the benefit and using the securities of one or more United States-based Lehman entities, such as LBI and LBSF, based in New York.[3025]

Consequently, there were two alternative structures for Repo 105 transactions: (1) a LBIE-only Repo 105 or Repo 108 transaction, executed by LBIE in London using securities owned by LBIE, and (2) a Repo 105 transaction using securities that were owned by, and originated from, a United States-based Lehman entity such as LBI or LBSF.[3026]

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engage in Repo 105 transactions and that this fact was explicitly referenced in Lehman's Repo 105 Accounting Policy. Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 7. Grieb also knew that some volume of assets was transferred to LBIE from United States-based Lehman entities for the sole purpose of executing Repo 105 transactions. *Id.* When the Examiner asked whether Grieb was ever concerned that in the face of not being able to acquire a United States true sale opinion, United States-based Lehman entities transferred inventory to LBIE for inclusion in Repo 105 transactions on its behalf, Grieb answered "It never raised a concern because I never linked the issues in my head." *Id.*

[3023] Letter from Linklaters, to Lehman Brothers International (Europe), re: Repurchase Transactions under a Global Master Repurchase Agreement (May 31, 2006) [LBEX-LBIE 000001], at pp. 8-9.

[3024] *See generally id.*

[3025] *See* Section III.A.4.d.3 of this Report. Furthermore, the volume of Repo 105 transactions using LBI securities, for the benefit of LBI's balance sheet, grew significantly after late 2007.

[3026] United States-based Lehman entities generally engaged in Repo 105, rather than Repo 108 transactions. Repo 108 transactions were limited to equities securities. *See* Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 4 [LBEX-WGM 748489]; Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at p. 1 [LBEX-DOCID 3213304].

The anatomy of a Repo 105 transaction involving assets that originated on the books of LBIE was identical to the anatomy of an ordinary repo transaction, except the Repo 105 transaction carried a greater haircut. In this type of Repo 105 transaction, LBIE transferred $105 or $108 worth of securities it owned to its counterparty in exchange for $100 in cash.[3027] LBIE then used the $100 in cash to pay down other short-term liabilities.[3028]

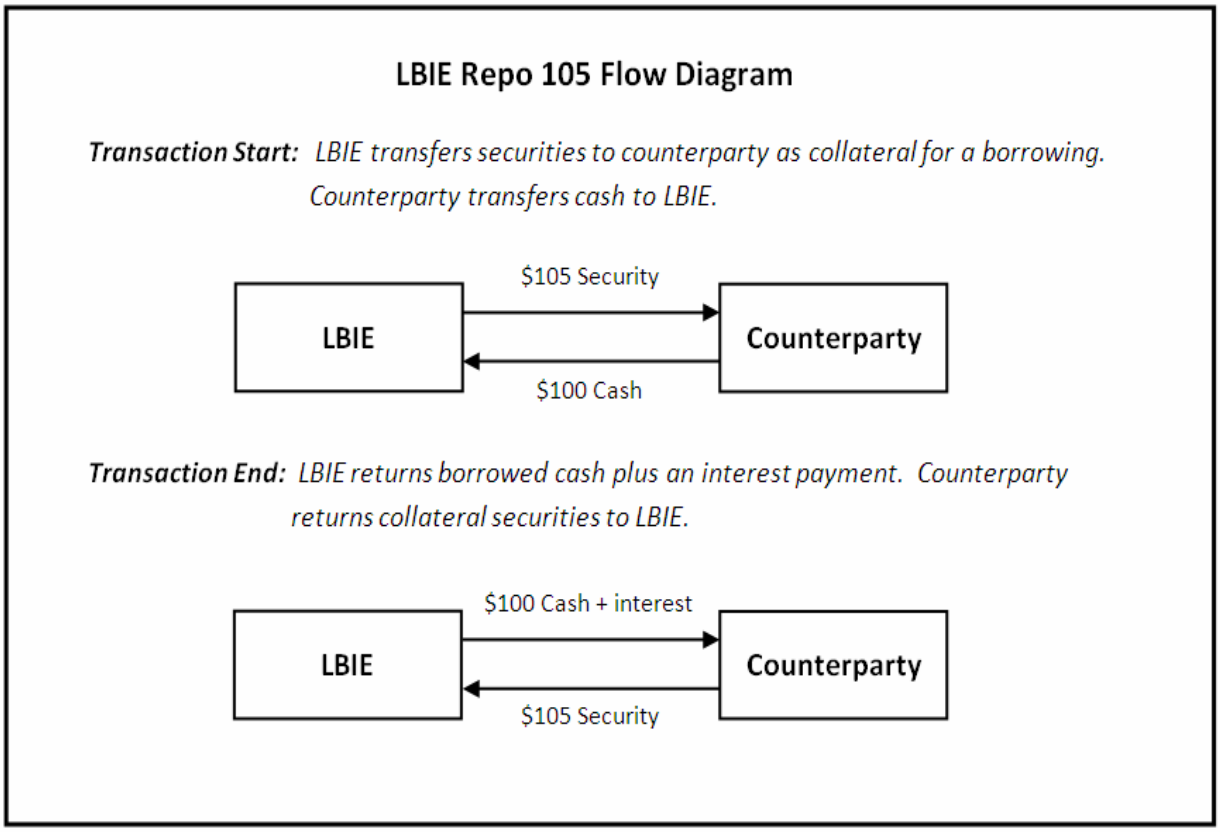
When the Repo 105 transaction matured, LBIE repaid the cash plus interest and received its collateral back.[3029] Because Lehman was a consolidated business and LBIE's financial results were rolled into the consolidated financial statements LBHI filed in the United States, the LBIE-only Repo 105 practice impacted LBHI's publicly reported balance sheet and leverage ratios.[3030]

[3027] The only difference between the anatomy of a standard repo and a Repo 105 transaction is the haircut or overcollateralization; structurally, standard repo and Repo 105 transactions are identical.

[3028] *See* LBIE Repo 105 Flow Diagram, *infra*; Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at pp. 4-5; Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 9; Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 7; Examiner's Interview of Matthew Lee, July 1, 2009, at p. 14; LBHI 2007 10-K, at p. 86 (reporting that Lehman had $7.286 billion in cash and cash equivalents on November 30, 2007); LBHI 10-Q (filed Apr. 9 2008), at p. 5 (reporting that Lehman had $7.564 billion in cash and cash equivalents on February 29, 2008); LBHI 10-Q (filed July 10, 2008), at p. 5 (reporting that Lehman had $6.513 billion in cash and cash equivalents on May 31, 2008).

[3029] *See* LBIE Repo 105 Flow Diagram, *infra*; Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at pp. 6-8.

[3030] Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 11; Examiner's Interview of Kaushik Amin, Sept. 17, 2009, at p. 8; Examiner's Interview of Ernst & Young, Oct. 16, 2009, at p. 11 (statement of William Schlich).



When a United States-based Lehman entity undertook a Repo 105 transaction, that entity transferred securities valued at a minimum of $105 to LBIE via an intercompany repo transaction.[3031] No haircut was applied to the intercompany repo between the United States-based Lehman entity and LBIE.[3032] Upon receiving the securities inventory from the United States-based Lehman entity, LBIE would execute a

[3031] Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 9; Examiner's Interview of Mark Gavin, Sept. 24, 2009, at pp. 6-7; Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 8; *see also* Duff & Phelps, Explanation of Repo 105 Accounting Ledger Entries and Trading System Output (Jan. 5, 2010), at p. 1.

[3032] Lehman, Global Balance Sheet, Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 1 [LBEX-WGM 748489].

Repo 105 transaction with a European counterparty using those securities.[3033] The minimum haircut for the transaction between LBIE and the counterparty, which was the actual Repo 105 transaction, was five percent.[3034]

LBHI provided LBIE with an additional $5 cash in order for LBIE to then transfer $105 in cash to the United States-based Lehman entity in exchange for its securities inventory.[3035] The United States-based Lehman entity used the $105 in cash either to pay for the repoed securities inventory or, more likely, to pay down its short-term liabilities.[3036] When the term of the repo expired, LBIE repurchased the securities from the Repo 105 counterparty and then returned the securities to the United States-based Lehman entity through an intercompany repo.[3037]

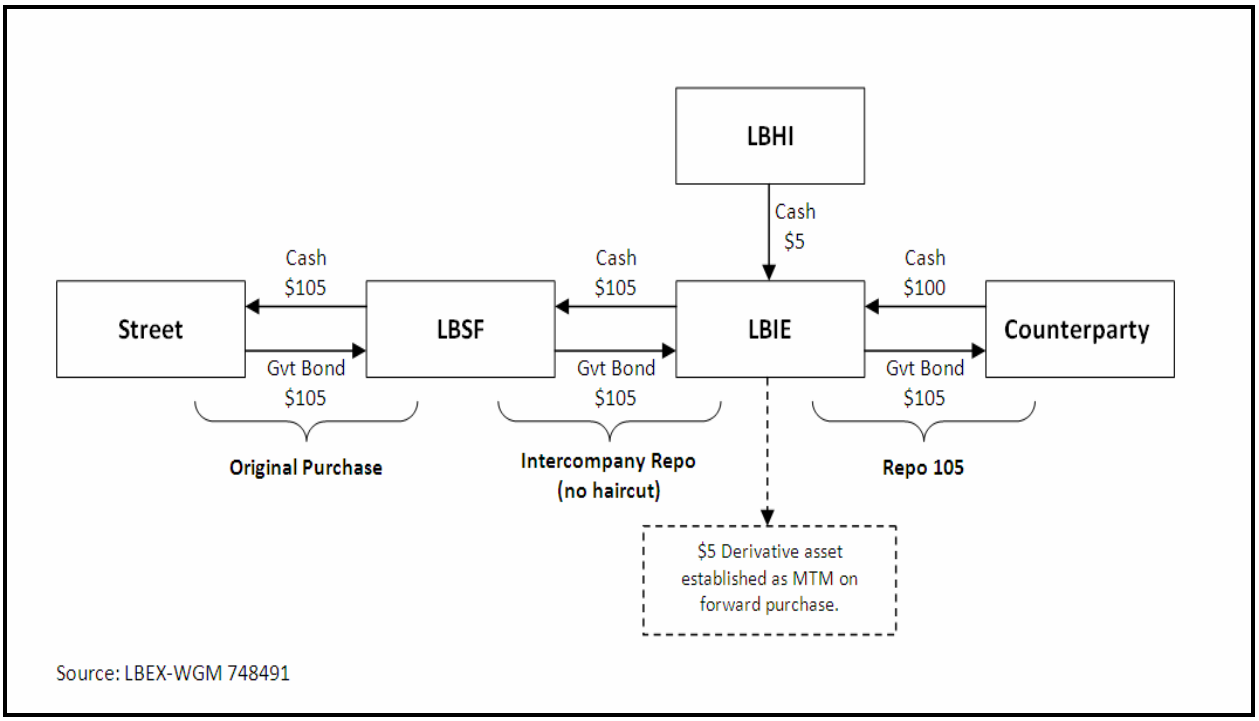
[3033] Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 9; Examiner's Interview of Mark Gavin, Sept. 24, 2009, at pp. 5-6; Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 8.

[3034] Lehman, Global Balance Sheet, Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 1 [LBEX-WGM 748489]; Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at pp. 1-2 [LBEX-DOCID 3213293].

[3035] Lehman, Global Balance Sheet, Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 1 [LBEX-WGM 748489].

[3036] Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 9; Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 7; Examiner's Interview of Matthew Lee, July 1, 2009, at p. 14; LBHI 2007 10-K, at p. 86 (reporting that Lehman had $7.286 billion in cash and cash equivalents on November 30, 2007); LBHI 10-Q (filed Apr. 9, 2008), at p. 5 (reporting that Lehman had $7.564 billion in cash and cash equivalents on February 29, 2008); LBHI 10-Q (filed July 10, 2008), at p. 5 (reporting that Lehman had $6.513 billion in cash and cash equivalents on May 31, 2008).

[3037] *See* Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 1 [LBEX-WGM 748489]. In fact, Repo 105 transactions using United States-based securities could include two intercompany repo transfers: first from LBSF to LBI, and then LBI to LBIE.



Numerous documents from Lehman's archives and numerous witness statements bear out that when a United States-based Lehman entity sought to employ Repo 105 transactions to remove securities inventory from its balance sheet at quarter-end, the United States-based Lehman entity would book the Repo 105 transactions through LBIE using an inter-company repo transaction.[3038] A substantial volume of

[3038] *See, e.g.*, E-mail from Kaushik Amin, Lehman, to Thomas Siegmund, Lehman, *et al.* (Aug. 23, 2006) [LBEX-DOCID 2786869] ("We have additional $2.5 Bln in Repo 105 that the firm has signed off on . . . . So, let's max out the capacity. We should be able to use some of the collateral from the Agency business in the US."); e-mail from Anthony Jawad, Lehman, to Terry Burke, Lehman (Mar. 3, 2008) [LBEX-DOCID 224902] ("[W]henever I do 105 for ledgers based in ny we never do a ledger transfer for the 105 part, the true sale is recognized and the long cash account debited."); e-mail from Michael McGarvey, Lehman, to Jerry Rizzieri, Lehman (Feb. 20, 2008) [LBEX-DOCID 3235353] (McGarvey: "For quarter end balance sheet do you still feel Rates Americas will be able to make target?" Rizzieri: "Can we get more Repo 105?"); e-mail from Jerry Rizzieri, Lehman, to Chaz Gothard, Lehman, *et al.* (Feb. 20, 2008) [LBEX-DOCID 3385847] ("I know you work with Mitch King [United States Agency Desk] to secure more repo 105 financing for agency product. I would like to know if we could continue to push the capacity higher. We are likely to use more agency product as collateral and might even use some TIPS and discount notes."); e-mail from Mark Gavin, Lehman, to John Feraca, Lehman, *et al.* (Feb. 29, 2008) [LBEX-DOCID 098494] ("Repo 105 on

US T's Agencies, TIPS, Aid Bonds for Q end just shy of $18bln."); e-mail from Mark Neller, Lehman, to Marc Silverberg, Lehman, *et al.* (Mar. 4, 2008) [LBEX-DOCID 3234667] (responding to request for list of confirmed quarter-end Repo 105 trades done out of LBI, Lehman's New York-based broker-dealer, sending Total Repo 105 & Repo 108 Report as attachment [LBEX-DOCID 3219760], and instructing "if you filter for Sum Americas you should see all your anticipated benefits"); e-mail from Michael McGarvey, Lehman, to Clement Bernard, Lehman, *et al.* (Mar. 13, 2008) [LBEX-DOCID 2794226] ("We have failed on 3 bn of repo 105 to UBS for this week's roll. . . . This is an ops issue that occurs sometimes due to the time difference between NY and London. If the repo desk in London does a 105 trade and those bonds are not in sitting in LBI's box we can fail. . . ."); e-mail from Jeff Michaels, Lehman, to Phil Morgan, Lehman, *et al.* (May 22, 2008) [LBEX-DOCID 3385953] (stating that the Repo 105 "point people" in the United States are Mitch King in Front Office Trading, Michael McGarvey in Finance Control, and Tejal Joshi in Balance Sheet Management); e-mail from Michael McGarvey, Lehman, to Mark Gavin, Lehman, *et al.* (Feb. 28, 2008) [LBEX-DOCID 810932] (sending London desk "a list of corporate bonds held in NY (all above BBB and 10 mm in market value) available for any additional Repo 105 capacity we can find" contained in attached schedule of securities [LBEX-DOCID 791568]); e-mail from Chaz Gothard, Lehman, to James W. Hraska, Lehman, *et al.* (Oct. 1, 2007) [LBEX-DOCID 3233264] (transmitting attached lists of Repo 105 trades from United States Agency Desk with Mizuho [LBEX-DOCID 3219676 and LBEX-DOCID 3235916], Barclays [LBEX-DOCID 3235823], UBS [LBEX-DOCID 3235853]); e-mail from Michael McGarvey, Lehman, to Jerry Rizzieri, Lehman (Nov. 5, 2007) [LBEX-DOCID 3233300] (transmitting lists of United States Agency Desk Repo 105 trades [LBEX-DOCID 3235736, LBEX-DOCID 3235807, LBEX-DOCID 3235832, LBEX-DOCID 3235928] and stating that "[w]e will try to get as high as possible for month end," *i.e.*, end of fiscal year 2007); e-mail from Mark Gavin, Lehman, to James W. Hraska, Lehman, *et al.* (Dec. 4, 2007) [LBEX-DOCID 3385990] (transmitting lists [LBEX-DOCID 3369462, LBEX-DOCID 3369531, LBEX-DOCID 3369532, LBEX-DOCID 3369537] of Repo 105 trades for United States Agency Desk). Tejal Joshi, Michael McGarvey, Mark Gavin, Mitch King, Ed Grieb and other witnesses stated that LBI was involved in Lehman's Repo 105 program. Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 9; Examiner's Interview of Tejal Joshi, Sept. 15, 2009, at p. 7; Examiner's Interview of Mitchell King, Sept. 21, 2009, at pp. 5-6, 8; Examiner's Interview of Mark Gavin, Sept. 24, 2009, at pp. 5-6; Examiner's Interview of Edward Grieb, Oct. 2, 2009, at pp. 7-8; Examiner's Interview of Kaushik Amin, Sept. 17, 2009, at p. 8; Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 13. In order to effectuate timely transfers of securities from United States-based Lehman entities to LBIE, Lehman's New York desk and its London (LBIE) desk communicated regularly. The United States desk did not use the Repo 108 mechanism, which was used on European Equities securities. Each Friday, Marc Silverberg, an analyst assigned to Lehman's Americas Rates trading desk in New York (within Lehman's Fixed Income Division), compiled lists of securities/assets that Lehman's Americas Rates business wanted to make available for use in Repo 105 transactions through LBIE the following week. E-mail from Marc Silverberg, Lehman, to Chaz Gothard, Lehman, *et al.* (Aug. 3, 2007) [LBEX-DOCID 3232701] (transmitting schedule of United States Agency Desk Repo 105 trades for Aug. 8, 2007 through Aug. 15, 2007 [LBEX-DOCID 3235803]); e-mail from Marc Silverberg, Lehman, to Mitchell King, Lehman, *et al.* (Feb. 26, 2008) [LBEX-DOCID 3234639] (transmitting attached list of United States Agency Desk collateral used in Repo 105 transactions [LBEX-DOCID 3235977; LBEX-DOCID 3235986]); e-mail from Marc Silverberg, Lehman, to Michael McGarvey, Lehman, *et al.* (Mar. 4, 2008) [LBEX-DOCID 3233386] (transmitting attached lists of Repo 105 trades from United States Agency Desk [LBEX-DOCID 3232665, LBEX-DOCID 3235775, LBEX-DOCID 3236009, LBEX-DOCID 3236010, and LBEX-DOCID 3236012]); e-mail from Marc Silverberg, Lehman, to Mark Gavin, Lehman, *et al.* (Nov. 27, 2007) [LBEX-DOCID 3232772] (transmitting lists [LBEX-DOCID 3219744, LBEX-DOCID 3235939] of additional collateral United States Agency Desk wished to use for Repo 105

Lehman's firm-wide Repo 105 transactions at each quarter-end in late 2007 through mid-2008 involved assets that originated with a United States-based Lehman entity.[3039] Specifically:

- fourth quarter 2007: $8.3036 billion[3040]

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transactions over year-end); e-mail from Marc Silverberg, Lehman, to Chaz Gothard, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 3232669] (transmitting list [LBEX-DOCID 3236024] of United States Agency Desk's Repo 105 trades). Lehman traders based in New York City created the lists of potential Repo 105 securities, which they gave to Silverberg each week. Silverberg then sent the lists to Lehman's London trading desk each Friday, in hopes that LBIE could find Repo 105 capacity among counterparties. According to one document of confirmed, executed Repo 105 trades for securities from New York's trading desk, the Rates Americas business (one unit within Lehman's FID) alone was able to reduce its quarter-end balance sheet in first quarter 2008 by $14.871 billion through the use of Repo 105 transactions. E-mail from Mitchell King, Lehman, to Jeff Michaels, Lehman (May 20, 2008) [LBEX-DOCID 3233043] (transmitting "Rates America Repo 105 Q1 Roll" list [LBEX-DOCID 3235728] of trades, by ledger, cusip, description of securities, face value, and repo value). On occasion, Michael McGarvey, the former Finance Controller in Lehman's Fixed Income Division, compiled lists of United States securities available for potential use in Repo 105 transactions. E-mail from Michael McGarvey, Lehman, to Jeff Michaels, Lehman, *et al.* (May 22, 2008) [LBEX-DOCID 3385955] ("The attached asset list [LBEX-DOCID 3369637] shows all available collateral by cusip, what has already been sent out on 105 (including subs) and what will be sent out. Please let us know of any additional collateral that you want to send out.").

[3039] *See* Lehman, Total Repo 105 & Repo 108 Report (Dec. 5, 2007) [LBEX-DOCID 3219746] (attached to e-mail from Anuraj Bismal, Lehman, to Marie Stewart, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223384]); Lehman, Total Repo 105 & Repo 108 Report (June 11, 2008) [LBEX-DOCID 2078195] (attached to e-mail from Kristie Wong, Lehman, to Martin Kelly, Lehman (June 11, 2008) [LBEX-DOCID 2325872]. Michael McGarvey, the former Finance Controller in Lehman's FID, said that a certain volume of Repo 105 trades were executed using "assets that were held in U.S. trading books." Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 9. Consequently, according to McGarvey, "the Repo 105 benefit applied to a U.S. trading desk." *Id.* McGarvey stated that the United States-based securities were usually "agencies, bullets, Fannie and Freddie." *Id.* McGarvey also stated that a Lehman New York trading desk would book an intercompany repo, transferring the securities to LBI's "box" in London. *Id.* John Feraca, who formerly worked in the Secured Funding Desk of Lehman's Prime Services Group, similarly stated that a certain volume of assets used in Lehman's Repo 105 transactions originated in New York at a United States-based Lehman entity, and landed on the books of LBIE by means of an intercompany transfer between LBI and LBIE, before LBIE transferred the assets to a third-party via the Repo 105 transaction. Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 8. Feraca said that this process was "well known in Finance and Accounting Policy, completely up the ranks." *Id.* McGarvey's and Feraca's description of the mechanics of how a United States-based Lehman entity engaged in Repo 105 transactions, using an inter-company repo with LBIE, is consistent with both flow diagrams of Repo 105 transactions contained in internal Lehman documents and descriptions from other witnesses. *See* Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 1 [LBEX-WGM 748489].

- first quarter 2008: $14.889 billion[3041]
- second quarter 2008: $13.6307 billion.[3042]

(4) Types of Securities Used in Repo 105 Transactions

Lehman's Repo 105 Accounting Policy required that the assets used in a Repo 105 transaction "be readily obtainable," meaning that "a market must exist where the assets are either traded on a formal exchange or are considered liquid and trade in a market where price quotations either are published or are obtainable through another verifiable source."[3043] The Linklaters opinion letter for Repo 105 transactions conditioned its opinion on the assumption that "the Purchased Securities consist of liquid securities, so that the Buyer could easily dispose of the Purchased Securities and acquire equivalent securities if it wished."[3044]

[3040] *See* Lehman, Total Repo 105 & Repo 108 Report (Dec. 5, 2007) [LBEX-DOCID 3219746] (attached to e-mail from Anuraj Bismal, Lehman, to Marie Stewart, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223384]). The United States entities engaged in $8.3036 billion of Repo 105 transactions, out of a global total of $29.916 billion Repo 105-only or $38.634 billion combined Repo 105/108. *Id.*

[3041] *See* Lehman, Total Repo 105 & Repo 108 Report (June 11, 2008) [LBEX-DOCID 2078195] (attached to e-mail from Kristie Wong, Lehman, to Martin Kelly, Lehman (June 11, 2008) [LBEX-DOCID 2325872]). The United States entities engaged in $14.889 billion of Repo 105 transactions out of a global total of $42.200 billion Repo 105-only or $49.102 billion combined Repo 105/108. *Id.*

[3042] *See* Lehman, Total Repo 105 & Repo 108 Report (June 11, 2008) [LBEX-DOCID 2078195] (attached to e-mail from Kristie Wong, Lehman, to Martin Kelly, Lehman (June 11, 2008) [LBEX-DOCID 2325872]). The United States entities engaged in $13.6307 billion of Repo 105 transactions out of a global total of $44.536 billion of Repo 105-only or $50.383 billion combined Repo 105/108. *Id.*

[3043] *See*, *e.g.*, Lehman Brothers Holdings Inc., Accounting Policy Manual, Repo 105 and Repo 108 (Sept. 9, 2006), at p. 2 [LBEX-WGM 754598].

[3044] Letter from Linklaters, to Lehman Brothers International (Europe), re: Repurchase Transactions under a Global Master Repurchase Agreement (May 31, 2006), at p. 2 [LBEX-LBIE 000001]. *See* Appendix 17, Repo 105 Appendix.

The "liquidity requirement" for Repo 105 transactions was widely known throughout Lehman.[3045] Lehman had intermittent controls in place to ensure that Lehman personnel transferred only liquid securities as part of Repo 105 transactions, as required by Lehman's Repo 105 Accounting Policy.[3046] Contemporaneous documents reveal that employees within Lehman's Product Control group periodically would identify securities that had been included erroneously in Repo 105 transactions. For example, in October 2007, one Lehman employee wrote: "Having spoken to Product Control the following positions should not have been included for Repo 105 benefit as they related to Failed Sale Gross Up for Windermere 11 and 12. . . . Going forward,

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[3045] Anuraj Bismal, a former Senior Vice President in Lehman's Balance Sheet Group, explained that the requirement in Lehman's internal Repo 105 Accounting Policy that only highly liquid securities or "govies" could be used in Repo 105 transactions was well known throughout the firm. Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 10; Examiner's Interview of Herbert H. "Bart" McDade III, Sept. 16, 2009, at p. 4 (stating only highly liquid securities could be used in Repo 105/108); Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 14 (same); e-mail from Thomas Siegmund, Lehman, to Kaushik Amin, Lehman (May 2, 2008) [LBEX-DOCID 601783] ("[I]nternal accounting set rules on what paper can be 105'ed…in the past, we had to use the most liquid paper . . . . the true sale opinion is linked to liquidity and quality of paper – the lower liquidity and quality, the deeper the discount would have to be… and consequently the more expensive the exercise.").

[3046] Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 9 (explaining that Lehman's Balance Sheet Group would intermittently "ask the guys in Europe to check that the securities were liquid"). Bismal characterized this testing as a "snapshot test" that was "not a regular thing." *Id.* For example, in June 2008, Martin Kelly received a collateral quality testing report. *See* Lehman, Repo 105 Collateral Quality Testing (May 30, 2008) [LBEX-DOCID 2057755] (attached to e-mail from Kristie Wong, Lehman, to Martin Kelly, Lehman (June 11, 2008) [LBEX-DOCID 2325872]); *see also* Lehman, Repo 108 Checklist (June 1, 2008) [LBEX-DOCID 2078196] (attached to e-mail from Kristie Wong, Lehman, to Martin Kelly, Lehman (June 11, 2008) [LBEX-DOCID 2325872]). The May 2008 Collateral Quality Test reported that nearly 95% of the securities Lehman utilized in Repo 105 transactions "were rated investment grade by S&P, Moody's, Fitch, or DBRS Ratings Services." Lehman, Repo 105 Collateral Quality Testing (May 30, 2008) [LBEX-DOCID 2057755]. Less than 1% of the securities had no ratings information available. *Id.* A similar test from May 2007 reported that 8.27% of the tested Repo 105 securities were rated investment grade by S&P, Moody's, Fitch, or DBRS, and that 80.74% of the remaining securities had "similar company Investment grade ratings." Lehman, Repo 105 Collateral Quality Testing (May 31, 2007) [LBEX-DOCID 2464013] (attached to e-mail from Divyesh Chokshi, Lehman, to Anuraj Bismal, Lehman, *et al.* (Oct. 2, 2007) [LBEX-DOCID 2687082]).

Product Control will advise us of all positions relating to the FAS140 Failed Sale Gross Up."[3047]

In addition, documentary evidence suggests that as Global Head of Accounting Policy, Marie Stewart, was consulted on new applications of the Repo 105 mechanism.[3048] Stewart said that it was very "typical of people in the Front Office" to try to apply the Repo 105 mechanism to new situations, such as when FID Asia tried to include Australian securities in a Repo 105 transaction.[3049]

[3047] E-mail from Divyesh Chokshi, Lehman, to Anuraj Bismal, Lehman, *et al.* (Oct. 2, 2007) [LBEX-DOCID 2687082]; *see also* Lehman, Real Estate Europe Product Schedule (Oct. 2, 2007) [LBEX-DOCID 2717917] (attached to e-mail from Divyesh Chokshi, Lehman, to Anuraj Bismal, Lehman, *et al.* (Oct. 2, 2007) [LBEX-DOCID 2687082] and listing Windermere product names). The failed SFAS 140 true sale accounting treatment of the Windermere products was reported up to the Global Head of Accounting Policy. *See* e-mail from Marie Stewart, Lehman, to Todd Weiner, Lehman, *et al.* (Oct. 23, 2007) [LBEX-DOCID 3223368].

[3048] For example, when Mark Cosaitis hoped to use the Repo 105 mechanism to get failed sales deconsolidated, Stewart was involved, along with Ernst & Young and Ed Grieb, in denying him permission. *See* e-mail from Brett Beldner, Lehman, to Marie Stewart, Lehman, *et al.* (Aug. 17, 2008) [LBEX-DOCID 3223803]; e-mail from Marie Stewart, Lehman, to Mark Cosaitis, Lehman, *et al.* (Aug. 17, 2008) [LBEX-DOCID 3223806]; *see also* e-mail from Todd Weiner, Lehman, to Annie Lin, Lehman (Apr. 17, 2008) [LBEX-DOCID 739685] ("All new repo 105 activity needs to be discussed with Marie Stewart and Martin Kelly in New York.").

[3049] Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 10; e-mail from Annie Lin, Lehman, to Todd Wiener, Lehman, *et al.* (Apr. 16, 2007) [LBEX-DOCID 739685] (asking whether Lehman Brothers Australia Ltd. ("LBAU") could "do a back to back position transfer between LBAU and LBIE in order to benefit from repo 105 rule"); e-mail from Marie Stewart, Lehman, to Annie Lin, Lehman, *et al.* (Apr. 17, 2008) [LBEX-DOCID 739685] ("You cannot do Repo 105 in Australia. We will not approve it even if it technically works. I will explain further when I am back from vacation . . . ."); e-mail from Thomas Siegmund, Lehman, to Kaushik Amin, Lehman (Apr. 17, 2008) [LBEX-DOCID 739685] ("As B/S will be super tight, I need to make sure we make best use of 105: I want to investigate whether 105-mechanics can apply to Aussie paper. An answer like below, 'no . . . will explain when back from vac' is unacceptable in any circumstances and really out of line in the current situation!").

For the vast majority of Repo 105 transactions, Lehman used relatively liquid securities, but, there were certain exceptions.[3050] Notably, these same securities could have been used in ordinary repo transactions as well.

Most securities Lehman used in Repo 105 transactions were "governmental" in nature, suggesting a certain level of liquidity.[3051] Indeed, the vast majority of securities Lehman utilized in Repo 105 transactions were investment grade, with all but a few of

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[3050] *See*, *e.g.*, e-mail from Clement Bernard, Lehman, to Roger Nagioff, Lehman, *et al.* (Nov. 20, 2007) [LBEX-DOCID 173748] ("In the US we believe that most of our Agency positions will be out through 105 transactions…"); e-mail from Dominic Gibb, Lehman, to Mark Cosaitis, Lehman, *et al.* (Feb. 28, 2008) [LBHI_SEC07940_1829372] ("Jock and his team are aggressively working to obtain repo 105 funding for all eligible govvies positions. If they are successful then we will have $23 bn of assets on Repo 105 at quarter end. . . . This would leave FID with a net balance sheet of $51.7bn, $4.7 bn above the FID limit. . . ."). Certain documents, however, suggest that Lehman perhaps *attempted* to use less liquid collateral in Repo 105 transactions. *See* e-mail from Michael McGarvey, Lehman, to Gerard Reilly, Lehman, *et al.* (Aug. 17, 2007) [LBEX-DOCID 3213312] ("There was call this morning with John Feraca on getting Mortgages out on 105. London is going to show some examples of fixed AAA non-agency mortgages to Mizuho (who we have a good relationship with) to see if they would be open to taking them. Based on Mizuho's reaction we are going to meet again Monday to determine [how] much we can do."); e-mail from Kentaro Umezaki, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Aug. 17, 2007) [LBEX-DOCID 1533678] ("John Feraca is working on Repo 105 for our IG mortgage and real estate assets to reduce our Q3 balance sheet. . . . He will test the waters a bit in London with one counterparty.").

[3051] Governmental securities were used in Repo 105 transactions only. Repo 108 transactions utilized equities securities. Governmental security type includes, but is not limited to, governments, treasuries, and agencies. Agencies included Freddie Mac, Fannie Mae, and Federal Home Loan Bank System securities. *See* e-mail from Michael McGarvey, Lehman, to Jeff Michaels, Lehman, *et al.* (May 22, 2008) [LBEX-DOCID 482311] (transmitting list [LBEX-DOCID 472396] of all available collateral for Repo 105, including Freddie Mac and Fannie Mae). By late summer 2008, however, Repo 105 counterparties were unwilling to accept Freddie Mac securities. E-mail from Marc Silverberg, Lehman, to Chaz Gotthard, Lehman, *et al.* (Aug. 7, 2008) [LBHI_SEC07940_1742976] (stating that Freddie Mac had been removed from a Repo 105 counterparty's list because it is "no longer acceptable collateral to post for 105."). Some internal Lehman e-mails from within the Liquid Markets division referred to certain agency securities as "sticky," but the use of that term in such e-mails would not have indicated illiquidity, only that certain agency securities were more difficult to sell than others. *See* e-mail from Jeff Michaels, Lehman, to Kaushik Amin, Lehman (July 30, 2008) [LBEX-DOCID 613324] (stating "balance sheet allocation[] . . . [which] is really a bottom-up process about who has sticky inventory. Obviously in the US it is agencies. . . ." and transmitting graph of Agency Desk gross and net balance sheet pre-Repo 105 [LBEX-DOCID 775856] and graph of Euro Inflation Desk gross and net balance sheet pre-Repo 105 [LBEX-DOCID 775857]).

the securities falling within the A to AAA range.[3052] In addition, the majority of Lehman's Repo 105 securities fit within Level 1 under SFAS 157's "Fair Value Level" GAAP-required reporting categories.[3053]

Lehman also used the following volumes of non-"government" securities in Repo 105 transactions:[3054]

- November 30, 2007: $4.8 billion (out of a total of $29.9 billion in Repo 105 transactions), or 16% of the total Repo 105 volume;
- February 29, 2008: $4.8 billion (out of a total of $41.8 billion in Repo 105 transactions), or 11% of the total Repo 105 volume; and
- May 30, 2008: $4.2 billion (out of a total of $44.5 billion in Repo 105 transactions), or 9% of the total Repo 105 volume.

(5) Product Controllers Manually Booked Repo 105 Transactions

Repo 105 transactions began as ordinary repos booked in the same trading and accounting systems as ordinary repos.[3055] Lehman's electronic accounting systems

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[3052] Duff & Phelps Report, Repo 105 Security Liquidity Analysis (Oct. 21, 2009), at p. 5.

[3053] *Id.* at p. 6. The valuation of Level 1 assets under SFAS 157 requires the use of directly observable inputs, *i.e.*, quoted prices in active markets for identical assets or liabilities accessible on the valuation date. FAIR VALUE MEASUREMENTS, Statement of Fin. Accounting Standards No. 157, ¶ 24 (Fin. Accounting Standards Bd. 2006) ("SFAS 157"). The valuation of Level 2 assets requires the use of directly or indirectly observable prices in active markets for similar assets or liabilities, quoted prices for identical or similar items in markets that are not active and inputs other than quoted prices such as yield curves, credit risks, and volatilities. SFAS 157, ¶ 28. The valuation of Level 3 assets requires the use of unobservable inputs that reflect management's own assumptions about the assumptions that market participants would make. SFAS 157, ¶ 30.

[3054] Duff & Phelps Report, Repo 105 Security Liquidity Analysis (Oct. 21, 2009), at p. 3. Note that the figures listed report only the volumes of *Repo 105* transactions that Lehman engaged in at quarter-end for the reported period. The figures do not include the volume of Repo 108 transactions that Lehman undertook at the quarter-end periods.

[3055] Duff & Phelps, Explanation of Repo 105 Accounting Ledger Entries and Trading System Output (Jan. 5, 2010), at p. 3.

automatically treated all repo transactions as financing transactions, *i.e.*, borrowings.[3056] Since the accounting and trading systems were not designed to treat any repo transactions as sales, a "manual intervention" into Lehman's electronic books and records systems was necessary to re-characterize Repo 105 borrowings as sales for accounting purposes.[3057]

The financial results of LBIE's business operations rolled up into LBHI's consolidated financial statements filed in the United States. Lehman entities around the world maintained their books and records using United States GAAP principles.[3058] In addition, LBIE and LBSF product controllers were responsible for "transactional policing" and booking Repo 105 transactions manually and in a manner that complied with United States GAAP.[3059]

[3056] Examiner's Interview of Marie Stewart, Sept. 2, 2009, at pp. 9-10; Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 9; Examiner's Interview of Matthew Lee, July 1, 2009, at p. 13; Duff & Phelps, Explanation of Repo 105 Accounting Ledger Entries and Trading System Output (Jan. 5, 2010), at p. 3.

[3057] Examiner's Interview of Marie Stewart, Sept. 2, 2009, at pp. 9-10; Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 9; Duff & Phelps, Explanation of Repo 105 Accounting Ledger Entries and Trading System Output (Jan. 5, 2010), at p. 3.

[3058] Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 11.

[3059] *Id.* at p. 11; Duff & Phelps, Explanation of Repo 105 Accounting Ledger Entries and Trading System Output (Jan. 5, 2010), at p. 3 (citing statements of LBSF Controller Michael Montella and LBHI Controller Clifford Feibus that LBSF manual adjustments were made in New York and LBIE manual adjustments done in London); *see also* e-mail from Gerard Reilly, Lehman, to Kentaro Umezaki, Lehman, *et al.* (Sept. 4, 2007) [LBEX-DOCID 3232534] (stating that McGarvey, a product controller, "is our point on [Repo 105] from finance"); e-mail from Marie Stewart, Lehman, to Todd Weiner, Lehman (Sept. 7, 2007) [LBEX-DOCID 3223832] (responding to Weiner's request for internal Accounting Policy Manual for Repo 105 transactions "to circulate. . . amongst our colleagues in Product Control. . . apparently more folks looking to use Repo 105," by transmitting a copy of manual [LBEX-DOCID 3213300] and writing that "certain people in London P[roduct] C[ontrol] have had this policy forever"); e-mail from Marie Stewart, Lehman, to Gary Bachman, Lehman, *et al.* (Nov. 21, 2007) [LBEX-DOCID 3223383] ("Feraca knows all about Repo 105/108 and makes sure we keep by the rules. Also, FYI that we've had a few problems with people

Consequently, when LBIE's financial statements rolled up into LBHI's consolidated financial statements, no conversion to United States GAAP was

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claiming Repo 105/108 benefit recently when they should not have."); e-mail from John Feraca, Lehman, to Marie Stewart, Lehman (Nov. 22, 2007) [LBEX-DOCID 3223383] ("Conceptually yes I am the point person for the business. But Product Controllers in London are responsible for the day to day transactional policing. . . keep in mind I am not reviewing the transactional detail on a day to day basis nor making final decisions on what remains off balance sheet."). Gerard Reilly, Global Product Controller, appointed McGarvey, a product controller for Finance in FID to be the point person for Lehman's Repo 105 program. Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 10; *see also* e-mail from Michael McGarvey, Lehman, to Gerard Reilly, Lehman (Sept. 4, 2007) [LBEX-DOCID 3232534] ("We have been reviewing with the London repo desk and finance on a regular basis (We have roughly 80% of the month end 105 balance outstanding for the entire month although the daily average has been slipping.) We'll stay in front of it for the rest of the year."). When businesses within FID anticipated breaching their balance sheet limits, they would ask McGarvey for additional Repo 105 capacity. E-mail from Jerry Rizzieri, Lehman, to Michael McGarvey, Lehman (Feb. 20, 2008) [LBEX-DOCID 3235353] (McGarvey: "For quarter end balance sheet do you still feel Rates Americas will be able to make target?" Rizzieri: "Can we get more Repo 105?"). Documentary evidence shows that McGarvey regularly reported to Clement Bernard, CFO for FID, about Repo 105 policy, volumes and actual transactions. *See*, *e.g.*, e-mail from Michael McGarvey, Lehman, to Paul Mitrokostas, Lehman, *et al.* (June 3, 2008) [LBEX-DOCID 3235388] (reporting to Bernard and others that FID Net Balance Sheet for second quarter 2008 was $213.8 billion, $5.1 billion under target, and that the firm-wide Repo 105 benefit for second quarter 2008 was $50.9 billion); e-mail from Michael McGarvey, Lehman, to Clement Bernard, Lehman, *et al.* (Jan. 30, 2008) [LBEX-DOCID 2796630] ("We have repo 105 funding benefit trades on constantly in the normal course of business because accounting policy stipulates it must be a regular way fund our positions. We increase the balances for month end but try to keep it within 120 percent of the average daily usage. . . . I have a meeting Thursday with Mark Cositis and the London Repo desk to determine client appetite for Q1."); e-mail from Michael McGarvey, Lehman, to Clement Bernard, Lehman (Feb. 28, 2008) [LBEX-DOCID 810932] ("Given the critical balance sheet situation we are currently in I've attached a list of corporate bonds held in NY. . . available for any additional Repo 105 capacity we can find."). Notably, only days before Lehman's bankruptcy filing, Gerard Reilly asked Michael McGarvey to remove all references to Repo 105 from a third quarter schedule of all of Lehman's US government securities. *See* e-mail from Gerard Reilly, Lehman, to Michael McGarvey, Lehman, *et al.* (Sept. 12, 2008) [LBEX-DOCID 641537]. Bernard and Amin were among the recipients of the e-mail. Prior to Clement Bernard's assumption of the role of FID Chief Financial Officer, McGarvey reported on total Repo 105 trends. *See* Lehman, Global Repo 105/108 Trend (Aug. 2007) [LBEX-DOCID 3219672] (attached to e-mail from Michael McGarvey, Lehman, to Steven Becker, Lehman, *et al.* (Aug. 17, 2007) [LBEX-DOCID 3221344]); e-mail from Michael McGarvey, Lehman, to Clement Bernard, Lehman, *et al.* (Mar. 13, 2008) [LBEX-DOCID 2794226] (Bernard: "Do you know what is happening here on these repo 105?" McGarvey: "Repo ops has worked through most of it and we have delivered all but 750mm. This is an ops issue that occurs sometimes due to the time difference between NY and London. If the repo desk in London does a 105 trade and those bonds are not sitting in LBI's box we can fail . . . .").

required.[3060] LBHI did not subsequently verify that the Repo 105 entries manually entered by LBIE employees complied with United States GAAP.[3061] "With a UK legal opinion [*i.e.*, the Linklaters letter] that covered the [Repo] 105 [transactions], [Repo] 105 [transaction]s would be respected as a sale in the books of the entities doing them and booking them in US GAAP."[3062]

In short, Lehman undertook transactions in a foreign jurisdiction (the United Kingdom) that purported to comply with SFAS 140, where Lehman was unable to obtain a SFAS 140 true sale opinion from a United States law firm, and Lehman then relied upon the non-United States-based Lehman entity to ensure that the transaction complied with United States GAAP.

e) Managing Balance Sheet and Leverage

Starting in mid-2007, market participants began to more carefully scrutinize the leverage of investment banks.[3063] Consequently, in 2007, top Lehman executives pressured the firm's businesses to reduce balance sheet and leverage in order to meet market expectations and avoid a ratings downgrade.[3064] By January 2008, Richard Fuld

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[3060] Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 11.

[3061] *Id.*

[3062] *Id.* at p. 12.

[3063] Examiner's Interview of John Coghlan, Nov. 11, 2009, at p. 11 (recalling media's focus on the appropriateness of high leverage among financial institutions and that once the market was focused on leverage, Lehman executives believed Lehman should deleverage); Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 8 (stating that one of the motivations behind his desire to reduce net leverage was that rating agencies focused on the net leverage ratio).

[3064] Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 5 (stating that the leverage ratio target was "absolutely about how rating agencies would view Lehman" and that leverage was the "most critical"

made a strategic decision that Lehman would embark upon a firm-wide effort to reduce its balance sheet and lower the firm-wide net leverage ratio by selling assets.[3065] But many of Lehman's inventory positions had by then become increasingly "sticky" or difficult to sell without incurring substantial losses. It is against this backdrop of increased market focus on leverage that Lehman significantly increased its quarter-end use of Repo 105 transactions.

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topic for senior Lehman management in late 2007 and 2008). A downgrade in an issuer's credit rating has a significant negative impact on the financial position of a company like Lehman. *See*, *e.g.*, E-mail from Ian T. Lowitt, Lehman, to Herbert H. (Bart) McDade III, Lehman (June 30, 2008) [LBHI_SEC07940_643543] ("One notch downgrade requires 1.7 bn; and 2 notch requires 3.4 bn of additional margin posting."). Counterparties may respond to a downgrade by demanding that the issuer post additional cash collateral to secure its obligations. *See* Amadou N.R. Sy, The Systemic Regulation of Credit Rating Agencies and Rated Markets 8-9 (Int'l Monetary Fund, Working Paper, 2009) (noting that broker-dealers may use credit ratings to determine acceptable counterparties, as well as collateral levels for outstanding credit exposure); e-mail from Ian T. Lowitt, Lehman, to Eric Felder, Lehman (July 5, 2008) [LBEX-DOCID 071263] (stating that a downgrade "will affect lines and willingness of counterparties to fund secured."). Some of Lehman's derivative contracts had built-in "triggers" permitting counterparties to require additional cash collateral in the event of a downgrade. Lehman Brothers Holdings Inc., Current Report as of May 31, 2008 (Form 10-Q) (filed on July 10, 2008) ("LBHI 10-Q (filed July 10, 2008)"); *see also* Lehman, Global Treasury Downgrade Effect on Cash Capital Facilities 3-Jun-08 (June 2008) [LBHI_SEC07940_513314], attached to e-mail from Amberish Ratanghayra, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (June 3, 2008) [LBHI_SEC07940_513312]; *see also* Appendix 13, Survival, at pp. 1-3.

[3065] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at pp. 26-27 (stating that as part of deleveraging efforts in 2008, Fuld wanted Lehman to bring all of its inventory positions down, except the matched book, that he was concerned with reducing net leverage because rating agencies were concerned with net leverage, and that he wanted to reduce net leverage by reducing assets); Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at pp. 8-9 (stating that after Christmas 2007, Fuld gave clear directive to McDade to bring balance sheet down and that Fuld's focus was on less liquid assets, i.e., leveraged loans, residential securities, and CRE); Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at p. 10 (stating that he did not want to reduce the balance sheet in the matched book or on-the-run governments, but rather, in CMBS and RMBS).

(1) Lehman Management's Focus in Late 2007 on Reducing the Firm's Reported Leverage

In mid-to-late 2007, senior management began to consider the balance sheet and leverage ratios as important metrics followed by investors and the rating agencies.[3066] Lehman's Ryan Traversari (Senior Vice President-External Reporting) wrote in September 2007 to Tonucci that the "question" of net leverage ratio "has come up multiple times in the 20 seconds that I've been here – largely from [CFO] O'Meara, Freidheim, Lowitt, Corporate Strategy, *Investor Relations* and the like."[3067]

[3066] *See*, *e.g.*, e-mail from Edward Grieb, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Dec. 7, 2007) [LBEX-DOCID 3759517] (discussing net assets and leverage with Grieb, O'Meara, Callan, Tonucci and Kelly); LBHI 10-Q (filed Apr. 9, 2008), at p. 65 ("During the 2008 quarter, the Company operated in a liquidity, funding, and capital environment characterized by constrained market liquidity driven in part by balance sheet and leverage concerns."); e-mail from Ryan Traversari, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Sept. 10, 2007) [LBEX-DOCID 1695576] (comparing Lehman's net leverage ratio to that of Bear Stearns, Tonucci wrote that Lehman's net leverage calculation "was intended to reflect the methodology employed by S&P who were most interested and focused on leverage"). At least until late 2007, Lehman's Finance Committee – comprised of the firm's Chief Financial Officer (in chronological order, Christopher M. O'Meara, Erin M. Callan, and Ian T. Lowitt), Paolo Tonucci, Head of the firm's Fixed Income Division (in chronological order, Michael Gelband, Roger Nagioff, and Andrew Morton), plus other senior executives – set firm-wide balance sheet targets and leverage ratio targets. Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 7; Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 5; Examiner's Interview of Tejal Joshi, Sept. 15, 2009, at p. 5; Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 5; Examiner's Interview of Kaushik Amin, Sept. 17, 2009, at p. 5; Examiner's Interview of Mitchell King, Sept. 21, 2009, at p. 5; Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 11; Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 9; Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 5; *see also* Lehman, Treasury October 2007 Balance Sheet and Leverage Ratio Targets (Oct. 19, 2007) [LBEX-DOCID 3215540] (attached to e-mail from Lisa Kennish, Lehman, to Michael McGarvey, Lehman, *et al.* (Oct. 19, 2007) [LBEX-DOCID 3233628]); e-mail from Anuraj Bismal, Lehman, to Marie Stewart, Lehman, *et al.* (Dec. 21, 2007) [LBEX-DOCID 3223846] ("The finance committee does set balance sheet targets for each and every month end."). In approximately March 2008, however, Bart McDade was named Lehman's "balance sheet czar," tasked with setting and implementing balance sheet targets for Lehman to control leverage. Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 26; Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at p. 3; Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at p. 8.

[3067] E-mail from Ryan Traversari, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Sept. 11, 2007) [LBEX-DOCID 1695575] (emphasis added).

In a September 7, 2007 e-mail to O'Meara and Lowitt, Reilly wrote: "we need to keep the pressure on and get the firm's leverage to a good spot for year end. At least we need to restrict what inventory lines it can be used for."[3068] Lowitt agreed with Reilly's suggestion and said that Lehman "need[ed] to get tighter on B/S."[3069] Lowitt continued: "I am more worried about *how leverage number will be accepted by the market* than Chris [O'Meara] is."[3070]

Also in September 2007, O'Meara reported to the Finance and Risk Committee that Lehman's net leverage ratio was in line with Lehman's peers.[3071] Management's presentation regarding the net leverage metric noted:

> In the past, leverage was the key measure of equity adequacy. Between 2003 and 2006 we significantly reduced leverage. Low leverage was positively viewed by rating agencies and contributed to our 2005 upgrades. In 2006 and 2007, we worked with the regulatory and rating agencies to implement more accurate adequacy measures. As a result, we are comfortable with allowing our leverage to increase.[3072]

In a November 2007 e-mail, O'Meara, then-Lehman CFO, wrote to Reilly, "I realize we're in a tough spot given mkt, but we should be pressuring everywhere to try

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[3068] E-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Sept. 7, 2007) [LBEX-DOCID 1357178]

[3069] E-mail from Ian T. Lowitt, Lehman, to Gerard Reilly, Lehman, *et al.* (Sept. 7, 2007) [LBEX-DOCID 1357178]

[3070] *Id.* (emphasis added).

[3071] Lehman, Risk, Liquidity, Capital and Balance Sheet Update Presentation to Finance and Risk Committee of Lehman Board of Directors (Sept. 11, 2007), at pp. 2, 30 [WGM_LBEX_02247] (with Welikson's Handwritten Notes); Lehman Brothers Holdings Inc., Finance and Risk Committee Minutes (Sept. 11, 2007), at pp. 2-3 [LBEX-AM 067018].

[3072] Lehman, Presentation on Risk, Liquidity, Capital and Balance Sheet Update to Finance and Risk Committee of Lehman Board of Directors (Sept. 11, 2007), at p. 50 [LBEX-AM 067167].

to end year in good way on balance sheet . . . especially since the rev's are not materializing."[3073] Upon becoming Global Financial Controller on December 1, 2007, Martin Kelly studied net leverage ratio components and the definition of net assets across peer firms.[3074]

(a) Lehman's Calculation of Net Leverage

Under Lehman's definition of net leverage ratio, Lehman divided net assets by tangible equity, as a more "meaningful" calculation and a "more useful measure of leverage, because it excluded certain low-risk, non-inventory assets."[3075] In its Forms 10-K and 10-Q, Lehman defined net assets as total assets excluding: (1) cash and securities segregated and on deposit for regulatory and other purposes; (2) securities received as

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[3073] E-mail from Christopher M. O'Meara, Lehman, to Gerard Reilly, Lehman (Nov. 20, 2007) [LBEX-DOCID 578184].

[3074] Lehman, Components of Net Leverage Across Peer Firms Report (Dec. 7, 2007) [LBEX-DOCID 3299584] (attached to e-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Dec. 7, 2007) [LBEX-DOCID 3306110]; Lehman, Components of Net Leverage Across Peer Firms Graph (Dec. 7, 2007) [LBEX-DOCID 3328581] (attached to e-mail from Anuraj Bismal, Lehman to Martin Kelly, Lehman, *et al.* (Dec. 7, 2007) [LBEX-DOCID 3306110]; e-mail from Marie Stewart, Lehman, to Martin Kelly, Lehman, *et al.* (Dec. 7, 2007) [LBEX-DOCID 3306112] ("I understand that everyone negotiates their own definition of net assets with rating agencies and anytime I have asked about this historically I sensed hesitancy for us to renegotiate our definition. I had mentioned to Martin [Kelly] earlier this week that Paolo [Tonucci] and Ed [Grieb] could give him background on why our calculation is different from our peers."); e-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Dec. 7, 2007) [LBEX-DOCID 3759517] (reporting to Kelly that firm's net leverage was 16.2x). Recall that Lehman calculated net assets by subtracting from total assets: cash and securities segregated and on deposit for regulator and other purposes; securities under agreement to resell; identifiable intangible assets and goodwill; securities received as collateral; securities borrowed. That sum was divided by tangible equity capital, which was calculated by adding total stockholder's equity and junior subordinated notes and subtracting identifiable intangible assets and goodwill. *See* LBHI 2007 10-K, at p. 30; LBHI 10-Q (filed Apr. 9, 2008), at p. 70; LBHI 10-Q (filed July 10, 2008), at p. 56; Lehman, Components of Net Leverage across Peer Firms (Dec. 7, 2007) [LBEX-DOCID 3299584].

[3075] LBHI 2007 10-K, at p. 63; LBHI 10-Q (filed Apr. 9, 2008), at p. 72; LBHI 10-Q (filed July 10, 2008), at p. 88.

collateral; (3) securities purchased under agreements to resell; (4) securities borrowed; and (5) identifiable intangible assets and goodwill.[3076] Lehman calculated tangible equity capital by including stockholders' equity and junior subordinated notes and excluding identifiable intangible assets and goodwill.[3077]

The net leverage ratio calculation – a "brutal, rudimentary measurement"[3078] – did not capture the quality of the assets,[3079] and was therefore an expedient measurement for Lehman to utilize given the firm's "sticky" inventory. As Clement Bernard, former FID CFO wrote in early 2008: "[T]he firm is trying to move away from net leverage. However, they *cannot do that until* the quality of assets improve ie *we reduce our exposure to sticky assets* like Mortgages and Real Estate."[3080]

(2) By January 2008, Lehman Decided to Cut its Net Leverage in Half to Win Back the Confidence of the Market, Lenders and Investors

By no later than January 2008, Fuld was focused on net leverage and balance sheet reduction. Soon after Roger Nagioff replaced Michael Gelband as Head of FID in

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[3076] LBHI 2007 10-K, at p. 63; LBHI 10-Q (filed Apr. 9, 2008), at p. 72; LBHI 10-Q (filed July 10, 2008) at p. 88.

[3077] LBHI 2007 10-K, at p. 63; LBHI 10-Q (filed Apr. 9, 2008), at p. 72; LBHI 10-Q (filed July 10, 2008) at p. 88.

[3078] Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at pp. 6-7.

[3079] *Id.* at pp. 6-7; *see also* U.S. Securities and Exchange Commission Office of Inspector General, Report No. 446-A, SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program (Sept. 25, 2008), at p. 93 ("[A] leverage ratio is a crude measure and implicitly assumes that every dollar of balance sheet involves the same risk whether due to a treasury bond or an emerging market equity. . . . Finally, a leverage limit creates an incentive for firms to move exposures off balance sheet. . . .").

[3080] E-mail from Clement Bernard, Lehman, to Andrew J. Morton, Lehman, *et al.* (Feb. 1, 2008) [LBEX-DOCID 1853655] (emphasis added).

May 2007, Fuld authorized Nagioff to bring down positions in leveraged loans.[3081] By the end of 2007, Fuld expressed increasing concern about the economy.[3082] According to Fuld, in early 2008 he instructed Bart McDade, who would replace Joe Gregory and become Lehman's President and Chief Operating Officer in June 2008, to bring down Lehman's net balance sheet and net leverage ratio.[3083] Fuld at various times described the balance sheet reduction as applying to: (1) all positions except matched book; and (2) less liquid assets, such as leveraged loans, RMBS, CMBS, and CRE.[3084] Fuld and other members of senior firm management were concerned with reducing Lehman's large net balance sheet, *i.e.*, the inventory that Lehman owned, because the rating agencies only looked at Lehman's net leverage.[3085]

[3081] Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at p. 2.

[3082] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at pp. 26-27; Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at pp. 8-9; Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at p. 10.

[3083] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at pp. 26-27; Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at p. 8; Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at p. 10; e-mail from Herbert H. (Bart) McDade III, Lehman, to Herbert H. (Bart) McDade III, Lehman (Jan. 14, 2008) [LBEX-DOCID 3101094] ("[L]earning how to say no again…del[e]vering the balance sheet by 3 turns"); e-mail from Larry Wieseneck, Lehman, to Michael Konigsberg, Lehman, *et al.* (Mar. 19, 2008) [LBHI_SEC07940_390282] ("The firm is asking Bart McDade…to represent the firm's interests as the 'Balance Sheet Czar' - the point person for the firm's Exec Comm relative to the use of balance sheet and capital").

[3084] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at pp. 26-27 (recalling that Fuld told McDade to bring down all positions except matched book); Examiner's Interview of Richard S. Fuld, Jr., Nov, 19, 2009, at p. 8 (stating that his focus was on bringing down less liquid assets, *i.e.*, leveraged loans, RMBS, CMBS, and CRE); Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at p. 10 (stating that he did not instruct McDade to bring down matched book or on-the-run government securities as part of directive to reduce balance sheet).

[3085] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 27. Fuld recalled that rating agencies looked at net leverage because gross balance sheet included matched book. *Id.* Matched book is "where a trader reverses in and repos out collateral to the same or different dates." Lehman, Repo Manual (Nov. 8, 2005), at p. 16 [LBEX-LL 1175483]. "When the maturities of the reverse repos and repos are the same,

Contemporaneous documents from the Lehman archives confirm that senior management at all levels were critically focused on reducing Lehman's firm-wide leverage beginning in early 2008, including focusing on the impact leverage had on the firm's ratings:

- Two weeks before the close of Lehman's first quarter 2008 on February 29, 2008, Erin Callan, then-CFO, wrote to Tonucci, Reilly and Martin Klein, "would love to see the target projection [for net leverage] at 15.1."[3086] Reilly forwarded Callan's message to Andrew Morton, the head of Lehman's Fixed Income Division, stating "Would be great if fid could come in lower as leverage could be 1 of the few bright spots for the quarter."[3087] Morton replied, "Will pull out all the stops."[3088]

- In a March 19, 2008 e-mail, Larry Wieseneck reported "on a step the firm is taking to more actively manage the balance sheet usage across the firm."[3089] He continued: "The firm is asking Bart McDade (Head of Global Equities) to represent the firm's interests as the 'Balance Sheet Czar' – the point person for the firm's Exec Comm relative to the use of balance sheet…. He will coordinate with the trading desks and banking businesses across the firm as it relates to managing balance sheets down to target levels…. This will insure that we are 'disciplined'…."[3090]

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he or she is said to be running a matched book. But, in reality, most 'matched' books are actually 'mismatched' in that a trader will reverse in collateral to dates which are different than those maturities on the corresponding repos." *Id.* "A trader does this to profit from future shifts in interest rates that might occur between the unmatched maturities on the reverse repos and repos." *Id.* To be clear, Repo 105 transactions were ***not*** matched book transactions. *See also* e-mail from Robert Azerad, Lehman, to Edward Grieb, Lehman, *et al.* (Mar. 27, 2008) [LBEX-DOCID 3184420] (commenting upon external blog's critique of Lehman's leverage ratios calculation and balance sheet).

[3086] E-mail from Erin M. Callan, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Feb. 15, 2008) [LBEX-DOCID 1729329].

[3087] E-mail from Gerard Reilly, Lehman, to Andrew J. Morton, Lehman (Feb. 15, 2008) [LBEX-DOCID 1729329].

[3088] E-mail from Andrew J. Morton, Lehman, to Gerard Reilly, Lehman (Feb. 15, 2008) [LBEX-DOCID 1729329].

[3089] E-mail from Larry Wieseneck, Lehman, to Michael Konigsberg, Lehman, *et al.* (Mar. 19, 2008) [LBHI_SEC07940_390282].

[3090] *Id.*

- In a March 27, 2008 e-mail, Ken Cohen wrote: "We are very much in need of balance sheet. We must move things off by the end of the quarter. I need you all to go back to clients and offer them discounts to move things off. We have a lot of wood to chop in a short period of time but we can't afford to fail. If this means leaving p&l on the table so be it. If you have questions get back to me but we HAVE TO DO THIS!!"[3091]

Statements of numerous senior Lehman personnel also confirm that Lehman was focused on the net leverage ratio and the reduction of net assets beginning in late 2007:

- Tonucci recalled that McDade wanted to bring down Lehman's firm-wide balance sheet by "a few turns."[3092]

- McDade, who was named balance sheet czar in March 2008 and who became President and COO in June 2008, said that deleveraging was "absolutely" a critical issue to Lehman in early 2008.[3093]

- Ed Grieb, Lehman's former Global Financial Controller, stated that "the focus on balance sheet and net leverage gained much more importance" beginning in mid-2007.[3094]

- Murtaza Bhallo, Business/Risk Manager in Proprietary Trading Group for Liquid Markets, said that beginning in 2007, there was a "squeeze" on Lehman's balance sheet, and that Lehman personnel were worried about reporting the level of Lehman's assets against Lehman's equity (*i.e.*, leverage ratio).[3095]

- Anuraj Bismal, a former Senior Vice President in Lehman's Balance Sheet Group, said that Lehman's meeting of its leverage ratio target was the most critical piece ("a very hot topic") for senior management by the end of 2007.[3096] Bismal said that balance sheet targets and leverage ratio targets

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[3091] E-mail from Ken Cohen, Lehman, to Carmine Visone, Lehman (Mar. 27, 2008) [LBEX-DOCID 1374413]. *See* Section III.A.5.e.2 of the Report for further discussion of Lehman's deleveraging efforts.

[3092] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 26.

[3093] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 5.

[3094] Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 13.

[3095] Examiner's Interview of Murtaza Bhallo, Sept. 14, 2009, at p. 3.

[3096] Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 5.

were "absolutely about how rating agencies would view Lehman, and also creditors and the investing public."[3097]

- John Feraca, the former head of the Secured Funding Desk in Lehman's Prime Services group, said that in late 2007, as the industry was changing and entering a crisis period, Lehman made certain commitments to deleverage.[3098]

- Marie Stewart, Lehman's former Global Head of Accounting Policy, confirmed that Lehman set balance sheet targets with any eye to reaching certain leverage ratios that rating agencies used to measure and gauge Lehman's performance.[3099]

(a) Bart McDade, as Newly Appointed Balance Sheet Czar, Advised the Executive Committee in March 2008 to Cap Lehman's Use of Repo 105 Transactions

Bart McDade, who spent 25 years at Lehman, served as Lehman's Co-Global Head of FID from 2002 through 2005 and Global Head of Equities from 2005 until 2008.[3100] In March 2008, while remaining Global Head of Equities, McDade took on the additional role of balance sheet "czar" or balance sheet point person, for the Executive Committee.[3101] McDade later became Lehman's President and Chief Operating Officer, replacing Joe Gregory in June 2008.[3102]

[3097] *Id.*

[3098] Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 9.

[3099] Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 7.

[3100] Examiner's Interview of Herbert H. "Bart" McDade III, Sept. 16, 2009, at p. 1.

[3101] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 7.

[3102] *Id.* at p. 5.

According to Fuld, McDade had full authority to reduce firm-wide net leverage.[3103] Although Lehman's Treasury and Finance groups previously had set balance sheet targets,[3104] beginning in approximately March 2008, Gregory, Lehman's then-President and COO, assisted McDade with determining the balance sheet targets firm-wide.[3105] Although Fuld did not specifically direct Gregory and McDade on which Lehman divisions should have their balance sheet reduced, Fuld wanted to see the balance sheet reduction, particularly in less liquid asset classes, *i.e.* leveraged loans and residential and commercial real estate.[3106]

McDade took his responsibilities as balance sheet point person "very seriously."[3107] He viewed his "mission" as to coordinate Lehman's balance sheet issues.[3108] McDade wanted "to organize, coordinate, and influence."[3109] Bear Stearns had just nearly collapsed and McDade knew that Lehman had "tough assets" on its

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[3103] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at pp. 26-27 (stating that Fuld instructed McDade to bring down all of Lehman's positions except for matched book in order to get net leverage down to the low teens); Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at pp. 2-3 (stating that Fuld told McDade, after Christmas 2007, to bring down net leverage by half and that Fuld did not specifically direct Gregory and McDade on which divisions should have their balance sheets brought down); Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at p. 10 (stating that Fuld wanted reductions in places that Lehman was vulnerable, such as RMBS and CMBS).

[3104] Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 5.

[3105] Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at pp. 8-9.

[3106] *Id.*

[3107] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 7; e-mail from Larry Wieseneck, Lehman, to Michael Konigsberg, Lehman (Mar. 19, 2008) [LBHI_SEC07940_390282].

[3108] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 3.

[3109] *Id.* at p. 7.

balance sheet.[3110] In his role as balance sheet czar, McDade created a Daily Balance Sheet and Disclosure Scorecard report in order to have greater transparency with respect to the balance sheet.[3111] The Daily Scorecard was widely disseminated among senior Lehman management from April through September 2008 and routinely contained references to the impact Repo 105 transactions had on Lehman's daily balance sheet.[3112]

[3110] *Id.* at p. 3.

[3111] *Id.* at pp. 8-9 (stating also "I needed a daily scorecard to know where I wanted to push" on balance sheet issues).

[3112] *See, e.g.*, Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 7, 2008 (Apr. 9, 2008), at p. 9 [LBEX-DOCID 520619] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Apr. 9, 2008) [LBEX-DOCID 523578] and showing consolidated FID and Equities balance sheet reduced by $18.527 billion and Prime Services balance sheet reduced by $4.458 billion through Repo 105 transactions as of April 7, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 8, 2008 (Apr. 10, 2008), at p. 9 [LBEX-DOCID 520620] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Apr. 10, 2008) [LBEX-DOCID 523579] and showing consolidated FID and Equities balance sheet reduced by $18.853 billion and Prime Services balance sheet reduced by $4.562 billion through Repo 105 transactions as of April 8, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 9, 2008 (Apr. 10, 2008), at p. 9 [LBEX-DOCID 251339] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Apr. 10, 2008) [LBEX-DOCID 258560] and showing consolidated FID and Equities balance sheet reduced by $19.688 billion and Prime Services balance sheet reduced by $4.548 billion through Repo 105 transactions as of April 9, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 10, 2008 (Apr. 14, 2008), at p. 9 [LBEX-DOCID 251342] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Apr. 14, 2008) [LBEX-DOCID 275231] and showing consolidated FID and Equities balance sheet reduced by $19.967 billion and Prime Services balance sheet reduced by $4.491 billion through Repo 105 transactions as of April 10, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 11, 2008 (Apr. 14, 2008), at p. 9 [LBEX-DOCID 251344] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Apr. 14, 2008) [LBEX-DOCID 258562] and showing consolidated FID and Equities balance sheet reduced by $20.260 billion and Prime Services balance sheet reduced by $4.517 billion through Repo 105 transactions as of April 11, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 12, 2008 (May 13, 2008), at p. 1 [LBEX-LL 1950262] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (May 13, 2008) [LBEX-DOCID 3187357] and stating "Rates decreased by $(5.0B) from prior day due to . . . increased Repo 105 usage. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 22, 2008 (May 27, 2008), at p. 1 [LBEX-LL 1950706] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (May 27, 2008) [LBEX-DOCID 275984] and stating "Global rates net balance sheet decreased ($2.0B), predominantly due to an increase in Repo 105 benefit. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 28, 2008 (May 30, 2008), at p. 1 [LBEX-LL 1950670] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart)

In one his first acts as balance sheet point person, and in connection with his plan to aggressively reduce Lehman's firm-wide balance sheet, McDade requested that Lehman convene a special meeting of the Executive Committee on Friday, March 28, 2008, at 9:00 a.m.[3113] The entire Executive Committee, except Fuld, as well as *ex officio* members Ian Lowitt and Scott Friedheim, attended the meeting.[3114]

Broadly speaking, McDade's goal going into the March 28 meeting "was to have the Executive Committee come together and agree" about the direction Lehman would pursue, at least from the balance sheet perspective.[3115] More specifically, McDade said that his purpose in seeking a special meeting of the committee was "to request Joe

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McDade III, Lehman, *et al.* (May 30, 2008) [LBEX-DOCID 275995] and stating "Global rates net balance sheet decreased by ($3.1B) primarily due to a decrease in Americas driven by an increased utilization of Repo 105 within the Agency business"); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 29, 2008 (May 30, 2008), at p. 1 [LBEX-LL 1950658] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (June 2, 2008) [LBEX-DOCID 011127] and stating "Global Rates net balance sheet decreased ($6.5B) . . . [t]he decrease in Europe is coming from increased utilization of Repo 105"); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date June 18, 2008 (June 20, 2008) [LBEX-LL 1950514] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (June 20, 2008) [LBEX-DOCID 275942] and stating that "Global rates net balance sheet decreased…driven by a[n] . . . increase in Repo 105 utilization. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date August 13, 2008 (Aug. 14, 2008) [LBEX-LL 782812] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Aug. 14, 2008) [LBEX-DOCID 4214810] and stating that "Global rates net balance sheet decreased . . . driven by an increase in Repo 105 benefit. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date August 25, 2008 (Aug. 26, 2008) [LBEX-LL 782924] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Aug. 26, 2008) [LBEX-DOCID 079536] and stating that "Global Rates net balance sheet decreased . . . driven by an increase in repo 105 usage. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date August 28, 2008 (Aug. 29, 2008) [LBEX-LL 782966] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Aug. 29, 2008) [LBEX-DOCID 275880] and stating that "Global rates [net balance sheet] was down . . . driven by increased Repo 105 benefit. . . .").

[3113] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 3. According to McDade, Lehman's Executive Committee usually met only on Mondays or Tuesdays. *Id.* The March 28, 2008 meeting to discuss firm-wide balance sheet issues occurred on a Friday.

[3114] *Id.* at p. 4.

[3115] *Id.* at p. 3.

Gregory's approval to institute" the balance sheet reduction recommendations that McDade presented at the meeting.[3116]

The night before the March 28, 2008 Executive Committee meeting, McDade's assistant[3117] circulated two documents to the entire Executive Committee, Lowitt, and the assistants to Executive Committee members: (1) a meeting agenda, which listed seven total items, including "Repo 105/108," "Delever v Derisk" and "'Limit' Accountability;"[3118] and (2) a "Balance Sheet and Cash Capital Update."[3119] McDade and Gerard Reilly prepared the two documents to be discussed at the March 28 Executive Committee meeting.[3120]

At the March 28 Executive Committee meeting, McDade presented the Balance Sheet and Cash Capital Update document.[3121] McDade "tried to lay out very specifically the firm-wide balance sheet for the Executive Committee. We wanted to focus the Executive Committee on those things that impacted the firm's net leverage and balance

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[3116] *Id.*

[3117] E-mail from Patricia Lombardi, Assistant to Herbert H. (Bart) McDade III, Lehman, to Lehman Brothers Executive Committee Members, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 120929].

[3118] Lehman Brothers, Executive Committee Meeting Material, Agenda (Mar. 28, 2008) [LBEX-DOCID 115827] (attached to e-mail from Patricia Lombardi, Assistant to Herbert H. (Bart) McDade III, Lehman, to Lehman Brothers Executive Committee Members, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 120929]).

[3119] Herbert H. (Bart) McDade III, Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008) [LBEX-DOCID 095961] (attached to e-mail from Patricia Lombardi, Assistant to Herbert H. (Bart) McDade III, Lehman, to Lehman Brothers Executive Committee Members, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 120929]).

[3120] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 3.

[3121] *Id.*

sheet."[3122] With respect to net balance sheet limits, McDade wanted to impose "accountability," meaning that he "wanted all at the firm to stick within those limits."[3123]

McDade specifically recalled discussing with Executive Committee members on March 28, 2008 Lehman's use of Repo 105 transactions.[3124] The Balance Sheet and Capital Update document expressly reported that Lehman's quarter-end Repo 105 usage for first quarter 2008 was $49.1 billion.[3125] As balance sheet point person, McDade had no authority to authorize a firm-wide cap on Lehman's use of Repo 105 transactions.[3126] But McDade recommended to the Executive Committee during the meeting that Lehman cap or limit its firm-wide Repo 105 usage at a certain dollar amount.[3127] McDade said that "in order to make the seismic change" he wanted to accomplish with the balance sheet in March 2008, Lehman "had to make big changes," which included significantly reducing or ceasing the firm's use of Repo 105

[3122] *Id.* at p. 4.

[3122] *Id.*

[3123] *Id.* at p. 3.

[3124] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at pp. 3-4.

[3125] Herbert H. (Bart) McDade III, Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008), at pp. 1-2 [LBHI_SEC07940_628517]; Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 3; *see also* e-mail from Jennifer Fitzgibbon, Lehman, to Leonard Sciutella, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 1854825] (transmitting Balance Sheet and Cash Capital Update presentation and stating "attached balance sheet presentation discussed in today's executive committee meeting. . . . Reviewed with Bart [McDade] yesterday"). During his first Interview with the Examiner, McDade said that he was surprised when the Examiner advised him that Lehman reduced its net balance sheet at quarter-end of second quarter of 2008 by more than $50.38 billion using Repo 105 transactions. Examiner's Interview of Herbert H. "Bart" McDade III, Sept. 16, 2009, at p. 4. McDade said he thought that the volume of Lehman's quarter-end Repo 105 usage was no higher than $20 billion. *Id.*

[3126] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at pp. 3-4.

[3127] *Id.*

transactions.[3128] From McDade's perspective, Lehman's traders should have sold inventory to reduce balance sheet, rather than engage in Repo 105 transactions.[3129]

On April 2, 2008, McDade received an e-mail that said "Not sure you are familiar with Repo 105 but it is used to reduce net balance sheet in our government businesses around the world."[3130] McDade responded that he considered Lehman's use of Repo 105 transactions to be undisciplined, "another drug we r on."[3131] McDade wanted Lehman's traders to exercise more discipline: "[T]raders knew that they could get access to balance sheet through these more costly transactions," meaning Repo 105 transactions.[3132] In other words, when traders found it hard to sell sticky assets or wanted to avoid selling them at a discount, they knew that they could "rent the balance sheet," according to McDade, by removing certain inventory temporarily through Repo 105 transactions while allowing other inventory to remain on the balance sheet and still

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[3128] *Id.*

[3129] *Id.*

[3130] E-mail from Hyung Lee, Lehman, to Herbert H. (Bart) McDade III, Lehman (Apr. 3, 2008) [LBEX-DOCID 1570783].

[3131] *See* e-mail from Herbert H. (Bart) McDade III, Lehman, to Hyung Lee, Lehman (Apr. 3, 2008) [LBEX-DOCID 1570783]; *see also* e-mail from Herbert H. (Bart) McDade III, Lehman, to Andrew J. Morton, Lehman (Apr. 3, 2008) [LBEX-DOCID 1570784] (explaining that the fact that Lehman's net balance sheet could increase at quarter-end if it could not find Repo 105 counterparty "is exactly why the drug is a problem").

[3132] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 6. Kaushik Amin recalled McDade stating that Lehman should use fewer Repo 105 transactions; Amin believed this was because of "a sense within Lehman that [Repo 105] might not meet a rigorous test in the market place." Examiner's Interview of Kaushik Amin, Sept. 17, 2009, at p. 8.

reach Lehman's balance sheet targets.[3133] McDade wanted traders to sell assets rather than rent the balance sheet.[3134]

Although McDade's Balance Sheet and Cash Capital Update presentation was discussed at the March 28, 2008 Executive Committee meeting,[3135] during a time when Erin Callan was a member of the Executive Committee and Lowitt sat as an *ex officio* member, when questioned by the Examiner, neither Callan nor Lowitt could recall the actual volume of quarter-end Repo 105 usage in late 2007 and 2008, or whether the Executive Committee discussed Lehman's Repo 105 usage.[3136] On April 9, 2008, twelve

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[3133] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 8.

[3134] *Id.*

[3135] E-mail from Jennifer Fitzgibbon, Lehman, to Leonard Scicutella, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 1854825] (transmitting copy of Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008) [LBEX-DOCID 1698670] and stating "please [see] attached balance sheet presentation discussed in today's executive committee meeting"); *see also* e-mail from Gerard Reilly, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 124422] (transmitting copy of Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008) [LBEX-DOCID 095966] and stating "This is the bs doc for exec co in the morning"); e-mail from Gerard Reilly, Lehman, to Martin Kelly, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 2636182] (transmitting copy of Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008) [LBEX-DOCID 2489767] and stating "This was the exec b[alance] s[heet] pres[entation]"); Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at pp. 2-3.

[3136] Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at pp. 17, 19 (stating that she believed Lehman's Repo 105 usage was $20 billion and that she did not recall being part of any discussions regarding limits on Repo 105 usage); Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at pp. 11, 13 (stating that he was not present at any Executive Committee meeting at which Repo 105 was discussed and that he had no recollection of focusing on Lehman's Repo 105 usage, including the $25 billion third quarter target); Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at p. 7 (stating that he did not attend any Executive Committee meeting where Repo 105 was discussed and stating he had no knowledge of Lehman's Repo 105 usage). Andrew Morton, who served on the Executive Committee beginning in June 2008, however, recalled that Lehman used Repo 105 transactions to reduce its net balance sheet and that these were "widely used, widely understood" transactions. Examiner's Interview of Andrew J. Morton, Sept. 21, 2009, at p. 4.

days after McDade's presentation to the Executive Committee, Callan signed Lehman's quarterly report.[3137]

Following Fuld's directive, and in connection with McDade's balance sheet point person role, Gregory and McDade sat down with Lehman division heads and discussed targets for asset classes and business lines.[3138] Gregory and McDade frequently checked in with division heads in mid 2008 regarding their progress in meeting balance sheet targets, and provided updates to Fuld, although not on a very granular level.[3139] Fuld recalled that Gregory was comfortable with the progress Lehman was making in bringing down its balance sheet and Fuld said that he believed Lehman was meeting its balance sheet targets by selling illiquid assets.[3140]

Other documents contemporaneous to McDade's presentation to the Executive Committee demonstrate that the issue of balance sheet and leverage reduction was being discussed at the highest levels of senior Lehman management:[3141]

- An April 1, 2008 internal Lehman presentation by Eric Felder, then-United States Head of Credit Products, highlighted how the market's mood and perception of risk had changed, and Lehman started to penalize brokers for maintaining high leverage.[3142] According to the presentation: "brokers will

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[3137] LBHI, 10-Q (filed Apr. 9, 2008), at p. 92.

[3138] Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at p. 9.

[3139] *Id.*

[3140] *Id.*

[3141] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 8 (stating that rating agencies cared about net leverage ratio).

[3142] Eric Felder, Lehman, Untitled Internal Presentation [Draft] (Apr. 1, 2008), at pp. 7-10 [LBHI_SEC07940_085870].

be ***forced to de-lever to maintain ratings*** and access to low-cost debt."[3143] Indeed, a ratings downgrade could lead to counterparty demands that Lehman post additional collateral for secured financing.[3144]

- An April 2008 "Leverage Analysis" report sent to Tonucci and Reilly compared Lehman's first quarter 2008 leverage ratios and balance sheet by business with the same measurements for Lehman's fourth quarter 2003.[3145] It also compared Lehman's and its competitors' net leverage ratios and net assets.

Two weeks before the close of Lehman's second quarter 2008 in May 2008, and following a meeting with Fidelity, Callan wrote to Gregory and Fuld about Fidelity's feedback:

> [W]e may get a very short leash if we show up with a rough quarter if we do not get the balance sheet exercise completed. No matter what, *the skeptics are focused on our balance sheet and that is the key to the future*. . . . I know we are saying it over and over but *we HAVE to deliver on the balance sheet reduction this quarter and cannot give any room to FID for slippage*.[3146]

At the close of Lehman's second quarter in May 2008, and in connection with Morton's Global FID meeting on balance sheet issues, Freidheim, a Lehman Managing Director, wrote to Lowitt and Morton about the materiality of Lehman's balance sheet reduction:

[3143] *Id*. (emphasis added).

[3144] E-mail from Ian T. Lowitt, Lehman, to Eric Felder, Lehman (July 5, 2008) [LBEX-DOCID 071263] (stating that a downgrade "will affect lines and willingness of counterparties to fund secured"); Amadou N.R. Sy, The Systemic Regulation of Credit Rating Agencies and Rated Markets 8-9 (Int'l Monetary Fund, Working Paper, 2009) (noting that broker-dealers may use credit ratings to determine acceptable counterparties, as well as collateral levels for outstanding credit exposure).

[3145] Lehman, Leverage Analysis Report (Apr. 4, 2008) [LBEX-DOCID 103786] (attached to e-mail from Robert Azerad, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Apr. 4, 2008) [LBEX-DOCID 125281]).

[3146] E-mail from Erin M. Callan, Lehman, to Richard S. Fuld, Jr., Lehman, *et al.* (May 13, 2008) [LBHI_SEC07940_034732] (emphasis added).

> Regarding balance sheet reduction - I would not say 'we have reduced the balance sheet and brought it down from 15.6 to 12.6' - that is *material non public information* and everyone (the market) is looking for the number etc. and in a forum of thousands of people is not sr mgmt and leak possibility is very high). however you can say whatever erin has said 'it is a significant accomplishment that we have deleveraged the balance sheet so quickly + positioned ourselves for future' . . . I would not use the number.[3147]

(b) McDade Became President and COO on June 12, 2008 and Authorized the Reduction of Repo 105 Usage

Lehman used $50.38 billion of Repo 105 transactions at the end of the second quarter on May 30, 2008, up slightly from the previous quarter.[3148] Upon becoming Lehman's President and COO on June 12, 2008, McDade was finally empowered to authorize a firm-wide reduction in Repo 105 usage.[3149] On June 17, 2008, Reilly circulated to McDade, Lowitt, Andrew Morton (Head of FID), and Chris O'Meara a document entitled "Balance Sheet and Key Disclosures" that incorporated McDade's plan to reduce Lehman's firm-wide Repo 105 usage by half – from $50 billion to $25 billion in third quarter 2008.[3150] In response to Reilly's circulation of the presentation announcing that Lehman's firm-wide Repo 105 usage would be cut by 50% in the third

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[3147] E-mail from Scott J. Freidheim, Lehman, to Ian T. Lowitt, Lehman, *et al.* (May 30, 2008) [LBEX-DOCID 1906851] (emphasis added).

[3148] *See, e.g.*, Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets [Draft] (June 16, 2008), at p. 3 [LBHI_SEC07940_641516].

[3149] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 9.

[3150] Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets [Draft] (June 16, 2008), at p. 3 [LBEX-DOCID 3363493] (attached to e-mail from Gerard Reilly, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (June 17, 2008) [LBEX-DOCID 3383643]); *see also* e-mail from Gerard Reilly, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Aug. 17, 2008) [LBEX-DOCID 4517376] ("Repo 105 should be 25 b about half of what it was last quarter.").

quarter 2008, Morton complained that the proposed balance sheet target for FID in third quarter 2008 was identical to the second quarter target, but with the Repo 105 limit cut in half, the Rates business of FID would not survive.[3151] Reilly responded to Morton: "Think this is most conservative case and initially Bart [McDade] had a view of keeping total assets flat but that was two weeks ago and may have changed."[3152]

McDade, Reilly, Lowitt, Morton and O'Meara met to discuss the Balance Sheet and Key Disclosures document in June 2008.[3153] McDade recalled that he brought O'Meara "back in the [balance sheet] process" to help in light of O'Meara's past experience as CFO.[3154]

McDade discussed the Balance Sheet and Key Disclosures document with Richard Fuld in June 2008.[3155] McDade "specifically walked Fuld through the

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[3151] E-mail from Andrew J. Morton, Lehman, to Gerard Reilly, Lehman (June 17, 2008) [LBEX-DOCID 4553451].

[3152] E-mail from Gerard Reilly, Lehman, to Andrew J. Morton, Lehman (June 17, 2008) [LBEX-DOCID 4553451].

[3153] E-mail from Christopher M. O'Meara, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (June 17, 2008) [LBEX-DOCID 033813] (replying to receipt of Balance Sheet and Key Disclosures 2008 3Q Targets [Draft] (June 16, 2008) and stating that "meeting is being set up to discuss" the Balance Sheet and Key Disclosure 2008 3Q Targets document); e-mail from Gerard Reilly, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (June 19, 2008) [LBEX-DOCID 2962369] (transmitting Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets (June 19, 2008) [LBEX-DOCID 2932594] and stating "[u]pdated from our meeting"). One e-mail suggests that the Executive Committee approved the reduction soon thereafter. *See* e-mail from Jennifer Fitzgibbon, Lehman, to Francis Pearn, Lehman, *et al.* (June 23, 2008) [LBEX-DOCID 1856501] (transmitting Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets (June 19, 2008) [LBEX-DOCID 1698850] and stating "[a]ttached is final balance sheet and certain key disclosure targets for 3Q. Should be approved by exec comm today").

[3154] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 8

[3155] *Id.* at p. 5.

presentation. . . ."[3156] McDade discussed page three of the presentation with Fuld, which identified that Lehman used $38.6 billion, $49.1 billion, and $50.3 billion of Repo 105 transactions, at quarters-end fourth quarter 2007, first quarter 2008, and second quarter 2008, respectively.[3157] McDade said that, as referenced on page three of the Balance Sheet and Key Disclosures document, he also told Fuld that he (McDade) recommended that Lehman reduce its firm-wide Repo 105 usage to $25 billion in the third quarter 2008.[3158]

McDade observed that Fuld "was familiar with the term 'Repo 105.'"[3159] McDade recalled that Fuld's response to the entire document was "good, good, good; he was nodding approval" and that Fuld was "supportive of reducing the firm's use of Repo 105."[3160] More specifically, regarding McDade's recommendation to cut Lehman's use of Repo 105 in half in the third quarter 2008, McDade recalled Fuld asked, "Is it doable? Is it necessary? If so, [Fuld] said, go do it."[3161] McDade concluded that "Fuld knew about the accounting of Repo 105."[3162]

During the June meeting with Fuld over the Balance Sheet and Key Disclosures document, McDade and Fuld discussed that Lehman's need to deleverage was

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[3156] *Id.*
[3157] *Id.*
[3158] *Id.*
[3159] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 5.
[3160] *Id.*
[3161] *Id.* at p. 6.
[3162] *Id.*

"absolutely" a critical issue to Lehman.[3163] On July 10, 2008, a few weeks after discussing the "Balance Sheet and Key Disclosures" document with McDade, Fuld signed Lehman's quarterly report.[3164] Fuld denied any recollection of conversations with McDade or other members of Lehman's Executive Committee regarding Repo 105.[3165]

(3) The Market's Increased Scrutiny of the Leverage of Investment Banks

In mid-to-late 2007, Lehman faced a growing challenge: the market began demanding that investment banks shrink their balance sheet and lower their leverage.[3166] Before mid-2007, rating agencies, media, and outside analysts who

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[3163] *Id.* at p. 5.

[3164] LBHI, 10-Q (filed July 10, 2008), at p. 160.

[3165] Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at p. 8.

[3166] Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 6; Mark Jickling, Averting Financial Crisis, CRS Report for Congress, at 18 (Mar. 10, 2008, updated on Oct. 8, 2008) (explaining that the market began demanding that investment banks lower their balance sheet and reduce leverage). Balance sheet management, which refers to the manner in which firms control the size of their balance sheet, is important to firms for numerous reasons, including the impact balance sheet has on leverage. Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at pp. 5-6; Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 26 (stating that balance sheet targets were driven by what managers considered a good range for leverage); Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at pp. 30-31; e-mail from Ian T. Lowitt, Lehman, to Roger Nagioff, Lehman (Apr. 16, 2007) [LBEX-DOCID 175349] (transmitting balance sheet management policy [LBEX-DOCID 148914] and 2007 Balance Sheet Targets and Usage). The purpose of balance sheet management at Lehman was to control the firm's leverage ratios. Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 5. Capital adequacy, as that phrase is used vis-à-vis large investment banks, is commonly measured using a leverage ratio, which divides some measurement of the investment bank's assets by the capital equity in the bank, to determine the risk profile and relative solvency of the entity. *See* LBHI 2007 10-K, at pp. 30, 63; Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), 2009, at p. 6. Thus, in order to control leverage, Lehman's balance sheet targets were "reverse engineered," working backward from the firm's leverage ratio target. Examiner's Interview of Matthew Lee, July 1, 2009, at p. 15; Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 5; Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 6. There is nothing necessarily improper about balance sheet management; it is a normal business practice

observed Lehman focused on the firm's revenues and profit and loss, "P&L."[3167] Sometime in mid-2007, however, those same outside rating agencies and analysts pronounced the metrics of an investment bank's balance sheet and capital at least as important, if not more, than revenue and P&L.[3168] The breakdown of securitization and structured finance markets in late 2007 intensified balance sheet pressures on banks.[3169]

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used by many institutions. As discussed in the Examiner's Conclusions, balance sheet management done in a way that materially misrepresents the true financial position of the company can, however, give rise to a colorable claim.

[3167] Mike Shedlock, MISH's Global Economic Trend Analysis, Bank Balance Sheets and Earnings, http://globaleconomicanalysis.blogspot.com/2007/09/bank-balance-sheets-and-earnings.html (Sept. 30, 2007, 1:38 PM); Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 6.

[3168] *See, e.g.*, Ben Bernanke, Chairman of the Bd. of Governors of the U.S. Fed. Reserve Sys., The Recent Financial Turmoil and its Economic and Policy Consequences, Address at the Economic Club of New York 3 (Oct. 15, 2007), *available at*: http://www.federalreserve.gov/newsevents/speech/bernanke20071015a.htm (stating that strains in financial markets prompted banks "to become protective of their liquidity and balance sheet capacity"); Tobias Adrian and Hyun Song Shin, Liquidity, Monetary Policy, and Financial Cycles, CURRENT ISSUES IN ECON. & FIN. (Jan. - Feb. 2008), at 4, available at http://www.nyfrb.org/research/current_issues (discussing how financial institutions' chief tool in adjusting leverage is collateralized borrowing and lending (*i.e.*, repo and reverse repo agreements) and that in times of market turmoil, financial institutions try to lower their leverage); The Economic Outlook: Hearing Before H. Comm. on the Budget, 110th Cong. (Jan. 17, 2008) (statement of Ben Bernanke, Chairman of the Bd. of Governors of the U.S. Fed. Reserve Sys.), *available at*: http://www.federalreserve.gov/newsevents/testimony/bernanke20080117a.htm; Mark Jickling, Averting Financial Crisis, CRS Report for Congress, at 18 (Oct. 8, 2008, updated on Mar. 21, 2009) (explaining that the market began demanding that investment banks lower their balance sheet and reduce leverage); Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 6.

[3169] Timothy F. Geithner, President, Fed. Reserve Bank of N.Y., Reducing Systemic Risk In A Dynamic Financial System, Remarks at the Economic Club, New York City, New York, (June 9, 2008), *available at* http://www.newyorkfed.org/newsevents/speeches/2008/tfg060809.html ("The funding and balance sheet pressures on banks were intensified by the rapid breakdown of securitization and structured finance markets. Banks lost the capacity to move riskier assets off their balance sheets, at the same time they had to fund, or to prepare to fund, a range of contingent commitments over an uncertain time horizon."); *see also* Diane Hinton, Standard & Poor's RatingsDirect, Liquidity Management In Times Of Stress: How The Major U.S. Broker-Dealers Fare (Nov. 8, 2007), at pp. 2-3 [LBHI_SEC07940_439424] ("Recent disruptions in the subprime market and its contagion effects into the leveraged finance, asset-backed commercial paper (ABCP), and CDO spaces have substantially curtailed market liquidity. The sudden loss of appetite for subprime and other high-yield exposure has significantly narrowed these markets, while uncertainty regarding asset valuations left many institutions unable to unwind exposures at fair market prices. . . . As a result, the markets for these assets have considerably shrunk.").

One analyst wrote in late September 2007: "[Banks'] net incomes this quarter don't matter. And they don't matter because of one simple rule for financial services firms: *The income statement is the past. The balance sheet is the future*. . . . At the top of a credit cycle, the income statement for a financial institution shows 'the best of times' but *buried in the balance sheet is 'the worst of times' to come*."[3170]

The market's increased focus on balance sheet and leverage only intensified in 2008.[3171] Rating agencies, analysts, and the media became more concerned about the types of inventory investment banks, including Lehman, maintained on their respective balance sheets, the size of a bank's balance sheet, and how much of its balance sheets a firm used.[3172] For example, following the near collapse of Bear Stearns in March 2008, an editorial columnist asked the question "Will Citibank Survive?" and answered by

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[3170] Mike Shedlock, MISH's Global Economic Trend Analysis, Bank Balance Sheets and Earnings, http://globaleconomicanalysis.blogspot.com/2007/09/bank-balance-sheets-and-earnings.html (Sept. 30, 2007, 1:38 PM) (emphasis added); *see also* Cong. Research Serv., 110th Cong., Financial Crisis? The Liquidity Crunch of August 2007 7 (CRS Report RL 34182) (Darryl E. Getter, *et al*.) (stating that market optimism and underestimation of risk "encouraged the overuse of leverage, or borrowed money, to boost returns"); Mark Jickling, Averting Financial Crisis 6, CRS Report for Congress (Mar. 10, 2008) ("As its capital loses value, the firm must shrink its balance sheet to maintain a given leverage ratio. As firms sell assets to reduce balance sheet exposure, asset prices are driven down.").

[3171] E-mail from Peter Eavis, Wall Street Journal, to Kerrie Cohen, Lehman (Mar. 18, 2008) [LBEX-DOCID 1610003] (asking Lehman to explain its net leverage calculation); LBHI 10-Q (filed Apr. 9, 2008), at p. 65 ("During the 2008 quarter, the Company operated in a liquidity, funding, and capital environment characterized by constrained market liquidity driven in part by balance sheet and leverage concerns."); John Hilsenrath, *et al. Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis*, Wall St. J. (Sept. 22, 2008) at A1 (reporting that the "world no longer tolerates high leverage" and that analysts felt that investment banks relied too heavily on short-term borrowed money).

[3172] Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 6.

"examining Citi's balance sheet [and] ignoring its income statement because in a crisis, future cash-flow is basically irrelevant to a bank's survival and need for liquidity."[3173]

The market turned its focus to the leverage of investment banks in mid-to-late 2007, just as Lehman found it increasingly difficult to sell its "sticky" inventory.[3174] As a consequence, by late 2007, the highest levels of Lehman senior management placed increasing emphasis on reducing the balance sheet and reducing Lehman's leverage.[3175] This "concerted effort" by senior Lehman management was done with an eye towards the rating agencies' views of Lehman.[3176]

(a) The Cost of Deleveraging

In order to reduce its net leverage, Lehman could have either decreased the numerator used in its net leverage ratio calculation (*i.e.*, net assets), or increased the denominator by raising equity.[3177] Fuld acknowledged that although raising equity

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[3173] James Turk, Will Citibank Survive?, Financial Sense, Mar. 17, 2008, http://www.financialsense.com/editorials/turk/2008/0317.html; *see also* Systemic Regulation, Prudential Matters, Resolution Authority and Securitization: Hearing Before H. Comm. on Financial Servs., 111th Cong. 3 (Oct. 29, 2009) (statement of Jane D'Arista, Americans for Financial Reform) (explaining how excessive leverage throughout the financial system made institutions "vulnerable to any event that might threaten their ability to roll over the funding that supported their inflated balance sheets").

[3174] Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 6.

[3175] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 8. Fuld explained that he made strategic decisions to reduce Lehman's balance sheet and bring down the net leverage ratio to improve market perceptions of Lehman.

[3176] Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at pp. 5, 8; Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 5; *see also* Lehman, Lehman Presentation to Rating Agencies [Draft] (May 12, 2008), at p. 20 [LBEX-DOCID 3192668] (attached to e-mail from Kevin Thatcher, Lehman, to Ian T. Lowitt, Lehman, *et al.* (May 21, 2008) [LBEX-DOCID 3200389] and stating that "[i]n an effort to reduce Q2 '08 leverage ratios, the Firm is undergoing a deleveraging exercise which will be driven by specific balance sheet reductions coupled with capital raising").

[3177] Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 27.

could also reduce the net leverage ratio, Lehman had to improve its net leverage by reducing its net assets (*i.e.*, selling inventory) because "there was a perception issue" with raising equity.[3178] "If we raised equity, we would have brought the [net leverage ratio] number down, but would not have really fixed anything."[3179] Accordingly, to meet its goal of reducing the firm-wide net leverage ratio, Lehman sought to reduce its net assets.[3180]

Reducing net assets through outright sales, however, also came at a cost to Lehman. First, the sale of many of its inventory positions would result in substantial losses to Lehman. An internal Lehman PowerPoint presentation that CFO Erin Callan prepared in early April 2008, entitled "Leverage Analysis," illustrates this point.[3181] "Lehman's growth in net balance sheet has been weighted toward mortgages and loans. Deleveraging will require selling these assets, which will result in losses for Lehman. . . . Reducing leverage is necessary to remove refinancing risk and win back the confidence of the market, lenders, and investors."[3182] Winning back the confidence of the market was necessary, in part, because "[a]fter initially declining, Lehman Brothers' net

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[3178] *Id.*

[3179] *Id.*

[3180] *Id.*; Examiner's Interview of Clement Bernard, Oct. 23 2009, at p. 12. Clement Bernard made a similar point as Fuld regarding Lehman's route to reducing its net leverage ratio. Bernard stated that Lehman could easily have reduced its gross balance sheet by reducing matched book, but that reducing net balance sheet was more difficult as it required Lehman either to sell assets or engage in additional Repo 105 transactions.

[3181] Erin M. Callan, Lehman, Lehman Brothers - Leverage Analysis (Apr. 7, 2008), at p. 1 [LBEX-DOCID 1401225] (attached to e-mail from Edward Grieb, Lehman, to Edward Grieb, Lehman (Apr. 5, 2008) [LBEX-DOCID 1542476]).

[3182] *Id.* at p. 1.

leverage. . . ha[d] crept back towards the higher end of the peer group in recent years, signaling higher risk."[3183] Lehman's "change in Net Leverage [wa]s small, but weighted towards illiquid assets like mortgages and loans."[3184] In fact, the composition of Lehman's Level 3 assets was 60% mortgages.[3185] Callan reported the potential cost to Lehman of deleveraging: moving $22 billion of illiquid assets would have cost Lehman an estimated $750 million.[3186]

In addition to the losses Lehman would incur by selling "sticky" assets at fire-sale prices, deleveraging also raised the additional problems of market perception and valuation.[3187] As Secretary Timothy Geithner explained to the Examiner, selling "sticky" assets at discounts could hurt Lehman by revealing to the market that Lehman "had a lot of air in [its] marks" and thereby further draining confidence in the valuation of the assets that remained on Lehman's balance sheet.[3188]

[3183] *Id.* at p. 5.

[3184] *Id.* at p. 7.

[3185] *Id.* at p. 9.

[3186] Erin M. Callan, Lehman, Lehman Brothers - Leverage Analysis (Apr. 7, 2008), at p. 12 [LBEX-DOCID 1401225].

[3187] Examiner's Interview of Secretary Timothy F. Geithner, Nov. 24, 2009, at pp. 7-8.

[3188] *Id.*; *see also* The Economic Outlook: Hearing Before H. Comm. on the Budget, 110th Cong. (Jan. 17, 2008) (statement of Ben Bernanke, Chairman of the Bd. of Governors of the U.S. Fed. Reserve Sys.), *available at*: http://www.federalreserve.gov/newsevents/testimony/bernanke20080117a.htm (explaining that as financial institutions came under pressure in 2007 and 2008 to remove hard-to-value products from balance sheet of special purpose entities and onto their own balance sheet, banks' balance sheets swelled with illiquid, sticky inventory).

(4) "Sticky" Inventory and FID's Balance Sheet Breaches Hampered Lehman's Ability to Manage Its Net Leverage

Lehman expanded its Repo 105 practice in the context of an increasingly "sticky" balance sheet. In February 2007, Joseph Gentile, FID's then-Chief Financial Officer who reported directly to Gerard Reilly, sent a proposal to Ed Grieb, then-Global Financial Controller, petitioning Grieb to increase the firm's $22 billion combined firm-wide Repo 105/108 limit to $25 billion.[3189] Gentile's February 2007 request provided three interrelated reasons why Lehman should increase its internal Repo 105 limit:

- Lehman's Real Estate Group likely would not be able to conduct its Windermere securitization ($2B) in first quarter 2007 and Lehman's Mortgages Group "will have a great deal of difficulty in selling sub prime loans (5.0bn), adversely affecting balance sheet. Exiting these position[s] would be impossible or prohibitively costly."[3190]
- "Repo 105 offers a low cost way to offset the balance sheet and leverage impact of current market conditions."[3191]
- Lehman would have significant difficulty "exiting" large positions in its Real Estate and Mortgage Groups without "incur[ring] large losses due to the steep discounts that they would have to be offered at and [the] substantial reputation risk in the market as it would suggest a serious 'issue' with our Mortgage/Real Estate concentrations. A Repo 105 increase would help avoid this without negatively impacting our leverage ratios."[3192]

[3189] Joseph Gentile, Lehman, Proposed Repo 105/108 Target Increase for 2007 (Feb. 10, 2007) [LBEX-DOCID 2489498] (attached to e-mail from Joseph Gentile, Lehman, to Edward Grieb, Lehman (Feb. 10, 2007) [LBEX-DOCID 2600714]). Recall that a July 2006 Overview of Repo 105/108 Presentation stated that Grieb and CFO Chris O'Meara were responsible for setting Lehman's limits on Repo 105 activity at $17 billion and Repo 108 activity at $5 billion for a total of $22 billion in combined Repo 105/108 limits.

[3190] Joseph Gentile, Lehman, Proposed Repo 105/108 Target Increase for 2007 (Feb. 10, 2007) [LBEX-DOCID 2489498].

[3191] *Id.*

[3192] *Id.*; *see also* e-mail from Heidimarie Echterman, Lehman, to Gerard Reilly, Lehman (Feb. 23, 2007) [LBEX-DOCID 1620265] ("Net leverage is down 1 turn vs number discussed at this morning's FOC (15.5x

Subsequent Lehman e-mails indicate that Lehman raised the combined Repo 105/108 limit in February 2007 by $3 billion, from $22 billion to $25 billion.[3193]

As it became increasingly difficult in 2007 for Lehman to exit certain positions, Lehman's maneuverability with respect to meeting balance sheet and leverage targets diminished.[3194] This put additional pressure on more liquid businesses within Lehman to reduce balance sheet, as exemplified by Gentile's February 2007 request to Grieb.[3195]

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now 15.4x vs target 14.8x). Do you think we will be able to get below this for quarter end? I have not had any discussion with Chris on this - do we need to alert him?"). Echterman forwarded this e-mail to Paolo Tonucci, then-Treasurer, adding: "Sorry I meant to copy you – it's all in IRP and Real Estate. They are looking to do more Repo 105 and sell down positions. Gelband has been alerted by Joe [Gentile]." *Id.*

[3193] E-mail from Joseph Gentile, Lehman, to Michael Gelband, Lehman, *et al.* (Feb. 21, 2007) [LBEX-DOCID 4553218] ("I have been able to get a temp limit of 3 bn for repo 105 activity, which covers known real estate issues. . . ."); e-mail from Joseph Gentile, Lehman, to Gerard Reilly, Lehman (Feb. 21, 2007) [LBEX-DOCID 4553220] (responding to question "Where did the 3bn come from?" by writing: "We spoke with grieb…and he was ok with a temporary excession of $3. . . ."); e-mail from Michael McGarvey, Lehman, to Anuraj Bismal, Lehman, *et al.* (May 9, 2007) [LBEX-DOCID 3223356] ("17 bn was the year end limit for FID. In Q1 Joe Gentile spoke to Edward Grieb about raising it to 20bn (based on the attached doc) and according to Joe Ed agreed.").

[3194] Joseph Gentile, Lehman, Proposed Repo 105/108 Target Increase for 2007 (Feb. 10, 2007) [LBEX-DOCID 2489498] (attached to e-mail from Joseph Gentile, Lehman, to Edward Grieb, Lehman (Feb. 10, 2007) [LBEX-DOCID 2600714]); e-mail from Sigrid Stabenow, Lehman, to Eric Addington, *et al.* Lehman (Feb. 1, 2008), [LBHI_SEC07940_1840953] ("The FID business analysis team . . . review[ed] 'how' FID is using its balance sheet. The purpose [of the review] is . . . to give clarity on what is movable balance sheet in the current env't and . . . to address the Q1 balance sheet limit issues we're facing. . . . [T]he global problem that FID is facing [is] that they are expected to be $15 bn over limit. . . . The stickiness of real estate & securitized products in americas and europe are creating issues."); e-mail from Clement Bernard, Lehman, to Andrew J. Morton, Lehman, *et al.* (Feb. 4, 2008) [LBEX-DOCID 1849805] (discussing firm-wide net leverage ratio, FID's sticky/illiquid/Level 3 inventory, the percentage of FID's balance sheet that this sticky inventory constitutes, and that Level 3 assets "have increased a lot in 2007 due [to] some assets becoming less observable"). Lehman management monitored and assessed whether the dollar value of its assets (the numerator in the net leverage ratio equation used at Lehman) was at an appropriate level by setting balance sheet targets for the firm, specific business units, and even for individual traders. Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at pp.5-6; Examiner's Interview of Tejal Joshi, Sept. 15, 2009, at p. 5; Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 5; Examiner's Interview of Kaushik Amin, Sept. 17, 2009, at p. 5; Examiner's Interview of Mitchell King, Sept. 21, 2009, at p. 5; Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 11; Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 5. Balance sheet targets were a function of the firm-wide leverage ratio target, which was reported publicly. *See, e.g.*, e-mail from Clement Bernard, Lehman, to Roger Nagioff, Lehman, *et al.* (Nov.

20, 2007) [LBEX-DOCID 173748] ("The net Balance Sheet forecast for FID for November 30 has increased to $232.6 Bio from a previous forecast of $227 Bio. This is $12.6 Bio above the limit of $220 Bio. The limit of $220 Bio equates to a leverage ratio of 16 which is the current firm target…. Based on my conversations with Paolo [Tonucci] we need to get down to $225 Bio in order for the ratio to be back to target."); Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 26 (stating that Lehman's balance sheet targets were driven by what an acceptable range of leverage for the firm would be); Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 11; Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 5; Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at pp. 30-31 (stating that collaborative process between Finance, Fixed Income, Markets, and Treasury used to set balance sheet targets for businesses but that leverage ratio target was a firm-wide target). After the leverage target was set, each Lehman business group or division would allocate balance sheet usage to units within that business based upon how much balance sheet was needed to run a group's operations. For example, as part of his management reporting duties, Joseph Gentile, the former Financial Officer of Lehman's FID, tracked FID's balance sheet on a daily basis and as part of Lehman's balance sheet management process. Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 5. If Lehman's firm-wide net leverage ratio was too high, individual businesses such as FID would be informed of the impact their respective balance sheet breaches had on the firm's leverage ratio. *Id.; see also* e-mail from Gerard Reilly, Lehman, to Joseph Gentile, Lehman (Feb. 21, 2007) (stating the impact of $10 billion balance sheet breach by FID on Lehman's net leverage ratio and stating: "These guys are going to have to take accountability for under performance. At least tell guys to cut b[alance] s[heet] if they don't make money."); e-mail from Joseph Gentile, Lehman, to Gerard Reilly, Lehman (Feb. 21, 2007) [LBEX-DOCID 4553347]. Michael McGarvey similarly said that beginning sometime in 2007 (as leverage became increasingly important to market observers) and until September 2008, when Lehman filed for bankruptcy, he assumed a newly-created role in which he both worked with different product groups within FID to develop daily estimates of the group's balance sheet and how much funding each desk was using, and communicated to FID product controllers the balance sheet targets set by Lehman's Treasury group. Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 6. McGarvey also communicated these targets to the Financial Controller. *See* e-mail from Michael McGarvey, Lehman, to Martin Kelly, Lehman (Jan. 30, 2008) [LBHI_SEC07940_861472-861474] (reporting that FID's Rates business has $113.6 billion in net assets, that the quarter-end forecast is more than $3 billion over target, so Lehman should reduce net assets by $68 billion). Lehman documents, including PowerPoint presentations and e-mail communications, confirm the setting of balance sheet targets and leverage ratio targets at the firm. *See, e.g.*, Lehman, Rates Business Projected Balance Sheet Spreadsheet (Aug. 21, 2006) [LBEX-DOCID 2783441]; e-mail from Kentaro Umezaki, Lehman, to Ian T. Lowitt, Lehman (Apr. 16, 2007) [LBEX-DOCID 288764] ("Giving out targets for Q2 as we speak. Numbers attached . . . all biz's are aware of it's importance now . . . Gerry [Reilly] has us working with a 195 net balance sheet target now . . . to get us to 15x net leverage by end of May . . . ."); Lehman, Lehman Asset Statement Balance Sheet January 10, 2007 Spreadsheet (Jan. 11, 2007) [LBEX-DOCID 648081]; e-mail from Michael McGarvey, Lehman, to Clement Bernard, Lehman (Nov. 29, 2007) [LBEX-DOCID 1852001] (discussing whether Rates Asia, within FID, will make its balance sheet target); Lehman, Rates Projected Balance Sheet Spreadsheet (Jan. 25, 2007) [LBEX-DOCID 1447282]; e-mail from Kentaro Umezaki, Lehman, to Joseph Gentile, Lehman (Feb. 21, 2007) [LBEX-DOCID 1808076] ("What is our lev ratio target this quarter?"); Lehman, Global FID Balance Sheet Forecast as of November 12, 2007 (Nov. 13, 2007) [LBEX-DOCID 3215542]; e-mail from Sarah Paek, Lehman, to Balance Sheet Group, Lehman (Nov. 29, 2007) [LBEX-DOCID 1851789] (transmitting attached FID balance sheet forecast [LBEX-DOCID 1733969] reporting amount by which business within FID are over/under gross and net balance sheet targets); e-mail from Michael McGarvey, Lehman, to Martin Kelly, Lehman (Jan. 30, 2008) [LBEX-

Although, as noted above, only highly liquid securities were eligible for Repo 105 treatment, Grieb, Reilly and others explored whether they could remove sticky inventory from Lehman's balance sheet through the use of Repo 105 transactions.[3196]

DOCID 1728898] ("As of the 28th, Rates had 113.6bn of net assets. Right now our quarter-end forecast is at ~3bn over target so we should reduce net assets by 68 bn."); e-mail from Clement Bernard, Lehman, to Roger Nagioff, Lehman, *et al.* (Nov. 20, 2007) [LBEX-DOCID 173748] ("The net Balance Sheet forecast for FID for November 30 has increased to $232.6 [billion] from a previous forecast of $227 [billion]. This is $12.6 [billion] above the limit of $220 [billion]. The limit of $220 [billion] equates to a leverage ratio of 16 which is the current firm target. . . . Based on my conversations with Paolo [Tonucci] we need to go down to $225 [billion] in order for the ratio to be back to target."); *id.* (noting also that most of the United States Agency positions will be off balance sheet through Repo 105 transactions).

[3195] Joseph Gentile, Lehman, Proposed Repo 105/108 Target Increase for 2007 (Feb. 10, 2007) [LBEX-DOCID 2489498] (attached to e-mail from Joseph Gentile, Lehman, to Edward Grieb, Lehman (Feb. 10, 2007) [LBEX-DOCID 2600714]); *see also* e-mail from Kaushik Amin, Lehman, to Herbert H. (Bart) McDade III, Lehman (June 3, 2008) [LBEX-DOCID 574610] (stating that Liquid Markets division within FID made "Herculean" efforts to reduce its balance sheet $25 billion lower than its actual balance sheet target near the quarter-end in second quarter 2008 in order to compensate for other businesses within FID that were unable to meet their targets and transmitting report [LBEX-DOCID 522198] showing Liquid Markets conducted over $42 billion in Repo 105 transactions at close of second quarter 2008 and over $39 billion in Repo 105 transactions at close of first quarter 2008).

[3196] For example, Grieb recommended to Lehman's Accounting Policy Group that Lehman use the Repo 105 program to remove from the balance sheet certain residual positions from mortgage backed and real estate backed securitizations. *See* e-mail from Marie Stewart, Lehman, to Mark Cosaitis, Lehman, *et al.* (Aug. 17, 2007) [LBEX-DOCID 3223799] ("I discussed the issue . . . with Ed Grieb to make sure he would be OK with doing this. . . . You will need to repo 105 every single piece of the deal on b/sheet. Is that the plan?"); e-mail from Mark Cosaitis, Lehman, to Marie Stewart, Lehman, *et al.* (Aug. 17, 2007) [LBEX-DOCID 3223800] (discussing whether, if Lehman can transfer all Windermere securities using Repo 105, Lehman "can…eliminate the gross up in addition to netting down the bonds?"); e-mail from Marie Stewart, Lehman, to Mark Cosaitis, Lehman, *et al.* (Aug. 17, 2007) [LBEX-DOCID 3223801] (indicating that Stewart planned to have a meeting that day with Grieb to discuss possibility of placing Windermere bonds into Repo 105 program); e-mail from Marie Stewart, Lehman, to Brett Beldner, Lehman, *et al.* (Aug. 17, 2007) [LBEX-DOCID 3223803] ("Ed told me yesterday that it was his idea that we use Repo 105 to achieve this outcome. . . . I'm not warm and fuzzy about using [Repo 105] to get entire deals off b/sheet and [Ed Grieb] should discuss with E&Y."); e-mail from Brett Beldner, Lehman, to Marie Stewart, Lehman (Aug. 17, 2007) [LBEX-DOCID 3223803] ("I am also convinced that E&Y will say it doesn't work."); e-mail from Marie Stewart, Lehman, to Mark Cosaitis, Lehman, *et al.* (Aug. 17, 2007) [LBEX-DOCID 3223806] ("I spoke to Ed [Grieb]. While a Repo 105 would work for saying the specific assets under the Repo 105 have been sold, because a repo involves a promise to repurchase those assets (and we actually book a fwd) we don't think it will work to get failed sales deals deconsolidated. Brent Beldner in process of double checking with E&Y. . . ."); *see also* Lehman, Repo 105/108 Benefit Summary (Nov. 9, 2007) [LBEX-DOCID 3219736] (attached to e-mail from Anuraj Bismal, Lehman, to David Vasey, Lehman, *et al.* (Nov. 9, 2007) [LBEX-DOCID 3223369] and showing $744,212,553 in Repo 105 transactions using

Specifically, in the summer of 2007, Grieb and Reilly enlisted the help of John Feraca, Kentaro Umezaki, and Michael McGarvey in an attempt to move mortgage-backed securities into the Repo 105 program.[3197] Though they were unsuccessful in their efforts

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"real estate held for sale" in third quarter 2007 and calling this "something odd"); e-mail from Anuraj Bismal, Lehman, to Marie Stewart, Lehman, *et al.* (Nov. 12, 2007) [LBEX-DOCID 3223374] ("Sounds to me that we did Repo 105 on Real Estate Held for Sale. We have introduced a control check to try and detect if this happens at Q4."); e-mail from Marie Stewart, Lehman, to Anuraj Bismal, Lehman, *et al.* (Nov. 12, 2007) [LBEX-DOCID 3223375] (replying to news that commercial mortgage backed securities were used for Repo 105 by stating, "My head will explode if we have to talk them about this again"); e-mail from Marie Stewart, Lehman, to Richard Holmes, Lehman, *et al.* (Nov. 12, 2007) [LBEX-DOCID 3223373] (stating that "because the CMBS we hold do not exist for GAAP we cannot get a repo 105 benefit from them"); e-mail from Marie Stewart, Lehman, to Gary Bachman, Lehman, *et al.* (Nov. 21, 2007) [LBEX-DOCID 3223381] ("FYI that we've had a few problems with people claiming Repo 105/108 benefit recently when they should not have.").

[3197] E-mail from Gerard Reilly, Lehman, to Steven Becker, Lehman, *et al.* (Aug. 16, 2007) [LBEX-DOCID 251602] ("Why can't we repo 105 some prime AAA stuff?"); e-mail from Steven Becker, Lehman, to Gerard Reilly, Lehman, *et al.* (Aug. 16, 2007) [LBEX-DOCID 251603] ("I spoke with John who is currently trying to get off as much of the European deals [apparently CMOs or collateralized mortgage obligations] as he can via REPO 105."); e-mail from Gerard Reilly, Lehman, to Steven Becker, Lehman, *et al.* (Aug. 16, 2007) [LBEX-DOCID 251605] ("Any mortgage should be our highest priority."); e-mail from Kentaro Umezaki, Lehman, to Gerard Reilly, Lehman (Aug. 16, 2007) [LBEX-DOCID 1905992] ("Who can give me a repo 105 status/projection. This is around the mortgage inventory and using repo 105. . . . I need some sense of what we are doing, and whether we can move some of the high rated mortgage products into that framework."); e-mail from John Feraca, Lehman, to Gerard Reilly, Lehman (Aug. 18, 2007) [LBEX-DOCID 4553350] (Feraca and Reilly discuss putting either commercial mortgage backed securities or residential mortgage backed securities into Repo 105); e-mail from Gerard Reilly, Lehman, to John Feraca, Lehman (Aug. 18, 2007) [LBEX-DOCID 4553351] ("Many benefits to us getting these assets [CMBS and RMBS] into the [Repo 105] program."); e-mail from John Feraca, Lehman, to David Sherr, Lehman, *et al.* (Aug. 19, 2007) [LBEX-DOCID 4553352] ("[W]e are looking at the possibility of Repo 105 for AAA RMBS and CMBS positions . . . only want to focus on non-agency products for this exercise as both agency pass-thrus and agency CMOs roll up as government or agency products in the balance sheet, not mortgages."); e-mail from David Sherr, Lehman, to John Feraca, Lehman, *et al.* (Aug. 19, 2007) [LBEX-DOCID 4553353] (discussing placement of CMBS and RMBS into Repo 105 program); e-mail from Gerard Reilly, Lehman, to John Feraca, Lehman, *et al.* (Aug. 19, 2007) [LBEX-DOCID 4553356] (same); e-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman (Aug. 19, 2007) [LBEX-DOCID 4553354] (forwarding previous e-mail chain discussions regarding mortgage backed securities and Repo 105 to Chris O'Meara).

to place mortgage-backed securities into the Repo 105 program in 2007,[3198] by May 2008, Reilly raised the idea again.[3199]

Lehman was ultimately not able in 2007 to remove non-agency residential and commercial mortgage-backed securities ("RMBS" and "CMBS") from its balance sheet through Repo 105 transactions, but senior management soon recognized that ramping-up the use of Repo 105 transactions still offered Lehman a way to relieve some of the balance sheet pressure caused by the firm's illiquid and sticky positions.[3200] As Reilly wrote in one e-mail, "At least . . . cut b[alance] s[heet] if [you] don't make money."[3201] In

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[3198] E-mail from John Feraca, Lehman, to David Sherr, Lehman, *et al.* (Aug. 20, 2007) [LBEX-DOCID 4553357] ("We spoke to the 3 of the 4 counterparties we currently use for Repo 105 on UST and Agencies via LBIE (the MTS equivalent) and all 3 declined our proposal to use AAA private label RMBS and CMBS. . . . [O]ur only other choice will be to look if any of our existing counterparties in LBI would be willing to transact through LBIE."); *see also* e-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Aug. 20, 2007) (forwarding Feraca e-mail discussing use of RMBS and CMBS in Repo 105 program); e-mail from Kentaro Umezaki, Lehman, to John Feraca, Lehman, *et al.* (Aug. 20, 2007) [LBEX-DOCID 4553359] (Umezaki replies to Feraca, "not sure that is worth the effort…we need Chris [O'Meara] to opine."); e-mail from Gerard Reilly, Lehman, to Kentaro Umezaki, Lehman, *et al.* (Aug. 21, 2007) [LBEX-DOCID 4553360] ("What about agency cmo's [collateralized mortgage obligations]? We should pass on non-agency at this point."); e-mail from John Feraca, Lehman, to Gerard Reilly, Lehman, *et al.* (Aug. 21, 2007) [LBEX-DOCID 4553361] ("My understanding is agency cmos roll up to govt products for our balance sheet disclosures and I do not think it will change the view we got from the lenders we approached yesterday.").

[3199] E-mail from Gerard Reilly, Lehman, to John Feraca, Lehman, *et al.* (May 1, 2008) [LBEX-DOCID 4553429] ("If we can get mortgage assets into 105 we need to do that. I would think it is hard to do but clearly they would be our priority.").

[3200] *Cf.* E-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Feb. 25, 2008) [LBEX-DOCID 3187495] (stating that FID's overage in balance sheet "is in real Estate and Securitized Products which currently have less ability to reduce balance sheet" and that "FID would like to do more [Repo 105] but it's a question of available capacity").

[3201] E-mail from Gerard Reilly, Lehman to Joseph Gentile, Lehman (Feb. 21, 2007) [LBEX-DOCID 4553198]. By April 2007, FID's balance sheet had grown 19% since 2005, while its revenue had grown only 3%. Lehman, FID Balance Sheet Management (April 2007), at p. 2 [LBEX-DOCID 1303268]. Moreover, 52% of FID's balance sheet was in businesses with Return on Assets (ROA) below FID's average. *Id*. During this same period of time, FID's off-balance sheet Repo 105 "benefit" grew from $15 billion in first quarter 2006 to $22 billion in first quarter 2007. *Id.*

a November 2007 e-mail from Reilly to Clement Bernard, Reilly wrote: "Let's get our best thoughts on fid b[alance] s[heet]. *We are slipping in real estate*. Take a look at liquid holdings like cp and *items we can put into the repo 105 program*. We need fid close to 5b on net."[3202]

Consistent with Gentile's recommendation to Grieb to increase the firm's Repo 105 limits, Anuraj Bismal, a former Senior Vice President in Lehman's Balance Sheet Group, said that the "stickiness" of mortgage-backed securities and other real estate securities inventory put pressure on "everything else."[3203] That is, to the extent Lehman could not remove sticky inventory from its balance sheet by selling it, Lehman had to remove even greater amounts of other types of inventory from its balance sheet – either via sales or Repo 105 transactions – to meet the balance sheet and leverage ratio targets set by senior management. According to Bismal, this was a factor in Lehman's increased use of Repo 105 transactions starting in mid-to-late 2007.[3204] Mitch King, the former head of Lehman's United States Agencies Trading Desk, also believed that Lehman's increased use of Repo 105 transactions beginning in mid-to-late 2007 was linked to the balance sheet pressure Lehman faced caused by illiquid assets on its balance sheet that the firm could not sell.[3205]

[3202] E-mail from Gerard Reilly, Lehman, to Clement Bernard, Lehman (Nov. 20, 2007) [LBEX-DOCID 3221687] (emphasis added).
[3203] Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 6.
[3204] *Id.*
[3205] Examiner's Interview of Mitchell King, Sept. 21, 2009, at pp. 4-7.

The reasons Gentile advanced for why Lehman's Repo 105 limit should be increased in February 2007 – namely, sticky inventory Lehman could not sell or could only sell by incurring substantial losses – only became more relevant in late 2007 and early 2008, as even more of Lehman's real estate and mortgage assets became illiquid and difficult to sell without substantial losses. Indeed, a significant portion of Lehman's real estate securities ultimately proved very difficult for Lehman to sell.[3206] As a result, Lehman's illiquid holdings ballooned during 2007. At the same time during 2007, Lehman's FID consistently breached its balance sheet limits.[3207]

The origins of Lehman's balance sheet difficulties rest in Lehman's aggressive countercyclical growth strategy spearheaded by Fuld in 2006 and early-to-mid-2007.[3208] This strategy included a decision to spend capital to make acquisitions, which, in turn, greatly increased the risk profile of the firm.[3209] Within the Global Real Estate Group ("GREG"), a business unit that fell mostly under the firm's Fixed Income Division umbrella,[3210] the growth strategy involved deploying capital more aggressively, increasing the bridge equity business, and acquiring and originating CMBS.[3211] GREG

[3206] *See* Section III.A.1.b.4 of the Report.

[3207] Lehman, FID Balance Sheet Management (April 2007), at p. 2 [LBEX-DOCID 1303268] (attached to e-mail from Anuraj Bismal, Lehman, to Matthew Lee, Lehman (Apr. 30, 2007) [LBEX-DOCID 1334311]).

[3208] *See* Sections III.A.1.b.1–2 of the Report; *see also* Lehman Brothers, Executive Committee Offsite, Opportunities for Additional Risk Deployment (Aug. 3, 2006) [LBEX-DOCID 2781866].

[3209] *See* Sections III.A.1.b.1–2 of the Report; *see also* Lehman Brothers, Executive Committee Offsite, Opportunities for Additional Risk Deployment (Aug. 3, 2006) [LBEX-DOCID 2781866].

[3210] With the exception of Real Estate Private Equity, which was co-managed with Private Equity, GREG was a unit within FID.

[3211] *See* Section III.A.1.d of the Report.

also oversaw the leveraged buyout of the Archstone-Smith REIT by the joint venture between Lehman and Tishman Speyer. [3212]

As a result of these acquisitions, the size of Lehman's commercial real estate ("CRE") asset holdings significantly escalated in 2006 and 2007.[3213] A significant part of the CRE inventory ultimately proved very difficult, if not impossible, for Lehman to sell.[3214] The total illiquid positions on Lehman's balance sheet increased from $41 billion in 2006 to $115 billion in 2007 and $120 billion in the first quarter of 2008.[3215]

While deleveraging took on more urgency in 2008, it was not a new subject; Lehman had been concerned about balance sheet and net leverage for some time. An April 2007 internal Lehman FID Balance Sheet Management Presentation reported that FID failed to meet its net balance sheet targets 11 out of the prior 15 months.[3216] The

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[3212] *See* Section III.A.1.d of the Report.

[3213] *See* Section III.A.1.d of the Report; *see also* Lehman, Global Real Estate Group, Global Real Estate Update (Nov. 6, 2007) [LBEX-DOCID 2504331]; Mark Walsh, Lehman, Commercial Real Estate Update, Presentation to Lehman Board of Directors (Mar. 25, 2008), at p. 4 [LBHI_SEC07940_127250] (March 2008 CRE Update).

[3214] *See* Section III.A.1.b.4 of this Report. In early February 2008, then Lehman President Joseph Gregory warned GREG that it had to get its real estate balance sheet down quickly. E-mail from Mark Walsh, Lehman, to Andrew J. Morton, Lehman (Feb. 26, 2008) [LBHI_SEC07940_115814]. At that time, firm CFO Erin Callan told GREG to get $5 billion of CRE off its balance sheet by the time of Lehman's March 18, 2008 earnings call. E-mail from Paul Hughson, Lehman, to Mark Gabbay, *et al.* Lehman (Feb. 27, 2008) [LBEX-DOCID 1869265] (discussing the schedule for the $5 billion reduction target); e-mail from Paul Hughson, Lehman, to Mark Gabbay, Lehman, *et al.* (Mar. 7, 2008) [LBEX-DOCID 1723168] (providing update on sales progress and asking for updates regarding progress toward the $5 billion reduction target).

[3215] Andrew J. Morton, Lehman, Fixed Income Update, Presentation to Lehman Board of Directors, (May 7, 2008), at p. 4 [LBHI_SEC07940_027994].

[3216] Lehman, FID Balance Sheet Management (April 2007), at p. 2 [LBEX-DOCID 1303268] (attached to e-mail from Anuraj Bismal, Lehman, to Matthew Lee, Lehman, *et al.* (Apr. 30, 2007) [LBEX-DOCID 1334311]; *see also* e-mail from Joseph Gentile, Lehman, to Gerard Reilly, Lehman (Feb. 20, 2007) [LBEX-

presentation further provided, "Accounting changes have grown 'Dead Balance Sheet' to 21.2 bn and continues to put pressure on the balance sheet limit."[3217] As a result of the stress on its balance sheet, Lehman proposed a policy of incentives and penalties for meeting balance sheet targets.[3218] The cover e-mail to FID's April 2007 balance sheet presentation indicated that one of the purposes of the balance sheet management policy changes discussed in the presentation was to position Lehman for a ratings upgrade.[3219]

The same month as the FID Balance Sheet Management Presentation, April 2007, Kentaro Umezaki informed Ian Lowitt that he had distributed balance sheet targets for second quarter 2007 and that relevant Lehman personnel were "aware of its importance now."[3220] The new targets were meant to allow Lehman to reach a 15x net leverage ratio

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DOCID 4553219] (complaining about FID's serious balance sheet breaches and arguing that not only is FID unable to meet the balance sheet target, it isn't even "making money"); e-mail from Sigrid Stabenow, Lehman, to Gerard Reilly, Lehman, *et al.* (Apr. 4, 2007) [LBEX-DOCID 4553228] (transmitting presentation [LBEX-DOCID 4553110] and saying "talking points and key themes for the argument that FID needs to address balance sheet efficiency"); e-mail from Paul Mitrokostas, Lehman, to Kentaro Umezaki, Lehman (Nov. 14, 2007) [LBEX-DOCID 1859142] (reporting that FID Core looks to be $7 to $15 billion over its balance sheet limit).

[3217] Lehman, FID Balance Sheet Management (April 2007), at p. 2 [LBEX-DOCID 1303268] (attached to e-mail from Anuraj Bismal, Lehman, to Matthew Lee, Lehman, *et al.* (Apr. 30, 2007) [LBEX-DOCID 1334311]).

[3218] Lehman, FID Balance Sheet Management Policy (April 2007), at p. 3 [LBEX-DOCID 1303268] ("Penalty Charge of 5mm per billion on net balance sheet overages (Monthly) applicable at a regional POD level."); *see also* e-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Feb. 25, 2008) [LBEX-DOCID 3187495] ("In the past the Fixed Income Division has had in place a 'speeding ticket' charge for businesses that exceed their net balance sheet target…"); e-mail from Kaushik Amin, Lehman, to Kentaro Umezaki, Lehman, (May 18, 2007) [LBEX-DOCID 1811290] ("[T]he new balance sheet limits are going to really hurt the business. At a time when I am trying to get the traders to take more risk, this is inconsistent.").

[3219] E-mail from Kentaro Umezaki, Lehman, to Kaushik Amin, Lehman, *et al.* (Apr. 20, 2007) [LBEX-DOCID 1334311].

[3220] E-mail from Kentaro Umezaki, Lehman, to Ian T. Lowitt, Lehman (Apr. 16, 2007) [LBEX-DOCID 288764].

by the end of second quarter 2007.[3221] Umezaki advised Lowitt that Lehman's mortgage assets and real estate securities were the primary obstacles to Lehman reaching its net leverage ratio target at that time.[3222]

Another internal Lehman e-mail from April 2007 illustrates the discourse and dissension among senior Lehman management regarding the firm's balance sheet.[3223] In the e-mail chain, Chris O'Meara, Umezaki, Lowitt, Gelband and others discussed the "balance sheet belt tightening effort in FID" in light of a talk between Fuld and the firm's managing directors the night before.[3224] Umezaki indicated that senior management was sending conflicting messages: Fuld wanted to emphasize revenue growth, while the message within FID was that meeting balance sheet targets was necessary in order to achieve ratings upgrades.[3225] O'Meara noted that the firm had allowed its leverage ratio to increase higher than planned, which further exacerbated

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[3221] *Id.* ("Gerry has us working with a 195 net balance sheet target . . . to get us to 15x net leverage by end of May. . . .").

[3222] *Id.*

[3223] *See* e-mail from Kentaro Umezaki, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 18, 2007) [LBEX-DOCID 187618]; *see also* e-mail from Kentaro Umezaki, Lehman, to Paolo R. Tonucci, Lehman (Apr. 19, 2007) [LBEX-DOCID 318475].

[3224] E-mail from Kentaro Umezaki, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 18, 2007) [LBEX-DOCID 187618].

[3225] *Id.* When asked about a related e-mail from the following day in which Umezaki complained about inconsistent messages around risk and growth, Fuld explained that as CEO, he tried to motivate people but that he left it up to the Executive Committee to translate his remarks to the people in their ranks. Examiner's Interview of Richard S. Fuld, Jr., Sept. 25, 2009, at p. 17. Fuld did not specifically recall hearing that there was confusion about balancing growth and risk and was not aware of Umezaki's concerns. *Id.*

the tension between the two messages (growth vs. balance sheet belt-tightening).[3226] O'Meara continued: "I think we will have to make choices on how to best deploy the balance sheet we have available. From my perspective, getting AA- can be accomplished with our planned balance sheet leverage ratio."[3227]

In May 2007, Jonathan Cohen, a Senior Vice President in GREG, asked Umezaki whether GREG could trade its balance sheet allocation with other firm business groups to ease the pain of GREG's balance sheet breaches.[3228] Cohen suggested that if trading balance sheet was not an option, GREG would have no choice but to sell certain positions at discount prices in order to meet balance sheet targets and stay under the limit.[3229]

Significant effort was expended to remind FID, in particular, of its quarter-end balance sheet targets. Joseph Gentile, and after him, Clement Bernard, each of whom reported directly to Gerard Reilly, Lehman's Global Product Controller, was tasked with applying pressure on the head of FID to ensure FID met its quarterly balance sheet targets.[3230] Typically in this process, Gentile or Bernard would remind and cajole FID

[3226] E-mail from Kentaro Umezaki, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 18, 2007) [LBEX-DOCID 187618].

[3227] *Id.*

[3228] E-mail from Jonathan Cohen, Lehman, to Kentaro Umezaki, Lehman, *et al.* (Apr. 27, 2007) [LBEX-DOCID 188165].

[3229] *Id.*; *see also* Lehman, Global Real Estate Group, Global Real Estate Update (Nov. 6, 2007), at p. 1 [LBEX-DOCID 1419292] ("GREG believes that under any circumstances an estimated $15Bn reduction in global balance sheet is warranted.").

[3230] Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 5; Examiner's Interview of Clement Bernard, Oct. 23, 2009, at p. 11.

business leaders regarding their respective balance sheet targets as quarter-end approached.[3231] Michael McGarvey (Finance) would apply the same pressure on Lehman's individual trading desks and then report back to Reilly and Bernard.[3232]

In some instances, Gentile recalled having heated discussions with Umezaki in early 2007 about using every effort to ensure that FID attempted to meet its balance sheet target so that Gentile could avoid facing criticism from O'Meara, Lehman's then-

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[3231] *See*, *e.g.*, E-mail from Joseph Gentile, Lehman, to Michael Gelband, Lehman, *et al.* (Feb. 21, 2007) [LBEX-DOCID 810934] ("[W]e have a serious balance sheet issue for FID coming into the end of the Quarter. All businesses with the exception of credit are running large excessions. . . . I need you to stress to [your business leaders] the need to manage down their excessions."); e-mail from Kentaro Umezaki, Lehman, to Joseph Gentile, Lehman (Feb. 20, 2007) [LBEX-DOCID 1808077] (Umezaki: "What is 'serious'?" Gentile answers a $10 billion excession of the balance sheet limit and also states that "leverage ratio is too high."); e-mail from Clement Bernard, Lehman, to Kieran Higgins, Lehman (Feb. 22, 2008) [LBEX-DOCID 1854016] ("I am following up on the conversation that we had…on the Balance sheet. As you may know we are still struggling on our Balance Sheet. We are currently at 19 bn above our target. Within that number Rates Europe is 3.7 bn above target. . . . You mentioned that you would be doing some reduction in gvt and maybe add repo 105."); e-mail from Clement Bernard, Lehman, to Kaushik Amin, Lehman (Feb. 25, 2008) [LBEX-DOCID 756417] ("To follow up on our conversation for Q1. We are currently running at 15.0 bn above and we need to go down an extra $5.0 bn for the firm to meet its net leverage limit of 15.2. I need your help on this. . . . Let me know what you can do. . ."); e-mail from Clement Bernard, Lehman, to Eric Felder, Lehman (Feb. 25, 2008) [LBEX-DOCID 2080410] ("We need to reduce our net Balance sheet to hit the firm target net leverage ratio of 15.2. Currently FID is projected to be $15.0bn above its limit. . . . Let me know if there is anything you could do to reduce the Balance Sheet and what would the price of doing that."); e-mail from Clement Bernard, Lehman, to Eric Felder, Lehman (Feb. 25, 2008) [LBEX-DOCID 981497] ("I have currently a forecast of 11.8 vs a limit of 10.4. Let me know what you can do and if there is a price to move some BS out."); e-mail from Clement Bernard, Lehman, to Kaushik Amin, Lehman, *et al.* (Feb. 28, 2008) [LBEX-DOCID 1854189] ("FID's net balance sheet overage has increased to 14.3bn from 9.7bn as of yesterday. . . . This will drive Lehman net leverage ratio above target. Please let me know what we can do to minimize the impact. . . . I know it is late in the process but what ever we can do would help our ratio."); e-mail from Clement Bernard, Lehman, to Martin Potts, Lehman (Feb. 28, 2008) [LBEX-DOCID 1854189] ("We are looking at selling what ever we can and also doing some more repo 105."); e-mail from Clement Bernard, Lehman, to Paul Mitrokostas, Lehman, *et al.* (May 13, 2008) [LBEX-DOCID 1697936] (discussing progress in reaching quarter-end balance sheet targets).

[3232] E-mail from Michael McGarvey, Lehman to Mark Gavin, Lehman, *et al.* (Feb. 28, 2008) [LBEX-DOCID 810932] ("Given the critical balance sheet situation we are currently in I've attached a list of corporate bonds held in NY (all above BBB and 10mm in market value) available for any additional Repo 105 capacity we can find. Please let us know what issues are sent out so we can inform the desk not to trade them for the term of the repo.").

CFO, and Grieb, the firm's then-Global Financial Controller, if FID breached its quarter-end balance sheet target.[3233] Despite these efforts of senior management, FID routinely failed to meet its balance sheet targets in every quarter of Lehman's 2007 fiscal year and in 2008.[3234]

Even near the time of Lehman's bankruptcy, FID continued to perform poorly. In response to a late August 2008 e-mail from Reilly asking, "How much repo 105 do we have now and how much will we have at 8/31," McGarvey replied, "FID is the worst run division in the company."[3235]

In 2008, FID's breaches of the balance sheet limits continued to be concentrated in difficult-to-sell securitized products and real estate.[3236] A "FID Core Global Balance Sheet Liquidity" document dated January 17, 2008 (*reproduced below*) indicated that FID

[3233] Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at pp. 5-6.

[3234] Examiner's Interview of Clement Bernard, Oct. 23, 2009, at p. 11; Lehman, FID Balance Sheet Management (April 2007), at p. 2 [LBEX-DOCID 1303268] ("FID has missed its net balance sheet target 11 out of the last 15 months."); e-mail from Dominic Gibb, Lehman, to Mark Cosaitis, Lehman, *et al.* (Feb. 28, 2009) [LBHI_SEC07940_1829372] ("Jock and his team are aggressively working to obtain repo 105 funding for all eligible govvies positions. If they are successful then we will have $23bn of assets on Repo 105 at quarter end. . . . This would leave FID with a net balance sheet of $51.7bn, $4.7bn above the FID limit. . . "); e-mail from Clement Bernard, Lehman, to Andrew J. Morton, Lehman (Mar. 3, 2008) [LBEX-DOCID 1849880] ("We ended up at 15.6% on our net leverage ratio. . . . FID was $238 bn vs a limit of 223 ie 15 bn over limit.").

[3235] E-mail from Michael McGarvey, Lehman, to Gerard Reilly, Lehman, (Aug. 29, 2008) [LBEX-DOCID 4517471].

[3236] *See* Section III.A.1.b.4 of the Report; *see also* e-mail from Gary Mandelblatt, Lehman, to Alex Kirk, Lehman, *et al.* (Jan. 15, 2008) [LBEX-DOCID 1600235] (stating that "the lack of sales and syndication [was] a function of the tight credit markets"); Notes from Lehman Monthly Risk Meeting with SEC (June 19, 2008), at p. 7 [LBEX-SEC 007583] (Hughson stating that, in June 2008, "buyers and sellers [were] just staring at each other."); *see also* e-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Feb. 25, 2008) [LBEX-DOCID 3187495] (stating that "a part of FID Core's [balance sheet] overage is in Real Estate and Securitized Products which currently have less ability to reduce balance sheet anyways.").

held $115.857 billion in illiquid assets at that time.[3237] Of that amount, $55.747 billion was in real estate.[3238]

GLOBAL

BUSINESS UNIT	Net B/S 1/17	Acct Gross Up	MTM	Fails/Other	Long Inventory	Illiquid	Dedicated Prop	Cash Hedges	'Movable'
Global Rates	116,249	0	12,536	1,354	102,359	-	7,662	17,514	77,183
Foreign Exchange	5,789	0	2,076	269	3,444	-	35	13	3,396
Liquid Markets	**122,038**	**0**	**14,612**	**1,623**	**105,803**	**-**	**7,698**	**17,527**	**80,579**
Commodities	**2,411**	**0**	**1,915**	**333**	**163**	**-**	**-**	**-**	**163**
High Grade	15,921	0	393	219	15,309	4,250	0	293	10,766
CDO	10,365	2,483	3,907	349	3,626	3,377	249	-	(0)
High Yield	15,449	0	251	66	15,132	2,875	0	5	12,252
Credit	**41,735**	**2,483**	**4,551**	**634**	**34,067**	**10,502**	**249**	**298**	**23,017**
Real Estate	**65,798**	**9,407**	**154**	**488**	**55,748**	**55,747**	**-**	**2**	**(0)**
Securitized Products	**67,622**	**9,748**	**3,520**	**2,411**	**51,944**	**40,488**	**-**	**2,938**	**8,517**
Municipals	**7,045**	**885**	**2,506**	**1**	**3,653**	**-**	**415**	67	**3,171**
IBD Loans	6,014	0	0	2	6,012	6,012	-	-	0
FID Corp Loans	1,981	0	0	0	1,981	1,981	-	-	0
FID Corp	2,308	0	43	1,090	1,176	1,127	-	-	48
FID Corporate	**10,303**	**0**	**43**	**1,091**	**9,168**	**9,120**	**-**	**-**	**48**
TOTAL FID CORE	**316,952**	**22,523**	**27,300**	**6,583**	**260,547**	**115,857**	**8,362**	**20,832**	**115,496**
Americas	**212,075**	**15,361**	**20,325**	**3,998**	**172,391**	**76,563**	**7,898**	**5,808**	**82,123**
Europe	**72,530**	**5,366**	**6,942**	**2,289**	**57,933**	**26,010**	**429**	**12,627**	**18,866**
Asia	**32,347**	**1,796**	**33**	**296**	**30,223**	**13,284**	**35**	**2,396**	**14,508**

Similarly, an April 29, 2008 FID CORE balance sheet purporting to show first quarter 2008 figures, listed $108.75 billion in total illiquid securities inventory, of which $52.12 billion was real estate securities.[3239] So large was the amount of illiquid assets that some within Lehman referred colloquially to these FID balance sheets as "dead asset schedules."[3240]

[3237] Lehman, Presentation regarding FID Global Balance Sheet (Jan. 17, 2008), at p. 4 [LBHI_SEC07940_1954891].

[3238] *Id.*

[3239] Lehman, FID Core Q1 Balance Sheet (Apr. 29, 2008) [LBEX-DOCID 1741665] (attached to e-mail from Neeraj Chopra, Lehman, to Abe Kebede, Lehman (May 15, 2008) [LBEX-DOCID 1953960]).

[3240] Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 6; Examiner's Interview of Matthew Lee, July 1, 2009, at pp. 10-11.

(5) Deleveraging Resulted in Intense Pressure at Quarter-End to Meet Balance Sheet Targets for Reporting Purposes

The market focus on balance sheet and leverage in late 2007 and 2008 meant increased pressure from Lehman senior management on its various business units to meet their balance sheet targets to position the firm to meet its net leverage ratio target.[3241] In the time leading up to each of the firm's quarter-ends, business units and individual traders scurried to meet their balance sheet targets in time for the reporting period, in the case of FID, often through the expanding use of Repo 105 transactions.[3242]

[3241] Examiner's Interview of Tejal Joshi, Sept. 15, 2009, at pp. 5-6; Examiner's Interview of Kaushik Amin, Sept. 17, 2009, at p. 5; Examiner's Interview of Mitchell King, Sept. 21, 2009, at pp. 4-6.

[3242] Examiner's Interview of Tejal Joshi, Sept. 15, 2009, at pp. 5-6; Examiner's Interview of Kaushik Amin, Sept. 17, 2009, at p. 5; Examiner's Interview of Mitchell King, Sept. 21, 2009, at pp. 4-6. Numerous documents demonstrate the intense balance sheet pressure, especially near or at quarter-end. *See*, *e.g.*, e-mail from Mitchell King, Lehman, to Mark Gavin, Lehman, *et al.* (Dec. 3, 2007) [LBEX-DOCID 3232555] (stating with respect to US Agency Desk use of Repo 105, "As we approach our quarter end, we start to raise the balances so that we 'reserve' size with our counterparties the week we really need it (over quarter end). At this fiscal year end we took the amounts as high as we could, as we knew there would be intense balance sheet pressure."); e-mail from Jerry Rizzieri, Lehman, to Mitchell King, Lehman (Feb. 19, 2008) [LBEX-DOCID 3233177] (stating ten days before close of quarter, "Balance Sheet still a big push. Agency business, even with 105, still over by almost $4 billion. . . ."); e-mail from Mark Gavin, Lehman, to John Feraca, Lehman, *et al.* (Feb. 28, 2008) [LBEX-DOCID 098492] ("Just took a call from FID mgmt - seems they're up on net b/s by 3 bln unanticipated & are a little excited w Q end. I am looking to do an additional repo 105 with Mizuho using this additional limit . . . if they have appetite."); e-mail from Alvaro Mucida, Lehman, to Gabriel Buteler, Lehman, *et al.* (May 2, 2008) [LBEX-DOCID 601783] ("[P]ressure for balance sheet here is enormous and I was told that even 105 was scarce…"); e-mail from Mitchell King, Lehman, to Ryan Murphy, Lehman (May 19, 2008) [LBEX-DOCID 3233040] (stating 12 days before close of quarter, "Getting close, management walking around talking balance sheet"); e-mail from Mark Gavin, Lehman, to Michael McGarvey, Lehman, *et al.* (May 22, 2008) [LBEX-DOCID 3232907] (stating nine days before close of quarter, "there is a drive to get more Repo 105 in place"); e-mail from Kevin Croutier, Lehman, to Mitchell King, Lehman (May 22, 2008) [LBEX-DOCID 3233057] (nine days before close of quarter, Croutier: "How much more repo 105 trades are you trying to do before month end?" King: "We are trying to get everything out that we can."); e-mail from Mitchell King, Lehman, to Marc Silverberg, Lehman (May 28, 2008) [LBEX-DOCID 3233083] (stating three days before close of quarter, "I just want to see if there is any possibility to add to 105. . . . I'm pretty sure we have almost everything out, but want to check").

In November 2007, Lehman's Treasurer Paolo Tonucci informed Clement Bernard, FID's Chief Financial Officer, that FID's balance sheet limit had to be reduced, despite FID's repeated breaches of the balance sheet limit, in order to meet the firm's leverage ratio targets.[3243] Bernard typically communicated balance sheet limits and related net leverage ratio targets to FID personnel and pressured the FID business heads to reduce balance sheet by any means necessary, which usually entailed increased Repo 105 transactions at or near quarter-ends.[3244]

In a January 2008 e-mail, Michael McGarvey informed Bernard about a discussion with Alex Kirk and Andrew Morton regarding FID's $13 billion breach of the balance sheet limit. McGarvey wrote: "Alex was going to have a conversation with Kaushik [Amin] about potentially coming in under their target for balance sheet if need be" and that "[a] meeting has been set up . . . to review the next steps for Repo 105 for the Q1 (It would be helpful to know if Gerry [Reilly] has a view on what the maximum tolerable level of repo 105 is for the firm)."[3245]

Mitch King, the former Head of FID's United States Agencies Trading Desk, recalled "there was always balance sheet pressure at quarter ends," but that sometime in mid-2007 "there was a definite change" and the firm began "trying desperately to

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[3243] E-mail from Clement Bernard, Lehman, to Roger Nagioff, Lehman, *et al.* (Nov. 20, 2007) [LBEX-DOCID 272199].

[3244] Examiner's Interview of Clement Bernard, Oct. 23, 2009, at pp. 9-11.

[3245] E-mail from Michael McGarvey, Lehman, to Clement Bernard, Lehman (Jan. 28, 2008) [LBEX-DOCID 3384755].

reduce its balance sheet," thereby further intensifying the quarter-end alarm.[3246] The message from senior Lehman management was to "keep making P&L but . . . get balance sheet down."[3247] King continued: "There was a way to . . . to reduce balance sheet at quarter end . . . . To the powers that be, Repo 105 counted as balance sheet reduction."[3248]

Thus, Repo 105 transactions were used as a shortcut for meeting quarter-end balance sheet targets (*i.e.*, avoiding balance sheet limit breaches) and reaching the firm-wide net leverage ratio target:

- "Is there a formal limit on Repo 105? We are trying to do more of these in order to reduce the bs [balance sheet]."[3249]
- "As B/S [balance sheet] will be super tight, I need to make sure we make best use of [Repo] 105."[3250]

(6) Lehman's Earnings Calls and Press Release Statements Regarding Leverage

In its earnings calls and press releases in 2008, Lehman spoke extensively about the size of the firm-wide balance sheet, FID's performance, and firm-wide aggressive efforts to deleverage. Notably, Lehman never disclosed that it relied upon an expanded

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[3246] Examiner's Interview of Mitchell King, Sept. 21, 2009, at p. 4. When he held the position of Global Financial Controller, Edward Grieb would hold monthly "issues" meetings with his staff. Examiner's Interview of Matthew Lee, July 1, 2009, at p. 16. At least one attendee, Matthew Lee, recalled that when the issue of the volume of Lehman's Repo 105 transactions was raised, the response was usually that then-Chief Financial Officer Chris O'Meara was "quite keen on" reducing the balance sheet. *Id.*

[3247] Examiner's Interview of Mitchell King, Sept. 21, 2009, at p. 5.

[3248] *Id.*

[3249] E-mail from Clement Bernard, Lehman, to Gerard Reilly, Lehman (Jan. 27, 2008) [LBEX-DOCID 2793484].

[3250] E-mail from Thomas Siegmund, Lehman, to Kaushik Amin, Lehman (Apr. 17, 2008) [LBEX-DOCID 739685].

use of Repo 105 transactions at quarter-end to manage its balance sheet when market conditions declined. Similarly, Lehman never disclosed that its net leverage ratio – which Lehman publicly touted as evidence of its discipline and financial health – depended upon Lehman's Repo 105 practice.

During the first quarter 2008 earnings conference call, then-Chief Financial Officer Erin Callan remarked that since the previous quarter, Lehman had been "trying to give the group [*i.e.*, the analysts] a great amount of transparency on the balance sheet."[3251] At no time, however, did Callan or anyone else from Lehman disclose the firm's use of Repo 105 transactions to manage the balance sheet. Callan told the analysts that Lehman "did, very deliberately, take leverage down for the quarter. We ended with a net leverage ratio of 15.4 times down from 16.1 at year end. And we will continue to allocate capital on the balance sheet in the market in a way that we consider prudent, and that reflects the liquidity profile of the balance sheet."[3252]

When Callan briefly addressed Lehman's ordinary repo transactions during the first quarter 2008 earnings call, she made no mention of Lehman's Repo 105 program.[3253]

[3251] Final Transcript of Lehman Brothers Holdings Inc., First Quarter 2008 Earnings Call (Mar. 18, 2008), at p. 7 [LBHI_SEC07940_7579849].

[3252] *Id.* at p. 8. This "deliberate" deleveraging strategy is consistent with documentary evidence in which Clement Bernard, Kaushik Amin and others pressured FID business leaders to reduce their respective balance sheets at quarter-end, through either sales or Repo 105 transactions, so the firm could make its net leverage ratio target. Callan's statement also indicates that senior management gave orders to aggressively deleverage.

[3253] *Id.* at p. 9 ("Total repo, exclusive of the match[ed] book, was 215 billion of which a substantial majority of this collateral is eligible to be pledged under the new fed facility. We have 115 billion of tri-party

During the question and answer portion of the first quarter 2008 earnings call, an Oppenheimer analyst asked Callan to comment on "the lack of a permanent buyer for so many of these securities" and the time horizon and pace at which Lehman anticipated bringing down its leverage ratios.[3254] Callan's response linked the increased illiquidity of Lehman's balance sheet with Lehman's deliberate plan to deleverage, but she indicated that Lehman achieved the reduction in leverage through the sale of assets:

> We did have a deliberate decision this quarter to take leverage down, which I think is more appropriate for the increased illiquidity of the balance sheet, and if the environment continues to stay this way we'll continue to be focused on that discipline. The real balancing act that I'm sure you can appreciate, that we think hard about is the balancing act of our fundamental view of the assets themselves, what we consider to be the loss of P&L associated with selling an asset at a given price today, given what we think its MPV is. And the trade-off with that with prudent balance sheet management.[3255]

When a Bank of America analyst again raised the topic of leverage during the first quarter 2008 earnings call, Callan explained that Lehman would continue to sell assets in order to reduce its leverage.[3256] Callan told analysts that Lehman's "goal is to continue to take that leverage down . . . . In order to do so . . . we will sell assets as appropriate and within the right pricing context, to get to that outcome . . . . I don't see why there's any reason at this point to change off that course and we'll stay on that path

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secured financing, which is really just the total repo amount less treasuries and agencies which go through the FICC system anonymously.").

[3254] *Id.* at p. 13.

[3255] *Id.*

[3256] Final Transcript of Lehman Brothers Holdings Inc., First Quarter 2008 Earnings Call (Mar. 18, 2008), at p. 23 [LBHI_SEC07940_7579849].

until . . . something about the environment . . . tells us we should behave differently."[3257] No analyst could have been aware, on the basis of Lehman's statements during the first quarter 2008 earnings call, that Lehman employed over $49 billion of quarter-end Repo 105 transactions to manage its publicly reported net leverage for first quarter 2008.

In its second quarter 2008, which ended on May 31, 2008, Lehman continued to highlight its deleveraging efforts.[3258] Early in a June 9 analysts call, Callan focused on Lehman's success in reducing its net leverage and balance sheet:

> The net loss of $2.8 billion compares to net income of $489 million last quarter and $1.3 billion in the second quarter of 2007. Importantly – and you will hear this throughout the call – during the quarter we executed on a number of the capital and liquidity goals that we set out for ourselves, which includes as follows – lowering growth and net leverage to less than 25 times and less than 12.5 times, respectively. Both of those numbers are prior to today's capital raise. Reducing our gross assets by approximately $130 billion and our net assets by approximately $60 billion with a large part of the reduction, as I will talk about in detail, coming from less liquid asset categories and also providing significant price visibility for marking the remainder of our inventory.[3259]

Callan said that, taking into account the early June 2008 capital raise, Lehman reduced its net leverage to 10x.[3260] Callan described the firm's deleveraging effort as "aggressive" but said "we do not expect to use the proceeds of this equity raise to

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[3257] *Id.*

[3258] In addition to lowering its leverage ratios in second quarter 2008, Lehman also grew its cash capital surplus to $15 billion from $7 billion in first quarter 2008, and its liquidity pool to $45 billion from $34 billion in the previous quarter. Final Transcript of Lehman Brothers Holdings Inc. Second Quarter 2008 Preliminary Earnings Call (June 9, 2008), at p. 3. During this time, the performance of Lehman's Fixed Income Division was weak, with revenues of negative $3 billion. *Id.* at p. 4.

[3259] *Id.* at pp. 3-4.

[3260] *Id.* at p. 7.

further decrease leverage but rather to take advantage of future market opportunities."[3261] A Goldman Sachs analyst questioned Callan about Lehman's "defensive" deleveraging process during the second quarter preliminary earnings call.[3262] Callan's reply confirmed that senior Lehman management imposed strict balance sheet targets that quarter:

> I think part of the rationale for us this quarter of why we were so aggressive, why we put out explicit targets, and why we had such a tight schedule was exactly that. . . . [T]he business operators . . . knew what the targets were. We were explicit from the beginning of the quarter. . . . So I think the discipline of getting it done primarily in a single quarter was important to keep the mindsets focused.[3263]

One Merrill Lynch analyst asked Callan during the June 9 call to respond "to critics who are going to say that the $130 billion of assets sales [by which Lehman deleveraged] must be the absolute easiest assets to sell."[3264] Callan provided "anecdotal evidence" that Lehman sold whole loan positions from its commercial real estate and residential real estate books.[3265] Callan said nothing about Lehman's use of Repo 105 transactions, which as noted above involved only the firm's most liquid securities, to effectuate temporary sales at quarter-end to remove assets from the firm's balance sheet.

[3261] Final Transcript of Lehman Brothers Holdings Inc. Second Quarter 2008 Preliminary Earnings Call (June 9, 2008), at p. 7.
[3262] *Id.* at p. 9.
[3263] *Id.* at p. 9.
[3264] *Id.* at p. 12.
[3265] *Id.*

Lehman held another second quarter 2008 earnings call on June 16, 2008. By that time, Ian Lowitt had replaced Callan as Lehman's CFO and Bart McDade had replaced Joe Gregory as Lehman's President and Chief Operating Officer. McDade stated on the call that Lehman made "substantial improvements" in its balance sheet and that Lehman's "balance sheet improvements give us the additional resources and additional capacity to drive our client model."[3266] Asked whether the sales by which Lehman achieved the balance sheet improvements were "pretty much ratably spread over the quarter or were they more skewed toward either the early or latter part of the quarter," Lowitt replied that the sales "were spread over the whole quarter."[3267] Lehman's use of Repo 105 transactions, however, spiked at quarter-end, including the end of the second quarter 2008. For example, the total amount of assets involved in Repo 105 transactions on April 30, 2008 was $24.74 billion, but increased to $50.38 billion on May 30, 2008, at Lehman's quarter-end.[3268]

(a) Analysts' Statements Regarding Lehman's Leverage

In addition to documents demonstrating that Lehman, internally, continued to focus in 2008 on reducing its firm-wide leverage, analysts and the market similarly

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[3266] Final Transcript of Lehman Brothers Holdings Inc. Second Quarter 2008 Earnings Call (June 16, 2008), at p. 10 [LBHI_SEC07940_1139550].

[3267] *Id.* at p. 14.

[3268] Lehman, Total Repo 105 & Repo 108 Report (June 11, 2008), at p. 1 [LBEX-DOCID 2078195] (attached to e-mail from Kristie Wong, Lehman, to Martin Kelly, Lehman (June 11, 2008) [LBEX-DOCID 2325872]. (May 31, 2008, Lehman's quarter-end, was a Saturday).

continued their focus on the firm's leverage. A few illustrative examples of analyst comments follow:

- "The modest silver lining is that LEH was able to reduce gross assets by $130 billion, including large reductions in mortgage related (15%-20%) and leveraged loan (35%) exposures."[3269]
- "Leverage is down a lot (and even more post capital raise) . . . illiquid positions are down 15%-20% . . . ."[3270]
- "While LEH reduced gross leverage from 32x to 25x, increased their liquidity pool from $34B to $45B, and drove reductions across most troubled asset classes (and reduced total assets by $130B or 17%), we await more details on total remaining troubled assets in aggregate as well as a L-III or illiquid asset update to help answer the question of whether $6B in incremental capital raise is sufficient."[3271]
- "[T]he firm aggressively de-leveraged in the quarter as total balance sheet assets declined by $130 bn and net assets declined by about $60 bn, bringing gross leverage to 25.0x from 31.7x and net leverage to 12.5x from 15.4x. This broad based selling likely exacerbated the write-downs the firm took this quarter. As part of its de-leveraging, Lehman reduced RMBS and CMBS exposure by 15-20%, leveraged loans by 35% and high yield by 20%. While Lehman is clearly not out of the woods just yet, we believe today's announced capital raise will reduce investors' fears and help promote a better liquidation of assets should LEH want to continue to reduce its leverage."[3272]

[3269] Sandler O'Neill & Partners Report, Lehman Brothers Holdings Inc. (June 9, 2008), at p. 1 [LBEX-DOCID 015863] (attached to e-mail from Roopali Hall, Lehman, to Lehman Brothers Executive Committee Members, Lehman (June 9, 2008) [LBEX-DOCID 15861]).

[3270] UBS Investment Research, First Read: Lehman Brothers (June 9, 2008), at p. 1 [LBEX-DOCID 015863] (attached to e-mail from Roopali Hall, Lehman, to Lehman Brothers Executive Committee Members, Lehman, *et al.* (June 9, 2008) [LBEX-DOCID 15861]).

[3271] Bank of America Equity Research Report, Lehman Brothers Holdings Inc. (June 9, 2008), at p. 1 [LBEX-DOCID 015863] (attached to e-mail from Roopali Hall, Lehman, to Lehman Brothers Executive Committee Members, Lehman, *et al.* (June 9, 2008) [LBEX-DOCID 15861]).

[3272] Goldman Sachs Report, Lehman Brothers Holdings Inc. (June 9, 2008), at p. 1 [LBEX-DOCID 015863] (attached to e-mail from Roopali Hall, Lehman, to Lehman Brothers Executive Committee Members, Lehman, *et al.* (June 9, 2008) [LBEX-DOCID 15861])

- "Despite the negative results this quarter, there were some positive takeaways: Balance sheet and leverage reduced . . . . Riskier assets cut . . . ."[3273]

- "Overall, we believe the company's moves to de-leverage the balance sheet are positive factors from a ratings perspective."[3274]

- "LEH reduced its balance sheet by $130bn (or 17%) and reduced net assets by $60bn. Even despite the large loss, this drove net leverage down to 12.5x and gross leverage below 25x. After the announced capital raise of $4bn in common equity and $2bn in mandatory convertible preferred, we expect gross leverage on a pro forma basis to fall to close to 20x and net leverage to fall to 10x – by far the lowest in the industry (25% – 35% lower than peers) . . . . [M]anagement noted that much of the sell down was focused on the riskier and less liquid assets, rather than the high grade and more liquid securities."[3275]

- "Lehman is the most levered large investment bank to the fixed income market, and hence a more challenging fixed income market (with higher long-term interest rates, lower volatility and wider credit spreads) could hurt them the most . . . . While Lehman reduced gross leverage from 32x to 25x, increased their liquidity pool from $34B to $45B, & drove reductions across most troubled asset classes (& reduced total assets by $130B, or 17%), we await more details on total remaining troubled assets in aggregate as well as a L-III or illiquid asset update to help answer the question of whether $6B in incremental capital raise is sufficient."[3276]

- "The company's gross leverage ratio improved to 24.3x (vs. 31.7x in 1Q08) and its net leverage ratio decreased to 12.0x, down from 15.4x in the prior

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[3273] Buckingham Research Report, Lehman Brothers Holdings Inc. (June 9, 2008), at p. 2 [LBEX-DOCID 245428] (attached to e-mail from Roopali Hall, Lehman, to Lehman Brothers Executive Committee Members, Lehman, *et al.* (June 9, 2008) [LBEX-DOCID 244039]).

[3274] CreditSights Report, Lehman Brothers Holdings Inc. (June 9, 2008), at p. 4 [LBEX-DOCID 245428] (attached to e-mail from Roopali Hall, Lehman, to Lehman Brothers Executive Committee Members, Lehman, *et al.* (June 9, 2008) [LBEX-DOCID 244039]).

[3275] Buckingham Research Report, Lehman Brothers Holdings Inc. (June 9, 2008), at p. 2 [LBEX-DOCID 245428] (attached to e-mail from Roopali Hall, Lehman, to Lehman Brothers Executive Committee Members, Lehman, *et al.* (June 9, 2008) [LBEX-DOCID 244039]).

[3276] Bank of America Equity Research Report, Lehman Brothers Holdings Inc. (June 9, 2008), at pp. 1, 3 [LBEX-DOCID 245428] (attached to e-mail from Roopali Hall, Lehman, to Lehman Brothers Executive Committee Members, Lehman, *et al.* (June 9, 2008) [LBEX-DOCID 244039]).

quarter. The improvement in the leverage ratios were driven by lower asset levels, partially offset by a drop in equity as the firm delevered its balance sheet. Lehman noted that it had finished the balance sheet de-leveraging it wanted to achieve, but it had not achieved the balance sheet mix that it wanted. So, we sense the company will continue to opportunistically dispose of mortgage-related exposures and leveraged lending."[3277]

f) The Purpose of Lehman's Repo 105 Program Was to Reverse Engineer Publicly Reported Financial Results

When senior management gave balance sheet targets to business divisions within Lehman, the orders were given so that the firm could manage its business towards a target net leverage ratio with an eye toward rating agencies and the firm's public disclosures.[3278] Lehman used SFAS 140's true sale accounting treatment for Repo 105 transactions and Repo 105 cash borrowings to make its balance sheet appear stronger than it actually was. In order for this off-balance sheet device to benefit Lehman, the firm had to conceal information regarding its Repo 105 practice from the public.

(1) Lehman Did Not Disclose Its Accounting Treatment For or Use of Repo 105 Transactions in Its Forms 10-K and 10-Q

Lehman reported a lower net leverage ratio in its publicly filed financial statements without revealing that it employed Repo 105 transactions to manage its net leverage ratio. Several Lehman witnesses with financial reporting responsibilities

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[3277] CreditSights Report, Lehman Brothers Holdings Inc. (June 16, 2008), at p. 2 [LBEX-DOCID 015911].

[3278] Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 5 (stating that Lehman as a firm managed its entire business towards a target net leverage ratio); Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 10 (stating that businesses within Lehman managed their respective businesses toward balance sheet targets).

confirmed the Examiner's conclusion that Lehman did not disclose its accounting treatment or use of Repo 105 transactions in its Forms 10-K and 10-Q.[3279]

Ed Grieb, former Lehman Financial Controller who prepared Lehman's Form 10-Q and Form 10-K statements, recalled that Lehman did not disclose its use of Repo 105 transactions or the accounting treatment they received.[3280] Marie Stewart, former Global Head of Accounting Policy, also said that Lehman made no disclosures relating to its Repo 105 program.[3281]

Lehman's increasing reliance on Repo 105 transactions and the absence of any disclosure of that fact in Lehman's Forms 10-Q and 10-K disquieted Martin Kelly (whose department was responsible for the preparation of Lehman's periodic reports).[3282] Kelly, Grieb's successor, told the Examiner that if an analyst or a member of the investing public were to read Lehman's Forms 10-Q and 10-K from cover to cover, taking as much time as she or he needed, "they would have no transparency into [Lehman's] Repo 105 program."[3283]

Similarly, Matthew Lee, who reported to Kelly, recalled that Lehman did not disclose its Repo 105 practice in its publicly filed statements. "If you don't say anything, is that disclosure? [Lehman] was telling the public they reduced the balance

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[3279] A detailed analysis of Lehman's Form 10-K and 10-Q misstatements and omissions appears in Section III.A.4.j.2.c.ii of this Report.
[3280] Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 14.
[3281] Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 15.
[3282] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 9.
[3283] *Id.*

sheet, but not telling them they were doing so by unartful means."[3284] Lee recalled that Lehman "had way more leverage than people thought; it was just out of [the public's] sight."[3285]

(a) Lehman's Outside Disclosure Counsel Was Unaware of Lehman's Repo 105 Program

Simpson Thacher & Bartlett served as Lehman's disclosure counsel in connection with Lehman's preparation and filing of its Forms 10-Q and 10-K statements during the time periods relevant to the Examiner's investigation. Andrew Keller, a Simpson Thacher partner involved in the preparation of Lehman's publicly filed financial statements, was not aware of Lehman's use of Repo 105 transactions, either by name or description. Nor was Keller aware of the impact Lehman's use of Repo 105 transactions had on Lehman's reported net leverage.[3286]

In his role as Lehman's disclosure counsel, Keller "always assumed that repos were treated as secured financings" because that was the "general rule" and was Lehman's stated policy in the notes to its financial statements.[3287]

Though he never had such a discussion with Lehman personnel regarding Repo 105, Keller advised the Examiner that if he had needed to discuss an off-balance sheet

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[3284] Examiner's Interview of Matthew Lee, July 1, 2009, at p. 16.

[3285] *Id.*

[3286] Examiner's Interview of Andrew Keller, Nov. 20, 2009, at p. 3. Keller explained that he generally spoke directly to Lehman's in-house counsel and Ryan Traversari, Senior Vice President of External Reporting, who reported to Lehman's Global Financial Controller. *Id.*

[3287] *Id.*; *cf.* Section III.A.4.j.2.c of this Report, discussing Lehman's actual Form 10-K and 10-Q disclosures regarding its repo transactions, including its statement that it treated repo transactions as financing transactions for reporting purposes.

item with Lehman as a general matter, he would have likely spoken to Ryan Traversari, Lehman's Senior Vice President of External Reporting, who reported to the Financial Controller.[3288] Traversari, whom Keller relied upon, knew about but did not disclose Lehman's Repo 105 practice in his discussions with Keller.[3289] In an interview with the Examiner, Traversari said he was familiar with Lehman's use of Repo 105 transactions and recalled that Lehman undertook these transactions on the basis of an opinion letter that a Lehman United Kingdom subsidiary had acquired.[3290] Traversari understood that Repo 105 transactions effectively reduced Lehman's net balance sheet and he did not recall any business purpose to the transactions.[3291]

(2) Lehman's Repo 105 Practice Improved the Firm's Public Balance Sheet Profile at Quarter-End

Kaushik Amin, the former head of the Liquid Markets group within Lehman's FID (a large user of Repo 105 transactions), pressured those who reported to him to meet the balance sheet targets that senior management imposed on Amin.[3292] Amin

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[3288] Examiner's Interview of Andrew Keller, Nov. 20, 2009, at p. 3.

[3289] *Id.* (stating that Ryan Traversari would have been the Lehman employee to inform him of off-balance sheet arrangements and that Keller was never informed of Repo 105 transactions or their accounting treatment); Examiner's Interview of Ryan Traversari, Sept. 24, 2009, at pp. 4-5 (stating that he was aware of Lehman's Repo 105 program and the impact of these transactions on Lehman's balance sheet).

[3290] Examiner's Interview of Ryan Traversari, Sept. 24, 2009, at pp. 4-5.

[3291] *Id.*

[3292] *See, e.g.*, E-mail from Gary Lynn, Lehman, to Kaushik Amin, Lehman (Aug. 22, 2006) [LBEX-DOCID 2786867] (informing Amin, nine days before quarter-end, that he may use $20 billion, rather than $17.5 billion, of Repo 105 transactions in order to meet balance sheet target, but that with the additional $2.5 billion of Repo 105, he is still $7.9 billion over his net balance sheet target); e-mail from Kaushik Amin, Lehman, to Thomas Siegmund, Lehman (Aug. 23, 2006) [LBEX-DOCID 2786869] ("We have additional $2.5 Bln in Repo 105 that the firm has signed off on . . . . So, let's max out the capacity. We should be able to use some of the collateral from the Agency business in the US."); e-mail from Gary Lynn, Lehman, to

explained that the quarter-end rush to meet balance sheet targets put discipline on traders to liquidate securities inventory as quickly as possible.[3293] Indeed, the investigation and review of internal Lehman documents revealed that Amin often sent forceful balance sheet target e-mails to those who reported to him, or on behalf of his peers, often at or near the close of the quarter.[3294]

Lehman management cared more about meeting quarter-end balance sheet targets, as opposed to monthly balance sheet targets, because Lehman's quarter-end balance sheet figures were published in the firm's quarterly financial reports and 10-Q

Sharan Mirchandani, Lehman, *et al.* (Feb. 21, 2007) [LBEX-DOCID 1431154] (writing one week before quarter-end, "[W]e are significantly over the Q1 balance sheet limits for IRP and LMP with one week to go, and Kaushik has delivered that message to the business heads that we need to come down further as there is no room for us to be over our limits"); e-mail from Clement Bernard, Lehman, to Kaushik Amin, Lehman (Feb. 25, 2008) [LBEX-DOCID 1849835] (Bernard: "To follow up on our conversation on Friday on the net balance sheet for Q1. We are currently running at 15.0 bn above and we need to go down an extra $5.0 bn for the firm to meet its net leverage limit of 15.2." Amin: "The entire team is focused on this and I am pushing everybody pretty hard. We should make the target."); e-mail from Kaushik Amin, Lehman, to Martin Kelly, Lehman (Apr. 17, 2008) [LBEX-DOCID 3223698] (following FID Asia's attempt to apply the Repo 105 mechanism to Australian securities, which Marie Stewart in Lehman's Accounting Policy forbade, Amin implored Kelly: "This is important for us. Would appreciate your help here").

[3293] Examiner's Interview of Kaushik Amin, Sept. 17, 2009, at pp. 5-6.

[3294] E-mail from Gary Lynn, Lehman, to Sharan Mirchandani, Lehman, *et al.* (Feb. 21, 2007) [LBEX-DOCID 1431154] ("As you are aware we are significantly over the Q1 balance sheet limits…with one week to go, and Kaushik has delivered that message to the business heads that we need to come down further as there is no room for us to be over our limits."); e-mail from Kaushik Amin, Lehman, to Kieran Higgins, Lehman (Feb. 28. 2008) [LBEX-DOCID 3234351] ("We have a desperate situation and I need another 2 billion from you, either through Repo 105 or outright sales. Cost is irrelevant, we need to do it."); e-mail from Kaushik Amin, Lehman, to Borut Miklavcic, Lehman (May 13, 2008) [LBEX-DOCID 2103909] ("[M]y target for Global Rates is only $75 Billion. There is no way I can hit my global target with you anywhere close to your current number."); e-mail from Kaushik Amin, Lehman, to Thomas Siegmund, Lehman (May 21, 2008) [LBEX-DOCID 756545] ("Do as much as you can in Repo 105. Can you find Repo 105 capacity among Japanese counterparties to take US Agencies?"); e-mail from Kaushik Amin, Lehman, to Kieran Higgins, Lehman (May 21, 2008) [LBEX-DOCID 3234382] ("Let's max out on the Repo 105 for your stuff and see where we end up.").

statements.[3295] As one e-mail put it, "The recent increase in [Repo] 105 business was urgently transacted to improve the Firm's balance sheet profile over . . . quarter-end."[3296] In another e-mail discussing Repo 105 usage at quarter-end, Michael McGarvey wrote: "We only focus on meeting our quarter end balance sheet targets. The intra month targets historically haven't been actively managed."[3297] Later in the same e-mail, McGarvey continued: "Being the non-quarter month end balance sheets aren't

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[3295] Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 5.

[3296] *See* e-mail from Stephen Allery, Lehman, to Miyuki Suzuki, Lehman (Aug. 31, 2007) [LBEX-DOCID 98492]. This e-mail chain regarding Allery's ongoing attempt to get increased capacity to undertake Repo 105 transactions with Mizuho contains interesting dialogue that provides transparency into the levels to which Lehman personnel went to utilize Repo 105 transactions for balance sheet relief during the late 2007-early 2008 time period. In November 2007, Allery implored Suzuki, "Given the very sensitive business environment faced by Lehman at present and ***our on-going desire to manage balance sheet to bolster our image*** and financial strength objectives, I am rather disappointed that Credit is imposing this rigid approach [*i.e.*, a limit to Repo 105 capacity]. Is there any latitude ***to trade at higher levels across key reporting dates*** such as Nov 30th?" E-mail from Stephen Allery, Lehman, to Miyuki Suzuki, Lehman (Nov. 8, 2007) [LBEX-DOCID 98492] (emphasis added). November 30 was the end of Lehman's fiscal year. Allery continued to press for Repo 105 capacity with Mizuho. On February 19, 2008, he wrote, "Quarter-end is approaching and we would like to maximize balance sheet efficiency via Mizuho." E-mail from Stephen Allery, Lehman, to Miyuki Suzuki, Lehman (Feb. 19, 2008) [LBEX-DOCID 98492]. The next day, he wrote again to Suzuki, "Sorry to chase, but we are being asked about our capacity to help FID reduce B/S at qtr-end." E-mail from Stephen Allery, Lehman, to Miyuki Suzuki, Lehman (Feb. 20, 2008) [LBEX-DOCID 98492]. Suzuki replied, "Could you advise how much you need for the balance sheet relief for the quarter end?" E-mail from Miyuki Suzuki, Lehman, to Stephen Allery, Lehman (Feb. 21, 2008) [LBEX-DOCID 98492]. On February 28, 2008, one day before the close of the quarter, Lehman's credit line for Repo 105 transactions with Mizuho was finally doubled to $5 billion. E-mail from Miyuki Suzuki, Lehman, to Stephen Allery, Lehman (Feb. 28, 2008) [LBEX-DOCID 98492]; *see also* Lehman Brothers, Credit Risk Management, Credit Review, Mizuho Financial Group, Inc. (Nov. 27, 2007) [LBEX-DOCID 2513180] (containing review and proposal for Repo 105 line increase with Mizuho, stating that "limit increase is to accommodate . . . increasing business requests for repo 105 activities at LBIE for our balance sheet relief, especially toward our fiscal year end" and attached to e-mail from Fumiyoshi Ooka, Lehman, to Patrick McGarry, Lehman (Nov. 27, 2007) [LBEX-DOCID 2552287]).

[3297] E-mail from Michael McGarvey, Lehman, to Dominic Gibb, Lehman, *et al.* (Dec. 20, 2007) [LBEX-DOCID 3223846].

published in the financials we don't focus on them. We don't want traders spending money to come down in balance sheet unless it's really necessary."[3298]

(a) Contemporaneous Documents Confirm That Lehman Undertook Repo 105 Transactions to Reduce Its Balance Sheet and Reverse Engineer Its Leverage

Lehman's Repo 105 practice engendered a certain level of cynicism within the firm.[3299] Notably, in response to an e-mail stating "[n]ot sure you are familiar with Repo 105 but it is used to reduce net balance sheet in our governments businesses around the

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[3298] E-mail from Michael McGarvey, Lehman, to Dominic Gibb, Lehman (Dec. 20, 2007) [LBEX-DOCID 3223846]. Dominic Gibb, a Lehman Managing Director based in London, became "nervous" about McGarvey's statements regarding quarter-end focus, writing: "We historically haven't liked to see massive swings in our utilisation of repo 105 just at quarter end." E-mail from Dominic Gibb, Lehman, to Michael McGarvey, Lehman (Dec. 20, 2007) [LBEX-DOCID 3223846]. This sentiment was echoed by Gerard Reilly, who replied to a request by Clement Bernard for expanded capacity for Repo 105 transactions to reduce the firm's balance sheet as follows: "If we fund our positions in this manner all the time then we can do it. Can't just be at quarter end." E-mail from Gerard Reilly, Lehman, to Clement Bernard, Lehman (Jan. 29, 2008) [LBEX-DOCID 2796630]. *See* Section III.A.4.f.3 (discussing continual use and 120% rules).

[3299] One e-mail appears to reflect a certain level of nervousness by one Lehman employee with respect to how counterparties would react to the "truth" about Repo 105 transactions. In the e-mail, LBIE's Jawad wrote to Higgins about his "quest for more counterparties for 105." *See* e-mail from Anthony Jawad, Lehman, to Kieran Higgins, Lehman (May 22, 2008) [LBEX-DOCID 3234386]. Jawad reported that the Reserve Bank of Australia asked Lehman why Lehman wanted to engage in Repo 105 transactions. *Id.* Jawad then stated, "I spoke to Mark Cosaitis about this and he obviously would like us to give a vague reason about getting better net down treatment, which isn't a lie. However, if they want a deeper explanation then we may have to get down to the nitty gritty of the truth. Do you want us to go down this line or want us to just give it a miss . . . . [T]he more people that know the truth, the more dodgy it can be." *Id.* Assi wrote back, "For the record the truth is that what we are doing is perfectly legal." *Id.* Amin replied, "My view is the same as Georges'. Accounting rules are very clear around Repo 105 . . . ." *Id.* The statement by Jawad about "better net down treatment" refers to Lehman's terminology for the reduction of net assets by means of Repo 105. *See* Duff & Phelps, Explanation of Repo 105 Accounting Ledger Entries and Trading System Output (Jan. 5, 2010), at pp. 3-4 (stating that "net down was the method of removal of the security from Lehman's consolidated balance sheet, *i.e.*, the amount by which the securities inventory would be reduced (sold) in a Repo 105 transaction pursuant to Lehman's Accounting Policy"). Though Assi referred to the legality of repo transactions, the issue from the Examiner's perspective is whether proper disclosure has been made by Lehman in its securities filings and other public statements.

world," Bart McDade, Lehman's former President and Chief Operating Officer, replied: "I am very aware . . . it is another drug we r on."[3300]

Numerous internal Lehman e-mails referred to Repo 105 transactions in pejorative terms, such as "balance sheet window-dressing." An illustrative example is found in the following July 2008 e-mail exchange:

> Vallecillo: "So what's up with repo 105? Why are we doing less next quarter end?"[3301]
>
> McGarvey: *"It's basically window-dressing. We are calling repos true sales based on legal technicalities*. The exec committee wanted the number cut in half."[3302]
>
> Vallecillo: "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?[3303]
>
> McGarvey: "Yes, No and yes. :)"[3304]

[3300] E-mail from Herbert H. (Bart) McDade III, Lehman, to Hyung Lee, Lehman (Apr. 3, 2008) [LBEX-DOCID 1570783]. During his first interview with the Examiner, McDade attempted to explain his "drug" comment as simply the thought that Repo 105 might be an easier way of managing the balance sheet than a more disciplined approach. Examiner's Interview of Herbert H. "Bart" McDade III, Sept. 16, 2009, at p. 4. In a related e-mail, McDade continued with his drug analogy. In response to an e-mail stating that a Repo 105 counterparty's refusal to roll Lehman's Repo 105 transactions would lead to an increase in Lehman's quarter-end net balance sheet unless Lehman could find an additional Repo 105 counterparty, McDade stated that this was "exactly why the drug is a problem." E-mail from Herbert H. (Bart) McDade III, Lehman, to Andrew J. Morton, Lehman (Apr. 3, 2008) [LBEX-DOCID 2984871].

[3301] E-mail from Jormen Vallecillo, Lehman, to Michael McGarvey, Lehman (July 2, 2008) [LBEX-DOCID 3379145].

[3302] E-mail from Michael McGarvey, Lehman, to Jormen Vallecillo, Lehman (July 2, 2008) [LBEX-DOCID 3379145] (emphasis added).

[3303] E-mail from Jormen Vallecillo, Lehman, to Michael McGarvey, Lehman (July 2, 2008) [LBEX-DOCID 3379145].

[3304] E-mail from Michael McGarvey, Lehman, to Jormen Vallecillo, Lehman (July 2, 2008) [LBEX-DOCID 3379145].

Numerous other internal Lehman e-mails confirm that Lehman's true purpose for undertaking Repo 105 transactions at quarter-end was balance sheet and leverage manipulation. By way of example only:

- In reference to the Agencies business's use of Repo 105 transactions: "As we approach quarter end, we start to raise the balances so that we 'reserve' size with our counterparties the week we really need it (over quarter end). At this fiscal year end we took the amounts up as high as we could, as we knew there would be intense balance sheet pressure."[3305]

- "[T]he firm has a function called repo 105 whereby you can repo a position for a week and it is regarded as a true sale to get rid of net balance sheet."[3306]

- "We have been using Repo 105 in the past to reduce balance sheet at quarter-end. . . ."[3307]

- When Lehman's repo trading desk in London informed personnel in Lehman's New York Fixed Income Division that certain Repo 105 counterparties were no longer interested in participating in Repo 105 transactions, Kentaro Umezaki wrote to Clement Bernard and Gerard Reilly, copying Kaushik Amin and Andrew Morton, stating "Looks like we may need to rethink how much of [Repo 105] we can rely on for balance sheet relief. Could someone in Finance coordinate how much of this we should expect to have available for balance sheet relief at month/quarter end going forward?"[3308]

[3305] E-mail from Mitchell King, Lehman, to Mark Gavin, Lehman, *et al.* (Dec. 3, 2007) [LBEX-DOCID 3232555].

[3306] E-mail from Anthony Jawad, Lehman, to Andrea Lenardelli, Lehman (Mar. 3, 2008) [LBEX-DOCID 235036].

[3307] E-mail from Raymond Chan, Lehman, to Paul Mitrokostas, Lehman (July 15, 2008) [LBEX-DOCID 3384937].

[3308] E-mail from Kentaro Umezaki, Lehman, to Clement Bernard, Lehman, *et al.* (Sept. 4, 2007) [LBEX-DOCID 3232534]. Numerous other documents support the conclusion that Lehman's Repo 105 program was a mechanism for managing the balance sheet at quarter-end. *See*, *e.g.*, e-mail from Anuraj Bismal, Lehman, to Marie Stewart, Lehman, *et al.* (Jan. 29, 2008) [LBHI-SEC07940_861461] (consisting of e-mail chain discussion regarding balance sheet projections and rise in net leverage in which Michael McGarvey states that additional Repo 105 will clean up the balance sheet and Anuraj Bismal calls Repo 105/108 "an important feature."); e-mail from Sigrid Stabenow, Lehman, to Gerard Reilly, Lehman, *et al.* (Jan. 30, 2008) [LBEX-DOCID 4292184] (reporting to Reilly and Clement Bernard regarding "the gap to quarter end

- Bernard wrote to Amin and Higgins on February 28, 2008, regarding FID's net balance sheet overage; in particular, Bernard indicated that FID's Rates business was $4.5 billion over target.[3309] Bernard warned: "This will drive Lehman net leverage ratio above target. Please let me know what we can do to minimize this impact . . . . I know it is late in the process but what ever we can do would help our ratio."[3310] Later that day, Bernard forwarded that message to Martin Potts, adding the message: "We are looking at selling what ever we can and also doing some more repo 105."[3311]

- After successfully lobbying for additional Repo 105 capacity at quarter-end, Jeff Michaels wrote to Amin: "The good news is . . . as soon as lehman gives the green light, we can reduce the net/gross by another 2.5–3 bn."[3312]

Indeed, Repo 105 transactions became such a deeply ingrained feature of balance sheet management that balance sheet targets and Repo 105 often were discussed together, as when Michaels e-mailed Amin "a spreadsheet Tejal [Joshi] helped me put together with my suggested allocations for the global balance sheet/repo 105 for this quarter."[3313] When Michaels explained in an e-mail that he was working on balance

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target" and stating that "FID is forecasting to be $15 bn over quarter end limit" and FID leaders made a "[r]ecommendation that Repo 105 program is expanded."); e-mail from Jerry Rizzieri, Lehman, to Kieran Higgins, Lehman, *et al.* (Apr. 22, 2008) [LBEX-DOCID 756532] (following the announcement of "new balance sheet targets for quarter end," Rizzieri wrote: "We will need to be focused very early in the process in order to meet these targets," that there is "no room for error this quarter" and that accordingly "we also need to have a coordinated approach to repo 105 allocation").

[3309] E-mail from Clement Bernard, Lehman, to Kaushik Amin, Lehman, *et al.* (Feb. 28, 2008) [LBEX-DOCID 1854189].

[3310] *Id.*

[3311] E-mail from Clement Bernard, Lehman, to Martin Potts, Lehman (Feb. 28, 2008) [LBEX-DOCID 1854189].

[3312] E-mail from Jeff Michaels, Lehman, to Kaushik Amin, Lehman (May 21, 2008) [LBEX-DOCID 736186].

[3313] E-mail from Jeff Michaels, Lehman, to Kaushik Amin, Lehman, *et al.* (July 31, 2008) [LBEX-DOCID 756327] (transmitting attached spreadsheet of balance sheet targets and Repo 105 allocations [LBEX-DOCID 633334]).

sheet allocations, he wrote: "It is really a bottom-up process about who has sticky inventory. Obviously in the US it is Agencies, and in London it is Inflation."[3314]

Lehman's internal balance sheets tracked the firm's Repo 105 usage and its resulting benefit to the firm-wide balance sheet.[3315] These balance sheets were used by

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[3314] E-mail from Jeff Michaels, Lehman, to Kaushik Amin, Lehman (July 30, 2008) [LBEX-DOCID 613324]. Because Michaels worked for the Liquid Markets division, "sticky" in this context does ***not*** refer to actually illiquid assets, but rather, is used relative to the most liquid inventory. Sticky agencies, for example, would likely refer to "off-the-run" securities – all government and treasury securities issued before the most recently issued security of a particular maturity is "off the run." "Off the run" securities are less frequently traded and are therefore "illiquid" compared to the most recently issued security.

[3315] *See*, *e.g.*, Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary [Draft] (Aug. 31, 2007) [LBEX-DOCID 3215510] (stating Repo 105 usage on Aug. 31, 2007 was $36.627 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary [Draft] (Sept. 28, 2007) [LBEX-DOCID 2705059] (stating Repo 105 usage on Sept. 28, 2007 was $24.406 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary [Draft] (Oct. 31, 2007) [LBEX-DOCID 2705943] (stating Repo 105 usage on Oct. 31, 2007 was $29.623 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Nov. 30, 2007) [LBEX-DOCID 3439086] (stating Repo 105 usage on Nov. 30, 2007 (quarter-end) was $38.634 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Jan. 29, 2008) [LBEX-DOCID 3363236] (stating Repo 105 usage on Jan. 29, 2008 was $28.883 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Feb. 13, 2008) [LBEX-DOCID 1697794] (stating Repo 105 usage on Feb. 13, 2008 was $23.602 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Feb. 22, 2008) [LBEX-DOCID 3363289] (stating Repo 105 usage on Feb. 22, 2008 was $31.029 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Feb. 29, 2008) [LBEX-DOCID 579841] (stating Repo 105 usage on Feb. 29, 2008 (quarter-end) was $49.102 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Mar. 13, 2008) [LBEX-DOCID 765323] (stating Repo 105 usage on Mar., 13, 2008 was $26.212 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Apr. 14, 2008) [LBEX-DOCID 766086] (stating Repo 105 usage on Apr. 14, 2008 was $19.546 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Apr. 21, 2008) [LBEX-DOCID 766088] (stating Repo 105 usage on Apr. 21, 2008 was $21.907 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Apr. 28, 2008) [LBEX-DOCID 766092] (stating Repo 105 usage on Apr. 28, 2008 was $24.077 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Draft) (Apr. 30, 2008) [LBEX-DOCID 394333] (stating Repo 105 usage on Apr. 30, 2008 was $24.709 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (May 6, 2008) [LBEX-DOCID 766102] (stating Repo 105 usage on May 6, 2008 was $24.388 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (May 13, 2008) [LBEX-DOCID 766107] (stating Repo 105 usage on May 13, 2008 was $25.282 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (May 28, 2008) [LBEX-DOCID 766924] (stating Repo 105 usage on May 28, 2008 was $43.112 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (May 29, 2008) (stating Repo 105 usage on May 29, 2008 was $46.820 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Aug. 14, 2008) [LBEX-DOCID 84891] (stating

management and were not reported externally.[3316] LBHI's Global Consolidated Balance Sheet, for example, showed securities inventory levels pre-Repo 105 usage and with Repo 105, and contained columns for "Repo 105/108 added back" as well as balance sheet targets.[3317] The Fixed Income Division's Global Rates business's balance sheet projections spreadsheets recorded the balance sheet target and projected net balance sheet, and populated with data individual columns for "actual pre-Repo 105," "Repo 105," "actual post-Repo 105," and "Repo 105 target."[3318] The Global Rates business's balance sheet management reports included side-by-side columns for gross balance sheet, net balance sheet, and Repo 105.[3319] Other balance sheet spreadsheets from the

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Repo 105 usage on Aug. 14, 2008 was $18.274 billion); *see also* e-mail from Mark Neller, Lehman, to Anthony Kush, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223384] ("Please be aware that all Repo 105 benefit taken to Management Balance Sheet at November month end needs to be replicated within respective entities DBS accounting.").

[3316] *See* e-mail from Jody Li, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Mar. 15, 2008) [LBEX-DOCID 117307] (transmitting to Lehman's Treasurer the Global Consolidated Balance Sheet [LBEX-DOCID 120158] showing Repo 105 balance on Mar. 13, 2008); e-mail from Gerard Reilly to Herbert H. (Bart) McDade III (Mar. 27, 2008) [LBEX-DOCID 560109] (transmitting Global Consolidated Balance Sheet for Feb. 29, 2008 (Mar. 27, 2008) [LBEX-DOCID 579841] and stating "Bart this is the firm bs"); e-mail from Atiba Rodriguez, Lehman, to Clement Bernard, Lehman, *et al.* (May 29, 2008) [LBEX-DOCID 3221577] (transmitting Global Consolidated Balance Sheet [LBEX-DOCID 3237577] to Chief Financial Officer for FID).

[3317] E-mail from Gerard Reilly to Herbert H. (Bart) McDade III (Mar. 27, 2008) [LBEX-DOCID 560109] (transmitting Global Consolidated Balance Sheet for Feb. 29, 2008 (Mar. 27, 2008) [LBEX-DOCID 579841] to President and COO and stating "Bart this is the firm bs").

[3318] Lehman, Global Rates Net Balance Sheet (Dec. 20, 2007) [LBEX-DOCID 3215591] (attached to e-mail from Mark Neller, Lehman, to Divyesh Chokshi, Lehman (Dec. 21, 2007) [LBEX-DOCID 3234333]).

[3319] Lehman, Global Rates Q3 Balance Sheet Management (Aug. 18, 2008) [LBEX-DOCID 637339] (attached to e-mail from Tejal Joshi, Lehman, to Kaushik Amin, Lehman, *et al.* (Aug. 19, 2008) [LBEX-DOCID 736504]); Lehman, Global Rates Q3 Balance Sheet Management (Aug. 19, 2008) [LBEX-DOCID 637341] (attached to e-mail from Tejal Joshi, Lehman, to Kaushik Amin, Lehman, *et al.* (Aug. 20, 2008) [LBEX-DOCID 736507]); Lehman, Global Rates Q3 Balance Sheet Management (Aug. 21, 2008) [LBEX-DOCID 637338] (attached to e-mail from Tejal Joshi, Lehman, to Kaushik Amin, Lehman, *et al.* (Aug. 22, 2008) [LBEX-DOCID 736506]).

Rates business tracked net balance sheet, "[a]dditional Repo 105," reduction of government inventory, and total balance sheet reduction by trading desk.[3320] Similarly, the Liquid Markets group within FID reported internal balance sheet projection figures for both gross and net balance sheet targets along with Repo 105.[3321]

Senior management exerted pressure, particularly at or near quarter-end, to utilize the Repo 105 mechanism to meet the firm-imposed balance sheet targets:

- Four days before the close of Lehman's fiscal year in November 2007, Mitch King wrote to Marc Silverberg: "Let me know if we have room for any more repo 105. I have some more I can put in over month end."[3322] Jerry Rizzieri, who reported directly to Kaushik Amin, replied to King: "Can you imagine what this would be like without 105?"[3323]

- On February 28, 2008, one day before the close of Lehman's first quarter 2008, Amin, then-Head of Liquid Markets, wrote to Kieran Higgins: "We have a desperate situation and I need another 2 billion from you, either through Repo 105 or outright sales. Cost is irrelevant, we need to do it."[3324]

- Also on February 28, 2008, Mark Gavin wrote to John Feraca: "Just took a call from FID mgmt - seems they're up on net b/s by 3 bln unanticipated & are a little excited w Q end. I am looking to do an additional repo 105 with Mizuho. . . ."[3325]

[3320] Lehman, Rates Americas Balance Sheet (Feb. 26, 2008) [LBEX-DOCID 3218412] (attached to e-mail from Michael McGarvey, Lehman, to Jerry Rizzieri, Lehman (Feb. 28, 2008) [3233807].

[3321] Lehman, Liquid Markets Balance Sheet (May 15, 2008) [LBEX-DOCID 3439007] (attached to e-mail from Michael McGarvey, Lehman, to Tal Litvin, Lehman (May 19, 2008) [LBEX-DOCID 3383917].

[3322] E-mail from Mitchell King, Lehman, to Marc Silverberg, Lehman (Nov. 26, 2007) [LBEX-DOCID 3232804].

[3323] E-mail from Jerry Rizzieri, Lehman, to Mitchell King, Lehman (Nov. 26, 2007) [LBEX-DOCID 3232804].

[3324] E-mail from Kaushik Amin, Lehman, to Kieran Higgins, Lehman (Feb. 28, 2008) [LBEX-DOCID 3234351].

[3325] E-mail from Mark Gavin, Lehman, to John Feraca, Lehman, *et al.* (Feb. 28, 2008) [LBEX-DOCID 98492].

- Higgins wrote to Jeff Michaels, on May 2, 2008: "In light of…the firms max ratio at q end to month avg [] we started to [Repo] 105 irp balance sheet several weeks ago for q end (this has a real cost though)."[3326]

- On May 21, 2008, Amin wrote to Higgins: "Let's max out on the Repo 105 for your stuff and see where end up."[3327] When Amin asked Higgins for an update on the balance sheet management, Higgins replied: "*[A]nything that moves is getting 105'd*."[3328]

- In an e-mail from McGarvey to Reilly written ten days before the close of Lehman's second quarter 2008, McGarvey wrote: "Kaushik [Amin] has just requested that they do as much Repo 105 as possible."[3329]

- In an e-mail to Thomas Siegmund, also ten days from the close of Lehman's second quarter, Amin wrote: "Do as much as you can in Repo 105. Can you find Repo 105 capacity among Japanese counterparties to take US Agencies?"[3330]

- As the close of Lehman's third quarter 2008 was approaching, Amin asked Andrew Morton, then-head of Lehman's Fixed Income Division, for additional Repo 105 authority in order to make balance sheet targets.[3331]

[3326] E-mail from Kieran Higgins, Lehman, to Jeff Michaels, Lehman (May 2, 2008) [LBEX-DOCID 601783].

[3327] E-mail from Kaushik Amin, Lehman, to Kieran Higgins, Lehman (May 21, 2008) [LBEX-DOCID 3234382].

[3328] E-mail from Kieran Higgins, Lehman, to Kaushik Amin, Lehman (May 21, 2008) [LBEX-DOCID 3234382] (emphasis added).

[3329] E-mail from Michael McGarvey, Lehman, to Gerard Reilly, Lehman, *et al.* (May 21, 2008) [LBEX-DOCID 3221744].

[3330] E-mail from Kaushik Amin, Lehman, to Thomas Siegmund, Lehman (May 21, 2008) [LBEX-DOCID 756545]; *see also* e-mail from Jeff Michaels, Lehman, to Kaushik Amin, Lehman (May 27, 2008) [LBEX-DOCID 723365] (responding to Amin's message "Important to get as much of the Agency inventory out as possible," by stating: "They continue to do so, and have repo 105'd everything they can. . . .").

[3331] *See* e-mail from Kaushik Amin, Lehman, to Andrew J. Morton, Lehman (Aug. 20, 2008) [LBEX-DOCID 3234406] (responding to Morton's question "Can you keep going on bal sheet[?]" by stating: "I am squeezing hard. But, the challenge is that liquidity is poor given the European holidays. Most of our tough balance sheet is inflation and Agencies, which is extremely illiquid. I think we should relax the Repo 105 constraints a bit. Instead of $20 Bln, we should take it up to say $25 Bln.").

(b) Witness Statements to the Examiner Regarding the True Purpose of Lehman's Repo 105 Practice

Virtually every witness the Examiner questioned regarding Lehman's Repo 105 practice, including some in the top echelon of Lehman's management, agreed that Lehman relied upon Repo 105 transactions to reduce its net balance sheet at quarter-end. Among the statements made during the investigation of the Repo 105 issue are:

- Paolo Tonucci, former Treasurer, recalled that near the end of reporting periods, Lehman would deploy Repo 105 transactions to reduce its balance sheet.[3332] He also acknowledged that Lehman's use of Repo 105 transactions impacted Lehman's net leverage ratio.[3333]

- Ian Lowitt, former Chief Financial Officer, recalled that Lehman established a "regime of limits," meaning balance sheet targets, for each business unit to manage to and that Repo 105 was one way to "sell down assets" to meet the targets.[3334]

- Ed Grieb, former Global Financial Controller, stated that Lehman's total assets were reduced by Repo 105 transactions because the securities inventory came off Lehman's books and, importantly, the cash that Lehman received in a Repo 105 transaction was used to pay down other liabilities or to pay for securities it repoed.[3335] Grieb made clear that Lehman would not have simply sat on the cash it received in Repo 105 transactions, which would have resulted in a net zero impact on Lehman's assets.[3336] Accordingly, Grieb agreed that one consequence of Lehman's Repo 105 transactions was a reduction in Lehman's net leverage ratio.[3337]

[3332] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 27.

[3333] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 26.

[3334] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 10.

[3335] Examiner's Interview of Edward Grieb, Oct. 2, 2009, at pp. 9, 11.

[3336] *Id*.

[3337] *Id.* at p. 11.

- Martin Kelly, former Global Financial Controller, said that "the only purpose or motive for [Repo 105] transactions was reduction in the balance sheet" and that "*there was no substance to the transactions*."[3338]

- Clement Bernard, former Chief Financial Officer for FID, said that as the end of a quarter drew near, Lehman personnel relied upon Repo 105 transactions for "balance sheet relief" and to reach firm-imposed balance sheet targets.[3339]

- John Feraca, who ran the Secured Funding Desk in Lehman's Prime Services Group, stated: "Senior people felt urgency only in the sense of trying to get to their targets because the Finance Division wanted to report as healthy a balance sheet and leverage ratio as possible for investors, creditors, rating agencies and analysts."[3340] He added: "It was universally accepted throughout the entire institution that Repo 105 was used for balance sheet relief at quarter end."[3341]

- Kaushik Amin, former Head of Liquid Markets, said that Lehman reduced its net balance sheet at quarter-end by engaging in tens of billions of dollars of Repo 105 transactions and that a number of days after the opening of the new quarter, the Repo 105 inventory would return to Lehman's balance sheet.[3342]

- Matthew Lee, former Senior Vice President, Finance Division, in charge of Global Balance Sheet and Legal Entity Accounting, recalled that Lehman would "sell" assets through Repo 105 transactions approximately four or five days before the close of a quarter and then repurchase them approximately four or five days after the beginning of the next quarter in order to "reverse engineer" its net leverage ratio for its publicly filed financial statements.[3343]

[3338] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 7. *See* Sections III.A.4.g.1 and III.A.4.h.3.b–c of the Report for discussion of Kelly's discomfort with Repo 105 transactions; *see also* e-mail from Martin Kelly, Lehman, to Marie Stewart, Lehman (Feb. 14, 2008) [LBEX-DOCID 3223647] ("What is our current BS 'advantage' resulting from Repo 105/108 approx?"). When asked about this e-mail, Kelly told the Examiner that balance sheet "advantage" referred to a reduction of net balance sheet through Repo 105. Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 6.

[3339] Examiner's Interview of Clement Bernard, Oct. 23, 2009, at p. 7.

[3340] Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 9.

[3341] *Id.*

[3342] Examiner's Interview of Kaushik Amin, Sept. 17, 2009 at p. 6.

[3343] Examiner's Interview of Matthew Lee, July 1, 2009, at p. 13.

- Marie Stewart, the former Global Head of Lehman's Accounting Policy Group, described Repo 105 transactions as "a lazy way of managing the balance sheet as opposed to legitimately meeting balance sheet targets at quarter end."[3344]

- Anuraj Bismal, former Senior Vice President in Lehman's Balance Sheet group, agreed with other witness statements describing the firm's Repo 105 program in pejorative terms, such as "window-dressing" and a "drug."[3345] Bismal explained that although Lehman had acquired a legal opinion and developed an accounting policy justifying Repo 105 transactions, there remained "discomfort" within Lehman regarding the use of Repo 105 transactions for removing securities inventory from the balance sheet.[3346]

- Murtaza Bhallo, the former Business/Risk Manager for PTG Liquid Markets, said that Repo 105 was "an accounting gimmick."[3347]

- Mitch King was the former head of Lehman's United States Agencies trading desk who was required on a weekly basis to compile lists of collateral available for inclusion in Repo 105 transactions and send the lists to LBIE personnel.[3348] King stated that no business purpose existed for Repo 105 transactions other than to reduce Lehman's net balance sheet.[3349] King referred to Lehman's Repo 105 program as a "nuisance."[3350] Accordingly, he said, "[t]here was no reason for me to go out and Repo 105."[3351] King further stated that "[f]rom a trader's perspective, I would have rather never seen anything Repo 105-related. It was just another thing I had to do that was not a trade and that was not a part of my business. I would not go out and seek to Repo 105 [*i.e.*, if he wasn't required to by superiors]."[3352]

[3344] Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 7.

[3345] Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at pp. 7-8.

[3346] *Id.*

[3347] Examiner's Interview of Murtaza Bhallo, Sept. 14, 2009).

[3348] Examiner's Interview of Mitchell King, Sept. 21, 2009, at p. 6.

[3349] *Id.*

[3350] *Id.*

[3351] *Id.*

[3352] *Id.*

(3) Quarter-End Spikes in Lehman's Repo 105 Usage Also Suggest the True Purpose of Lehman's Repo 105 Practice Was Balance Sheet Manipulation

The documentary evidence and witness statements establish that Lehman employed Repo 105 transactions for quarter-end balance sheet reduction. This conclusion is further confirmed by the fact that that Lehman's use of Repo 105 transactions regularly spiked up at quarter-end.[3353]

Notably, this quarter-end spike in Repo 105 usage occurred notwithstanding evidence that certain Lehman personnel expressed concern about the concentration of transactions at quarter-end. For example, Martin Kelly, Lehman's Global Financial Controller from December 1, 2007 through September 2008, said that he had "discomfort" with the "skewing of Repo 105 transactions at quarter-end."[3354] Kelly further explained that he had expressed that concern about the quarter-end concentration to both CFOs to whom he reported, Erin Callan and Ian Lowitt.[3355]

To the extent senior Lehman personnel had "discomfort" regarding the quarter-end spikes in Repo 105 usage, or concern about the risk of growing dependant upon large volumes of Repo 105 transactions at quarter-end given that the FASB could potentially change SFAS 140, Chris O'Meara, Ed Grieb, and Gerard Reilly mandated a set of two related guidelines loosely known within Lehman as (1) the "80/20" or

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[3353] *See* Duff & Phelps, Repo 105/108 Usage vs. Limit Comment (Oct. 16, 2009), at pp. 7-9.

[3354] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 7.

[3355] *Id.* *See* Sections III.A.4.h.3.b–c of this Report (describing the conversations between Kelly and each Chief Financial Officer in detail).

"continual use rule" and (2) the "120% rule."[3356] Those guidelines provided, respectively, that (1) Repo 105 transactions outstanding at any time should be maintained at a level throughout an entire month that was approximately 80% of the amount at that month-end; and (2) the month or quarter-end spike in Repo 105 activity could not result in a balance that exceeded 120% of the daily average usage throughout that month.[3357]

[3356] Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 13. Paolo Tonucci, former Treasurer, attributed the setting of a cap on Repo 105 usage to concern regarding overdependence on Repo 105 transactions to manage balance sheet. Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 26.

[3357] *See* Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 2 [LBEX-WGM 748489] ("Repo 105 transactions must be executed on a continual basis and remain in force throughout the month. To meet this requirement, the amount outstanding at any time should be maintained at approximately 80% of the amount at month-end. [per Chris O'Meara and Ed Grieb."); e-mail from Michael McGarvey, Lehman, to Kentaro Umezaki, Lehman, *et al.* (Aug. 17, 2007) [LBEX-DOCID 1635769] ("The guide line for month end usage of repo 105 is that it should not exceed 120% of your daily average."). In another e-mail, McGarvey explained the rule to Clement Bernard (former FID CFO): "We have repo 105 funding benefit trades on constantly in the normal course of business because accounting policy stipulates it must be a regular way [to] fund our positions. We increase the balances for month end but try to keep it within 120 percent of the average daily usage (we are decent at this, not great)." *See* e-mail from Michael McGarvey, Lehman, to Clement Bernard, Lehman (Jan. 31, 2008) [LBEX-DOCID 2796633]. McGarvey was mistaken, however, that the "continual use rule" was part of Lehman's Repo 105 Accounting Policy, which does not mention the guideline. Grieb stated that the continual use rule was *not* an accounting-based rule. Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 13. *See also* E-mail from Clare Christofi, Lehman, to Joseph Gentile, Lehman, *et al.* (Dec. 1, 2006) [LBEX-DOCID 3234175] (forwarding earlier message stating "We have a provision for Repo 105/108 which is $24.6 bn…. The daily average for November is $18.1 bn giving $21.8 bn total that can be taken at 120%, so we are over by $2.9 bn."); e-mail from Anuraj Bismal, Lehman, to Clare Christofi, Lehman, *et al.* (May 8, 2007) [LBEX-DOCID 3234167] ("[I]t's more about consistent usage of Repo 105 and 108 - we should not have the deep troughs of usage that we used to have [in FID world]. The 80% rule that Clare talks about addresses that head on."); e-mail from Anuraj Bismal, Lehman, to Michael McGarvey, Lehman, *et al.* (May 9, 2007) [LBEX-DOCID 3223356] ("As the bs continues to grow- then maybe a higher limit would be supported by the 80% math."); e-mail from Divyesh Chokshi, Lehman, to Anuraj Bismal, Lehman, *et al.* (Aug. 14, 2007) [LBEX-DOCID 3234164] ("I thought that we had moved away from the Limit definitions as the desk needs to demonstrate a consistent application during the month of Repo [105] benefit taken."); e-mail from Divyesh Chokshi, Lehman, to Anuraj Bismal, Lehman, *et al.* (Aug. 14, 2007) [LBEX-DOCID 3234166] (disputing with Bismal whether Bismal knew that Lehman had moved away from limits and stating "we needed to ensure that there was a consistent application of Repo 105 Benefit. If hard limits have been set then let me know"; e-mail from Clare Christofi, Lehman, to Anuraj Bismal, Lehman, *et al.* (Aug. 14, 2007)

Grieb stated that the guidelines were "put in place to make sure the transactions had a legitimate business purpose."[3358] Grieb, O'Meara, and Reilly "put together" the guidelines because they "wanted to see there was a business purpose, that counterparties were doing this on an ongoing basis, and . . . that there were no spikes just at the end of the month or quarter-end."[3359]

Anuraj Bismal similarly recalled that Lehman management mandated Repo 105 usage throughout a quarter to demonstrate that Lehman's use of Repo 105 transactions was not solely window-dressing aimed at improving the firm's quarter-end financial number.[3360] Bismal stated that the so-called "80/20" rule was aimed at addressing firm-wide "discomfort" that no valid business reason existed for Repo 105 transactions.[3361] In Bismal's words, the continual use rule was for mitigating "the dips between the peaks."[3362]

[LBEX-DOCID 3234180] ("Ed [Grieb] and Gerry [Reilly] were interested in the 80/120% of av daily balance…."); Lehman, Global Repo 105/108 vs. 120% of Daily Average Graph (July 31 - Aug. 15, 2007) [LBEX-DOCID 3219672] (attached to e-mail from Michael McGarvey, Lehman, to Steven Becker, Lehman, *et al.* (Aug. 17, 2007) [LBEX-DOCID 3221344]); e-mail from Michael Anthony, Lehman, to Kieran Higgins, Lehman (Oct. 12, 2007) [LBEX-DOCID 738606] ("[I]t looks like the only limitation we have on size [for Repo 105] is the month end balance can't be more than 120% of our daily average throughout the month. More specifically for the index business, if all positions are term repo'd for at least one month than effectively there is no cap on size as our positions will be included as part of the daily average.").

[3358] Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 13.

[3359] *Id.*

[3360] Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 8. According to Bismal, in approximately 2005, then-Chief Financial Officer Chris O'Meara requested that John Feraca prepare a "business case justification" document. *Id.* Bismal believed that the document set forth the proposition that if Repo 105 transactions were a normal (*i.e.*, constant) source of funding for Lehman, a valid business reason existed to undertake the transactions. *Id.*

[3361] *Id.*

[3362] *Id.*

Lehman did not actually follow these self-imposed rules. That is not surprising, since no witness was able to explain a business rationale for the arbitrary 1x leverage, continual use, and 120% rules.[3363] If Repo 105 transactions made good business sense on their own, there would be no apparent reason to arbitrarily restrict the amount of such transactions to 1x leverage or to impose intra-month limits to ensure that the amount of the transactions at reporting periods did not spike to more than 120% of average usage. No reason, that is, except to keep the transactions under the radar, by limiting their total and the amount of a quarter-end spike.

These dips were nevertheless pronounced. For instance, the total amount of Repo 105 transactions at the end of first quarter (February) 2008 was approximately $49 billion, the intra-quarter dip as of April 30, 2008 was approximately $24.7 billion and the quarter-end amount for second quarter (May) 2008 was approximately $50.38 billion.[3364] Numerous balance sheet documents from Lehman's archives establish that Lehman's

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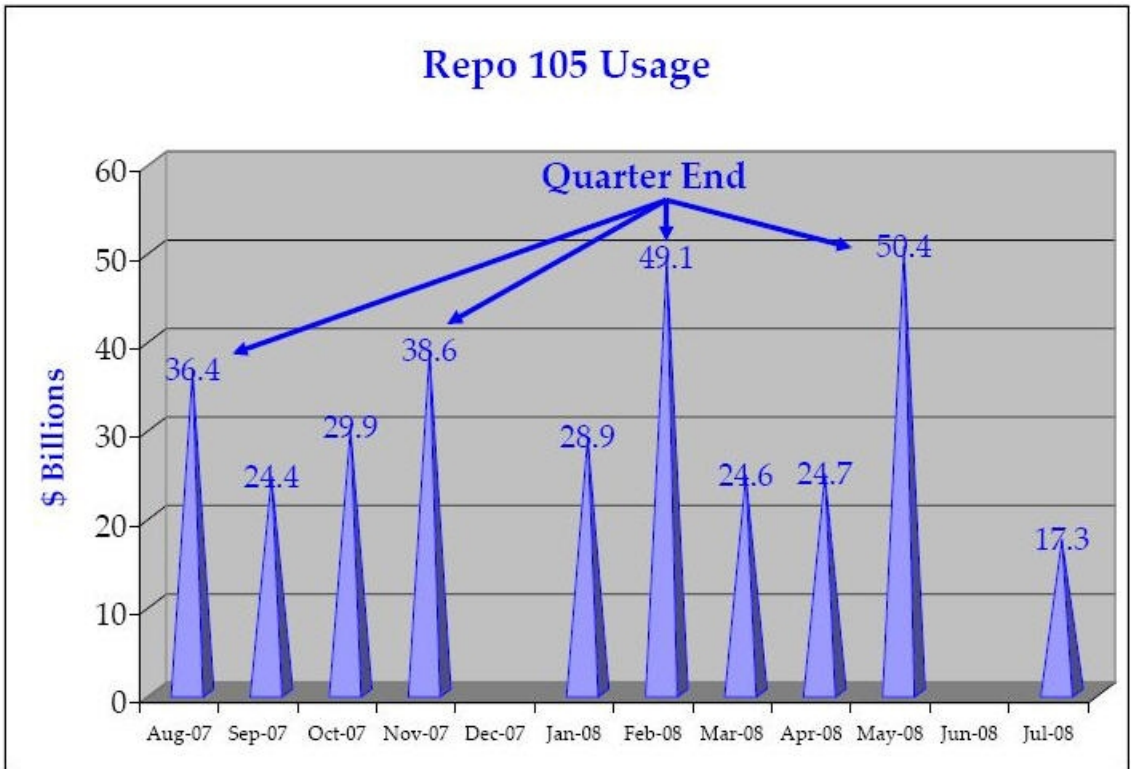
[3363] Note that Lehman's former Global Treasurer, Paolo Tonucci, cited two reasons why Lehman management set limits on Repo 105 usage: (1) if there were a change to SFAS 140, such that true sale treatment for repo transactions was no longer available, Lehman did not want to experience a seismic shift in its balance sheet; and (2) without limits, there was a risk that Lehman's businesses would become "too dependent on the amount of flexibility the Repo [105] arrangement provided." Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 27.

[3364] *See* Lehman, Total Repo 105 & Repo 105 Report (June 11, 2008) [LBEX-DOCID 2078195] (showing that total Repo 105 usage at close of first quarter 2008 was $49.1024 billion, April 30, 2008 total Repo 105 usage was $24.7439 billion, and total Repo 105 usage at close of second quarter 2008 was $50.3834).

intra-quarter use of Repo 105 transactions dipped significantly, as low as $12.75 billion.[3365]

[3365] *See*, *e.g.*, Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Aug. 31, 2007) [LBEX-DOCID 3237230] (stating Repo 105 usage on Aug. 31, 2007, a quarter-end, was $36.407 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary [Draft] (Sept. 28, 2007) [LBEX-DOCID 2705059] (stating Repo 105 usage on Sept. 28, 2007 was $24.406 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Draft) (Oct. 31, 2007) [LBEX-DOCID 2705943] (stating Repo 105 usage on Oct. 31, 2007 was $29.936 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Nov. 30, 2007) [LBEX-DOCID 3439086] (stating Repo 105 usage on Nov. 30, 2007, a quarter-end, was $38.634 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Jan. 29, 2008) [LBEX-DOCID 3363236] (stating Repo 105 usage on Jan. 29, 2008 was $28.883 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Feb. 13, 2008) [LBEX-DOCID 1697794] (stating Repo 105 usage on Feb. 13, 2008 was $23.602 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Feb. 15, 2008) [LBEX-DOCID 3215625] (stating Repo 105 usage on Feb 15, 2008 was $24.217 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Feb. 22, 2008) [LBEX-DOCID 3363289] (stating Repo 105 usage on Feb. 22, 2008 was $31.029 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Feb. 28, 2008) [LBEX-DOCID 4517138] (stating Repo 105 usage on Feb. 28, 2008 was $40.003 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Feb. 29, 2008) [LBEX-DOCID 579841] (stating Repo 105 usage on Feb. 29, 2008, a quarter-end, was $49.102 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Mar. 12, 2008) [LBEX-DOCID 022302] (stating Repo 105 usage on Mar. 12, 2008 was $26.685 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Mar. 13, 2008) [LBEX-DOCID 765323] (stating Repo 105 usage on Mar., 13, 2008 was $26.212 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Mar. 14, 2008) [LBEX-DOCID 3438624] (stating Repo 105 usage on Mar. 14, 2008 was $12.750 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Mar. 27, 2008) [LBEX-DOCID 3363367] (stating Repo 105 usage on Mar. 27, 2008 was $22.104 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Mar. 28, 2008) [LBEX-DOCID 3363367] (stating Repo 105 usage on Mar. 28, 2008 was $24.597 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Apr. 3, 2008) [LBEX-DOCID 3438756] (stating Repo 105 usage on Apr. 3, 2008 was $21.835 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Apr. 4, 2008) [LBEX-DOCID 3438756] (stating Repo 105 usage on Apr. 4, 2008 was $18.653 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Apr. 11, 2008) [LBEX-DOCID 766086] (stating Repo 105 usage on Apr. 11, 2008 was $20.260 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Apr. 14, 2008) [LBEX-DOCID 766086] (stating Repo 105 usage on Apr. 14, 2008 was $19.546 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Apr. 18, 2008) [LBEX-DOCID 1961054] (stating Repo 105 usage on Apr. 18, 2008 was $19.785 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Apr. 21, 2008) [LBEX-DOCID 766088] (stating Repo 105 usage on Apr. 21, 2008 was $21.907 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Apr. 28, 2008) [LBEX-DOCID 766092] (stating Repo 105 usage on Apr. 28, 2008 was $24.077 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Draft) (Apr. 30, 2008) [LBEX-DOCID 394333] (stating Repo 105 usage on Apr. 30, 2008 was $24.709 billion); Lehman,



Global Consolidated Balance Sheet, Global Consolidated Summary (May 6, 2008) [LBEX-DOCID 766102] (stating Repo 105 usage on May 6, 2008 was $24.388 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (May 12, 2008) [LBEX-DOCID 766107] (stating Repo 105 usage on May 12, 2008 was $25.550 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (May 13, 2008) [LBEX-DOCID 766107] (stating Repo 105 usage on May 13, 2008 was $25.282 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (May 27, 2008) [LBEX-DOCID 3237577] (stating Repo 105 usage on May 27, 2008 was $39.237 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (May 28, 2008) [LBEX-DOCID 766924] (stating Repo 105 usage on May 28, 2008 was $43.112 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (May 29, 2008) (stating Repo 105 usage on May 29, 2008 was $46.820 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (May 30, 2008) [LBEX-DOCID 1427836] (stating Repo 105 usage on May 30, 2008, a quarter end, was $50.383 billion); Lehman, Total Repo 105 & Repo 108 Report (July 14, 2008) [LBEX-DOCID 3363529] (stating Repo 105 usage on July 14, 2008 was $17.315 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (July 15, 2008) [LBEX-DOCID 3363529] (stating Repo 105 usage on July 15, 2008 was $16.828 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (July 21, 2008) [LBEX-DOCID 3363538] (stating Repo 105 usage on July 21, 2008 was $15.528 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (July 23, 2008) [LBEX-DOCID 3363541] (stating Repo 105 usage on July 23, 2008 was $14.786 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (July 29, 2008) [LBEX-DOCID 3363542] (stating Repo 105 usage on July 29, 2008 was $14.548 billion); Lehman, Global Consolidated Balance Sheet, Global Consolidated Summary (Aug. 14, 2008) [LBEX-DOCID 84891] (stating Repo 105 usage on Aug. 14, 2008 was $18.274 billion).

The chart above, for illustrative purposes only, uses confirmed Repo 105 data reported in Lehman's Global Consolidated Balance Sheet, a comprehensive report Lehman produced for purposes of tracking its success in achieving its gross and net balance sheet targets.[3366] The data from the Global Consolidated Balance Sheets demonstrate that Lehman's Repo 105 usage spiked at quarter-ends and fell off on an intra-quarter basis.[3367]

Lehman consistently failed to comply with the 80/20 rule.[3368] For most months (and all quarter-end months) Lehman failed to maintain an average daily balance throughout the month that equaled or exceeded 80% of the month-end balance.[3369] Similarly, at every quarter-end (and most month ends) after the first quarter 2006,

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[3366] *See* note 3365, *supra* (providing more data from Lehman's Global Consolidated Balance Sheet regarding Repo 105 usage on particular dates) and Appendix 17, Repo 105 Appendix (providing data in table form). Lehman's Global Consolidated Balance Sheet generally summarized, by division and business unit, Lehman's consolidated financial position – *e.g.*, its balance sheet size, day-over-day changes, net and gross balance sheet targets, amounts by which it was over/under targets – and the impact of Repo 105 on the net balance sheet was summarized as well. The impact of Repo 105 on Lehman's gross and net balance sheet as presented in the Global Consolidated Balance Sheet reports is consistent with the impact of Repo 105 usage on Lehman's net balance sheet that Duff & Phelps independently ascertained in its analyses. *See* Duff & Phelps, Assumed Hierarchy of Repo 105 Usage Data (Jan. 26, 2010), at p. 2 (also stating that Lehman's Global Consolidated Balance Sheet data on Repo 105 is very authoritative).

[3367] *See* note 3365, *supra*; Appendix 17, Repo 105 Appendix.

[3368] Duff & Phelps, Repo 105/108 Usage vs. Limit Comment (Oct. 16, 2009), at p. 7; *see also* e-mail from Michael McGarvey, Lehman, to Clement Bernard, Lehman (Jan. 30, 2008) [LBEX-DOCID 2796630] ("We increase the balances for month end but try to keep it within 120 percent of the average daily usage (we are decent at this, not great.)").

[3369] *See* Duff & Phelps, Repo 105/108 Usage vs. Limit Comment (Oct. 16, 2009), at p. 7.

Lehman's Repo 105 usage exceeded 120% of the preceding month's daily average usage.[3370]

(4) Repo 105 Transactions Served No Business Purpose Other Than Balance Sheet Reduction

When pressed to identify any legitimate business purpose for Lehman's use of Repo 105 transactions, several witnesses noted the secured short-term financing for the transactions in addition to the balance sheet reduction purpose.[3371] While one consequence of Repo 105 transactions was that Lehman received financing in exchange for collateral (which, as noted above, it did not record as a borrowing), a Repo 105 transaction was a more expensive way for Lehman to secure short-term financing as compared to an ordinary repo.[3372]

(a) Repo 105 Transactions Came at a Higher Cost Than Ordinary Repo Transactions

Nothing prevented Lehman from engaging in a traditional overnight repo transaction – using the same assets, with the same counterparty, but at a lower haircut (*e.g.*, 102 assets/$100 versus 105 or 108 assets/$100) and lower cost – on any particular

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[3370] *See id.*

[3371] Examiner's Interview of Mark Gavin, Sept. 24, 2009, at pp. 4-5 (stating that primary purpose of Repo 105 transactions was balance sheet management, but stating that they also had a funding purpose, though repeatedly acknowledging that "a regular repo would have been cheaper"); Examiner's Interview of John Coghlan, Nov. 11, 2009, at p. 7 (stating that the purpose was balance sheet reduction and financing, and acknowledging that Repo 105 transactions were more expensive than ordinary repo transactions).

[3372] Examiner's Interview of Mitchell King, Sept. 21, 2009, at p. 7; Examiner's Interview of Mark Gavin, Sept. 24, 2009, at pp.4-5; Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 6; Examiner's Interview of Matthew Lee, July 1, 2009, at p. 14.

date when Lehman engaged in a Repo 105 transaction.[3373] The more expensive route was taken because the traditional repo transaction would not have provided Lehman the balance sheet benefit that Repo 105 transactions provided to the firm – namely, Repo 105 transactions enabled Lehman to reverse engineer its externally reported net balance sheet and net leverage ratio for public consumption.[3374]

A Repo 105 transaction was more expensive to Lehman than an ordinary repo transaction for several reasons:[3375]

- Repo 105 transactions generally carried a higher yield, that is, the interest rate the counterparty charged Lehman for the borrowing.[3376] "[C]ertain of

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[3373] Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 6 (stating that the same assets could be used in either an ordinary repo or a Repo 105 transaction, that with most counterparties, Lehman had the capacity to do either type of transaction). This is not to suggest that any counterparty with which Lehman engaged in ordinary repos would have also agreed to enter into a Repo 105 agreement with Lehman. Rather, Repo 105 counterparties would have been willing to enter into ordinary repo transactions.

[3374] Examiner's Interview of Mark Gavin, Sept. 24, 2009, at pp. 4-5 (stating that a regular repo transaction would have been cheaper than a Repo 105 transaction and that the latter was chosen for balance sheet management); Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 6 (stating that Repo 105 transactions were more expensive and that Lehman engaged in them because "[c]learly, this was an effort to reduce balance sheet."); Examiner's Interview of Matthew Lee, July 1, 2009, at p. 14.

[3375] Andrew J. Morton Interview, Sept. 21, 2009, at p. 22 (Repo 105 transaction more expensive than ordinary repo transaction); Examiner's Interview of John Coghlan, Nov. 11, 2009, at p. 7 (same); e-mail from Mark Gavin, Lehman, to Mark Neller, Lehman, *et al.* (Aug. 26, 2008) [LBEX-DOCID 3232989] ("FYI – am now running into pretty unpalatable levels on these trades . . . .")

[3376] Examiner's Interview of Mitchell King, Sept. 21, 2009, at p. 7 (stating that Repo 105 was "more costly" and "expensive way to finance," that he believed the charges were "unfair," and that there were sometimes discrepancies of 5 bps in the amount different Repo 105 counterparties charged for the same securities); Examiner's Interview of Mark Gavin, Sept. 24, 2009, at p. 7 (explaining that haircut, interest rate, and offshore trading made Repo 105 more expensive than ordinary repo); Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 5 (explaining why Repo 105 more expensive than ordinary repo). But note that Kaushik Amin said even though Repo 105 transactions were costlier than regular repo transactions, the additional cost was negligible and immaterial. Examiner's Interview of Kaushik Amin, Sept. 17, 2009, at p. 7. Unlike ordinary repos, the most common of whose term was overnight, Repo 105 transactions typically had a seven or ten day term. The longer term *could* carry a costlier interest rate than the overnight rate. However, during the relevant period (late 2007 to 2008), the interest rate on overnight repos was just as likely to be more expensive than the interest rate on a week-long repo using the same

our counterparties charge very expensive levels [for Repo 105], so we cannot retain those types of trades for any longer than necessary."[3377]

- As set forth above, Repo 105 transactions were required to carry a higher margin or haircut (*e.g.*, the minimum five percent haircut for Repo 105 transactions, as opposed to a two percent haircut for an ordinary repo transaction using highly liquid collateral), which Lehman itself had to fund.[3378] That is, Lehman would have had to fund the additional haircut by either dipping into its equity or through long term borrowings.[3379] John

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treasury collateral. *See* Bloomberg Finance L.P. "RP GT 01D" Repo Financing OVERNIGHT and "RP GT 01W" Repo Financing 1 Week. Consequently, the higher interest rate in a Repo 105 could not have been a function of the term of the repo.

[3377] E-mail from Mitchell King, Lehman, to Mark Gavin, Lehman, *et al.* (Dec. 3, 2007) [LBEX-DOCID 3232555].

[3378] Examiner's Interview of Mitchell King, Sept. 21, 2009, at p. 7 (stating that Repo 105 was "more costly" and "expensive way to finance," that he believed the charges were "unfair," and that there were sometimes discrepancies in the amount different Repo 105 counterparties charged for the same securities); Examiner's Interview of Mark Gavin, Sept. 24, 2009, at p. 7 (explaining that haircut, interest rate, and offshore trading made Repo 105 more expensive than ordinary repo); Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 5 (explaining why Repo 105 more expensive than ordinary repo).

In late 2007 and 2008, Lehman often faced a 6.5% or higher haircut on Repo 105 transactions and a nine percent haircut on Repo 108 transactions. Lehman had been "losing liquidity" since July 2007, as repo lenders across the board gradually increased collateral requirements in their transactions with Lehman. Examiner's Interview of Richard Policke, May 28, 2009, at p. 4; *see also* Peter Hordahl & Michael R. King, Developments in Repo Markets During the Financial Turmoil, Banking Int'l Settlements Q. Rev., Dec. 2008, at 37 (focusing on the period since the start of the financial turmoil in mid-2007 and noting that "[a]s financing in unsecured markets became more expensive or unavailable, financial institutions with funding requirements bid more aggressively in repo markets to secure financing"); Gary Gorton, National Bureau of Economic Research, *Securitized Banking and the Run on Repo*, Yale ICF Working Paper No. 09-14 (Nov. 13, 2009), at 1, *available at*: http://ssrn.com/abstract=1440752 ("We argue that the financial crisis that began in August 2007 is a 'systemic event'. . . . We argue that the current crisis is similar [to the banking panics of the 19th century] in that contagion led to . . . unprecedented repo haircuts and even the cessation of repo lending on many forms of collateral."). Consequently, it appears that haircuts for all repos – not just Repo 105 transactions – could have increased in mid-2007 and 2008. *See* e-mail from Michael McGarvey, Lehman, to Divyesh Chokshi, Lehman (Aug. 21, 2007) [LBEX-DOCID 3234192] ("I was on a call with the funding desk on Friday and was told they were having difficulty maintaining Repo 105 term liquidity on even the best collateral."); e-mail from Michael McGarvey, Lehman, to Anuraj Bismal, Lehman (Aug. 23, 2007) [LBEX-DOCID 3232709] (stating that Mizuho rejected Freddie Mac subdebt for Repo 105 transactions and that "[t]his is just indicative of the liquidity situation in the market."); e-mail from Michael McGarvey, Lehman, to Anuraj Bismal, Lehman, *et al.* (Jan. 31, 2008) [LBEX-DOCID 3223415] (referring to "disruptions in the repo market which Jawad described as the worst he's seen in 7 years").

[3379] The contribution to the cost of a Repo 105 transaction of 3% additional collateral, relative to an ordinary repo, is significant. Ultimately, if all other features of a Repo 105 and ordinary repo transaction (including stated interest rate) were identical, the Repo 105 transaction would be more expensive. This is

Feraca, who was responsible for Lehman's Secured Funding Desk, said that unlike ordinary repo haircuts, the haircut on a Repo 105 was funded with more expensive forms of financing, such as long term debt.[3380]

- "Offshore trading" of United States agency securities, treasuries, and government securities was potentially more expensive than domestic trading within the United States.[3381] (Recall that a substantial volume of Lehman's Repo 105 transactions, conducted in Europe, involved these types of securities).

- As one witness recalled, "We were in a bit of a price-taking situation because the range of [Repo 105] counterparties was limited."[3382]

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due to the fact that the additional overcollateralization of Repo 105 borrowings was not financeable in the transaction and had to be funded by Lehman itself with equity or other long-term, more permanent forms of funding that carried higher costs. Further, the haircut determined the amount of leverage an institution undertook in a transaction. Such increases in haircuts from very low levels can have a particularly harmful impact on an institution's ability to maintain its level of earnings and its return on equity. This places a significant burden, potentially including the need to raise equity capital, on institutions that experience increasing haircuts. *See* Tobias Adrian, *et al. Financial Intermediaries, Financial Stability and Monetary Policy*, Federal Reserve Bank of New York Staff Report No. 346 (Sept. 2008), at pp. 11-13, *available at*: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1266714.

[3380] Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 5.

[3381] Examiner's Interview of Mark Gavin, Sept. 24, 2009, at p. 7.

[3382] Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 5; *see also* e-mail from Stephen Gerber, Lehman, to Gary Lynn, Lehman (Aug. 22, 2007) [LBEX-DOCID 3234616] (responding to Gerber's statement that "As we discussed yesterday, counterparties are getting a little pickier with Repo," by stating, "Uh oh…is this for repo 105?" to which Gerber responded: "Yes."). In the 2007 to 2008 period, Lehman's Repo 105 counterparties were primarily restricted to Mizuho, Barclays, UBS, Mitsubishi, and KBC, though some of these also tapered off their Repo 105 trading in 2008. E-mail from Chaz Gothard, Lehman, to Mark Gavin, Lehman, *et al.* (Sept. 4, 2007) [LBEX-DOCID 4553246] ("KBC are no longer able to finance our 105 agency trades. . . . This effectively means we only have 3 counterparts with which to transact this business – Mizuho, Barclays & UBS. Whilst they have taken all the paper we've thrown at them to date this situation should not be relied upon."); e-mail from John Feraca, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Feb. 28, 2008) [LBEX-DOCID 3207903] (reporting Repo 105 trades with "Barclays – $ 3 billion, UBS – $ 6 billion, Mizuho – $ 2 billion"); e-mail from Mark Gavin, Lehman, to Daniel Malone, Lehman, *et al.* (May 20, 2008) [LBEX-DOCID 736184] (noting in e-mail with subject line "RE: Repo 105 CPS" that "Mizuho - $5bln," "[n]o longer at the table: Barclays up to $15 bln," "UBS up to $10 bln," "Mitsubishi up to $1 bln," and "KBC up to $2 bln"); *see also* Lehman, US Agency Desk, Repo 105 12 Mar–19 Mar Mizuho @ 2.73% (Mar. 12, 2008) [LBEX-DOCID 4523953] (listing 6.5% haircut on Repo 105 transactions); Lehman, US Agency Desk, Repo 105 12 Mar–19 Mar. UBS @ 3.10% (Mar. 12, 2008) [LBEX-DOCID 4523950] (listing seven percent haircut on Repo 105 transactions); Lehman, US Agency Desk Repo 105 12 Mar–19 Mar UBS @ 2.75% (Mar. 12, 2008) [LBEX-DOCID 4523955] (listing 6.5% haircut on Repo 105 transactions); Lehman, US Agency Desk, Repo 105 28 May–4 Jun Mizuho @ 2.24 (May 27, 2008) [LBEX-DOCID 4523968]

Many variables impacted the interest rate for both an ordinary repo transaction and a Repo 105 transaction, so it is difficult to precisely measure the magnitude by which the interest rate on a Repo 105 was greater than an ordinary repo.[3383] However, witnesses who have knowledge on the subject uniformly advised the Examiner that Repo 105 trades generally were more expensive to Lehman than ordinary repos.[3384]

As one e-mail succinctly states: "Everyone knows 105 is an off balance sheet mechanism so counterparties are looking for ridiculous levels to take them."[3385] Asked

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(reflecting haircuts on Repo 105 transactions ranging from 6.5% to 210%); Lehman, US Agency Desk, Repo 105 Mizuho 28 May–4 June (May 27, 2008) (showing 2.6% and 2.42% interest rate and 6.5% haircut on Repo 105 transaction). Lehman frequently petitioned to expand its Repo 105 line with Mizuho. *See, e.g.*, E-mail from Paolo R. Tonucci, Lehman, to Matthew Pinnock, Lehman (May 22, 2008) [LBEX-DOCID 1548434] ("Think I can get Chris [O'Meara] to agree [to] another $2 bill, but it is critical to get some context around what is changing."). In May 2008, only ten days before quarter-end, Matthew Pinnock, on behalf of Jeff Michaels and Kaushik Amin of FID, attempted to increase its Repo 105 line with counterparty Mizuho. *Id.* Tonucci and O'Meara were involved in this process of authorizing a temporary increase in Lehman's Repo 105 capacity limits for the close of second quarter 2008. *Id.* In February 2008, Lehman found a new Repo 105 counterparty in ABN Amro Bank NV (London Branch). *See* e-mail from Nirav Patel, Lehman, to Kandy Hosea, Lehman, *et al.* (Feb. 29, 2008) [LBEX-DOCID 3383394]. Deutsche Bank was also a Repo 105 counterparty to Lehman in 2008. When a Repo 105 transaction with Deutsche Bank failed, Tonucci assigned Carlo Pellerani (International Treasurer) to ensure the problem was resolved. *See* e-mail from Paolo R. Tonucci, Lehman, to John Coghlan, Lehman (Mar. 25, 2008) [LBEX-DOCID 117336].

[3383] Lehman's Repo Manual, a reference guide the firm published for internal use by its own sales people, provided that "[T]he rate used to calculate the interest is a function of many factors, including, but not limited to: the supply and demand for the securities used as collateral, the supply and demand for cash, the maturity of the Repo, and the method used to transfer the securities used as collateral from the dealer to the investor." Lehman, Repo Manual (Nov. 8, 2005), at p. 10 [LBEX-LL 1175483]. The Manual also stated that the repo interest rate "bears no relation to the interest rate on the securities used as collateral." *Id.* The calculation of the repo interest rate payment is as follows: (cash investment) x (repo interest rate) x (number of days repo outstanding) divided by 360 = repo interest. *Id.*

[3384] Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 10; Examiner's Interview of Mitchell King, Sept. 21, 2009, at p. 7; Examiner's Interview of Mark Gavin, Sept. 24, 2009, at p. 7; Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 5; Examiner's Interview of John Coghlan, Nov. 11, 2009, at p. 7.

[3385] E-mail from Michael McGarvey, Lehman, to Anuraj Bismal, Lehman (Jan. 31, 2008) [LBEX-DOCID 3384033]. Given that in a Repo 105 transaction, Lehman provided its counterparty with more collateral for the same amount of cash as in an ordinary repo, one might expect the interest rate to be lower, as the

by the Examiner to explain this statement, McGarvey, the author of the e-mail, stated that counterparties such as Mizuho knew that Repo 105 transactions received off-balance sheet treatment and as a result might "try to squeeze Lehman."[3386]

(b) Witnesses Also Stated That Financing Was Not the Real Motive for Undertaking Repo 105 Transactions

When asked directly, Joseph Gentile, a former FID Finance executive who reported to Gerard Reilly, did not believe that Lehman's motive for undertaking Repo 105 transactions was financing.[3387] Gentile stated unequivocally that no business purpose for Lehman's Repo 105 transactions existed other than obtaining balance sheet relief.[3388] Gentile said that he received his "Repo 105 education" sometime near the end of Lehman's 2006 fiscal year from Ed Grieb, Lehman's Global Financial Controller who

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terms were better for the lender, *i.e.*, had greater protection in the form of more collateral in the case Lehman did not repay its borrowing. The Examiner's analysis shows that, on the contrary, the interest rate in a Repo 105 transaction was higher than in an ordinary week-long repo despite the overcollateralization. Based on witness statements that Lehman was in a "price taking situation," and documents such as the e-mail in which Lehman staffers begged to increase the Repo 105 credit line with Mizuho to improve the balance sheet profile at quarter end, the higher interest rate in a Repo 105 transaction was likely a consequence of Repo 105 counterparties being aware of Lehman's desperation. Examiner's Interview of John Feraca (Oct. 9, 2009), at p. 5; *see* e-mail from Stephen Allery, Lehman, to Miyuki Suzuki, Lehman (Feb. 19, 2008) [LBEX-DOCID 098492].

[3386] Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 10.

[3387] Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at pp. 6-7. Similarly, Irina Veksler believed that Repo 105 transactions were not used to generate liquidity. Examiner's Interview of Irina Veksler, Sept. 11, 2009, at p. 8. What these witnesses meant is that Lehman's motive or purpose for entering into Repo 105 transactions was not financing. In other words, although Lehman received cash just as it did in an ordinary repo transaction, this was just an outcome of the transaction but not Lehman's motive for undertaking Repo 105 transactions. As described in detail in this Report, Lehman conceived its Repo 105 program for purposes of managing its balance sheet, particularly at quarter-end reporting periods. If Lehman had actually wanted to use its assets for purely financing arrangements to raise needed cash, Repo 105 transactions were a costlier and less effective means of generating liquidity than ordinary repo transactions.

[3388] Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 6.

reported directly to then-CFO Chris O'Meara.[3389] According to Gentile, Grieb explained that Repo 105 transactions were a balance sheet management mechanism: "a tool that could be used to reduce Lehman's net balance sheet."[3390]

Though Gentile did not understand the specific mechanics of Repo 105 transactions, he recalled that "Repo 105 was a vehicle that Grieb owned and he was using it to take my balance sheet away."[3391] When the Examiner asked for further explanation of that statement, Gentile said that if FID had "excessions" in its balance sheet, Grieb would authorize additional Repo 105 capacity to alleviate potential breaches of the balance sheet limit.[3392] Gentile explained that two ways existed for FID to make its balance sheet targets where excessions existed: by selling assets or by engaging in Repo 105 transactions.[3393] Repo 105 transactions filled the gap between what Lehman could sell through normal business practices and the assets that Lehman needed to move off its balance sheet in order to meet balance sheet targets.[3394]

[3389] *Id.* Before arriving at Lehman in June 2006, Gentile had never heard of Repo 105 transactions, either by name or description. *Id.* Without any prompting, Gentile said that it was his understanding that neither JP Morgan, where Gentile he had worked for 11 years, nor Bank of America, where he had worked for 5 years, used such a mechanism. *Id.*

[3390] *Id.* John Feraca similarly told the Examiner that the purpose of Repo 105 transactions was to take advantage of SFAS 140 for purposes of managing its balance sheet. Examiner's Interview of John Feraca, Oct. 9, 2009, at pp. 6-7, 12-13.

[3391] Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 6.

[3392] *Id.* As Lehman's quarter-end approached, O'Meara, Grieb and Reilly would pressure Gentile to ensure that FID met its balance sheet targets. *Id.* Grieb, on the other hand, denied having any recollection of Lehman facing balance sheet pressures in its Fixed Income Division in 2007. Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 11.

[3393] Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 6.

[3394] *See, e.g.*, E-mail from Kaushik Amin, Lehman, to Herbert H. (Bart) McDade III, Lehman (June 3, 2008) [LBEX-DOCID 574610] (stating that the Liquid Markets business within FID "targeted lower numbers

Similarly, Matthew Lee said there was no legitimate business purpose for Repo 105 transactions.[3395] In his view, Lehman's Repo 105 practice was for "window-dressing the balance sheet to make the credit rating higher."[3396]

g) The Materiality of Lehman's Repo 105 Practice

(1) The Repo 105 Program Exposed Lehman to Potential "Reputational Risk"

Martin Kelly, who CFO Erin Callan hand-picked to assume the role of Global Financial Controller on December 1, 2007 (replacing Ed Grieb) and who retained that position until Lehman's bankruptcy petition date in September 2008, first became familiar with Lehman's use of Repo 105 transactions soon after he became Financial Controller.[3397] Lehman's reliance on Repo 105 transactions for balance sheet relief

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since the rest of FID was having difficulty meeting its target," transmitting Liquid Markets Balance Sheet Report for May 30, 2008 [LBEX-DOCID 522198] showing that Liquid Markets used $42.221 billion in Repo 105 transactions to come in $9.2 billion below its quarter-end net balance sheet target, and stating "we spent a lot of money to achieve these targets. Now, we have to make money").

[3395] Examiner's Interview of Matthew Lee, July 1, 2009, at p. 16.

[3396] *Id.*

[3397] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 6. Kelly described a transition period at the end of 2007, when Grieb was transitioning out of the role of Financial Controller and Kelly was transitioning in. *Id.* In a November 6, 2007 e-mail, Marie Stewart (Global Head of Accounting Policy) sent Kelly a copy of the August 2007 version of the Balance Sheet Netting Grid, an accounting policy document that outlined the various mechanisms by which Lehman made adjustments to its balance sheet. E-mail from Marie Stewart, Lehman to Martin Kelly, Lehman (Nov. 6, 2007) [LBEX-DOCID 2736621] (stating "this is the doc that summarizes every reason we net down the b/sheet. As discussed, E&Y are in the process of reviewing it" and transmitting Accounting Policy Review Balance Sheet Netting and Other Adjustments (Aug. 2007) [LBEX-DOCID 2720761] ("The Netting Grid")). The Netting Grid includes a brief discussion of the Repo 105 program. *See* Accounting Policy Review Balance Sheet Netting and Other Adjustments (Aug. 2007), at p. 26 [LBEX-DOCID 2720761] ("Under certain conditions that meet the criteria as described in paragraphs 9 and 218 of FAS 140, Lehman policy permits…repo agreements to be recharacterized as purchases and sales of inventory."). An e-mail from December 2007 reveals that Kelly and Stewart intended to discuss the Repo 105 program sometime after Lehman filed its 2007 Form 10-K. *See* e-mail from Marie Stewart, Lehman, to Martin Kelly, Lehman (Dec. 18, 2007) [LBEX-DOCID 3221244].

caused Kelly "discomfort,"[3398] because of the magnitude of Lehman's usage and, in part, because he believed Lehman was the last of its peer CSE firms to employ similar accounting for these types of transactions.[3399]

Kelly further attributed his discomfort with Lehman's use of Repo 105 transactions to the fact "*that the only purpose or motive for the transactions was reduction in balance sheet*" and that "there was no substance to the transactions."[3400] Kelly thought that the lack of business purpose for these transactions, combined with the magnitude

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[3398] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 7.

[3399] *Id.* The Balance Sheet Group regularly apprised Kelly of the volume of Lehman's Repo 105 transactions. *See, e.g.*, E-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223388] ("We ended the year with $38 billion of repo 105/8 nettings"); Lehman, Current Day November 30, 2007 Total Repo 105 and Repo 108 Graph (Dec. 5, 2007) [LBEX-DOCID 3238265] (attached to e-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223388] and stating that total Repo 105 usage on November 30, 2007 was $38.634 billion); e-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Feb. 28, 2008) [LBEX-DOCID 3223439] ("Per PC - look like Repo 105/108 may land at $40B or slightly higher"); e-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Mar. 6, 2008) [LBEX-DOCID 3223441] ("Our initial estimates are that for Q1 2008 we used $48 Billion of repo 105/8 nettings."). Numerous witnesses and internal e-mails state that Lehman was the last of its peer investment banks to be using Repo 105-type transactions by December 2007. The Examiner has not verified whether other CSE firms had at one time used these kinds of transactions but later ceased using them. Bismal, Stewart, and McGarvey said that they believed that Lehman was the only CSE firm engaging in Repo 105 transactions by late 2007. Murtaza Bhallo said that Barclays did not use Repo 105 transactions. Joseph Gentile said that he had personal knowledge that JP Morgan and Bank of America did not engage in Repo 105-type transactions for managing their respective balance sheets. In December 2007, Bismal wrote: "Was chatting with ex-lehman employee [Carlos Lo] at Merrill yesterday – he is in their balance sheet group – he told me that they do not use repo 105/8," to which Marie Stewart replied, "Then that means we are the only one left who does." E-mail from Anuraj Bismal, Lehman, to Marie Stewart, Lehman (Dec. 5, 2007) [LBEX-DOCID 3223386]. In a January 2008 e-mail, McGarvey wrote: "By the way we are now the only large firm on the street that uses Repo 105." E-mail from Michael McGarvey, Lehman, to Clement Bernard, Lehman (Jan. 30, 2008) [LBEX-DOCID 2796630]. In a May 2008 e-mail from Ryan Traversari to O'Meara, Traversari reported that Citigroup and JP Morgan "likely do not do Repo 105 and Repo 108 which are UK-based specific transactions on opinions received by LEH from Linklaters. This would be another reason why LEH's daily balance sheet is larger intra-month then at month-end." E-mail from Ryan Traversari, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (May 16, 2008) [LBEX-DOCID 574498].

[3400] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 7.

of Lehman's Repo 105 usage at quarter-end (at $38.6 billion at fiscal year end 2007, when Kelly became Global Financial Controller) carried a potential for "*reputational risk*" to Lehman and that, should it become public knowledge, it may "reflect[] poorly on the firm."[3401]

Kelly further explained that "the size of the program in an absolute sense was of a size that presented *headline risk*," particularly as "the program was skewed to quarter ends."[3402] When asked by the Examiner what he meant by "headline risk," Kelly stated that "if there were more transparency to people outside the firm around the transactions, it would present a dim picture" of Lehman.[3403]

Lehman's increasing reliance on the Repo 105 transactions and the absence of any disclosure of that fact in Lehman's Forms 10-Q and 10-K disquieted Kelly; he remarked that if an analyst or a member of the investing public were to read Lehman's Forms 10-Q and 10-K from cover to cover, taking as much time as she or he needed, "they would have no transparency into [Lehman's] Repo 105 program"[3404]

Kelly's concerns about Lehman's use of Repo 105 transactions prompted him to raise them to both of the Chief Financial Officers in place during Kelly's tenure as

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[3401] *Id.*; *cf.* e-mail from Martin Kelly, Lehman, to Kaushik Amin, Lehman (Apr. 17, 2008) [LBEX-DOCID 488108] ("[Repo 105] Program has some risk to it. Reluctance to expand to new regions/geographies.").
[3402] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 8.
[3403] *Id.*
[3404] *Id.*

Global Financial Controller: Erin Callan and, later, Ian Lowitt.[3405] According to Kelly, "the purpose of the conversations being to make sure they understood the size of the program and that there was risk in the program."[3406]

Kelly spoke first to Callan and then to Lowitt, Callan's successor, regarding Lehman's use of Repo 105 transactions on separate occasions when each was serving as Lehman's CFO.[3407] Kelly recalled raising the following topics in his Repo 105 conversations with both Callan and Lowitt: (1) Kelly's discomfort with the possible "*reputational risk*" Lehman would suffer if the investing public and analysts learned that Lehman used Repo 105 transactions solely to reduce its balance sheet; (2) the size of Lehman's Repo 105 program, that is, the volume of Repo 105 transactions that Lehman undertook at quarter-end to reduce its balance sheet; (3) the "technical basis," from an accounting perspective, by which Lehman was authorized to engage in Repo 105 transactions; (4) Kelly's belief that none of Lehman's peer investment banks used Repo 105 transactions; and (5) the fact that Lehman's Repo 105 activity was "skewed at quarter-end," in other words, that the firm's Repo 105 usage spiked at quarter-end, during Lehman's reporting periods.[3408]

[3405] *Id.*; *see also* e-mail from Marie Stewart, Lehman, to Dominic Gibb, Lehman (Dec. 21, 2007) [LBEX-DOCID 3223846] ("FYI that our use of Repo 105 is a conversation at the CFO level at this point.").

[3406] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 8.

[3407] *Id.*

[3408] *Id.* Kelly's discussion with the CFOs is discussed further at Sections III.A.4.h.2.b–c of this Report.

(2) Lehman's Repo 105 Practice Had a Material Impact on Lehman's Net Leverage Ratio

Lehman's Repo 105 practice at quarter-end in late 2007 and for the first two quarters 2008 had a material impact on Lehman's publicly-reported net leverage ratio – and Lehman management knew it. For example, in a December 5, 2007 e-mail, Bismal reported that Lehman "would be at net leverage of 18.0x [vs say 16.3x] without repo 105/8."[3409] Consistent with Bismal's e-mail, Lehman publicly reported a firm-wide net leverage ratio of 16.1x in its Form 10-K for the 2007 fiscal year.[3410]

Using Lehman's firm-wide Repo 105 usage at the end of each quarter from November 2006 through May 2008, the Examiner analyzed the impact that Lehman's removal of assets from its balance sheet using Repo 105 transactions had on the firm's publicly-reported net leverage ratio. As the chart below demonstrates, for each of those seven reporting periods – fourth quarter 2006 through second quarter 2008 – by employing Repo 105 transactions rather than ordinary repo transactions, Lehman was able to reduce its published net leverage ratio by a minimum of 9%, with that reduction increasing to 12% and 15% in first quarter 2008 and second quarter 2008, respectively:

[3409] E-mail from Anuraj Bismal, Lehman, to Marie Stewart, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223384].

[3410] LBHI 2007 10-K, at pp. 29, 64.

Gross and Net Balance Sheet Ratios

		At the Quarter Ended						
	$ in Millions	May 31 2008	Feb 29, 2008	Nov 30, 2007	Aug 31, 2007	May 31, 2007	Feb 28, 2007	Nov 30, 2006
(a)	Total Assets	639,432	786,035	691,063	659,216	605,861	562,283	503,545
	Less:							
	Cash and securities segregated and on deposit for regulatory and other purposes	(13,031)	(16,569)	(12,743)	(10,579)	(7,154)	(6,293)	(6,091)
	Collateralized lending agreements *	(294,526)	(368,681)	(301,234)	(287,427)	(257,388)	(251,662)	(225,156)
	Identifiable intangible assets and goodwill	(4,101)	(4,112)	(4,127)	(4,108)	(3,652)	(3,531)	(3,362)
(b)	Net Assets	327,774	396,673	372,959	357,102	337,667	300,797	268,936
(c)	Total Stockholder's Equity	26,276	24,832	22,490	21,733	21,129	20,005	19,191
(d)	Tangible Equity Capital **	27,179	25,696	23,103	22,164	21,881	19,487	18,567
	Leverage Ratio (a) / (c)	24.3 x	31.7 x	30.7 x	30.3 x	28.7 x	28.1 x	26.2 x
	Net Leverage Ratio (b) / (d)	12.1 x	15.4 x	16.1 x	16.1 x	15.4 x	15.4 x	14.5 x
(e)	Repo 105/108 Usage	50,383	49,102	38,634	36,407	31,943	27,284	24,519
	If repos were used in place of repo 105s:							
	Leverage Ratio ((a) + (e)) / (c)	26.3 x	33.6 x	32.4 x	32.0 x	30.2 x	29.5 x	27.5 x
	% increase over actual Leverage Ratio	***8%***	***6%***	***6%***	***6%***	***5%***	***5%***	***5%***
	Net Leverage Ratio ((b) + (e)) / (d)	13.9 x	17.3 x	17.8 x	17.8 x	16.9 x	16.8 x	15.8 x
	% increase over actual Net Leverage Ratio	***15%***	***12%***	***10%***	***10%***	***9%***	***9%***	***9%***

Notes:

* Collateralized lending agreements are securities received as collateral, securities purchased under agreements to resell, and securities borrowed

** Tangible Equity Capital is Total Stockholders' Equity plus junior subordinated notes less identifiable intangible assets and goodwill.

Sources:

Asset and Equity data: Lehman Brothers' SEC 10-K and 10-Q filings.

Repo 105/108 Usage: Q4 2006, Q1, Q2 and Q3 2007: LBEX-DOCID 3363434; Q4 2007: LBEX-DOCID 3219746; Q1 and Q2 2008: LBEX-DOCID 2078195

A walk-through document related to Ernst & Young's 2007 fiscal year-end audit of Lehman defines "materiality," with respect to the process for reopening or adjusting a closed balance sheet, as "*any item individually, or in the aggregate, that moves net leverage by 0.1 or more (typically $1.8 billion)*."[3411] William Schlich, former lead partner on Ernst & Young's Lehman team, stated that this was Lehman's, rather than Ernst & Young's, definition of materiality and that it represented "Lehman's determination of a

[3411] Ernst & Young, LBHI/LBI Walkthrough Template for Balance Sheet Close Process (Nov. 30, 2007), at p. 14 [EY-LE-LBHI-CORP-GAMX-07-033384] ("Materiality is usually defined as any item individually, or in the aggregate, that moves net leverage by 0.1 or more (typically $1.8 billion)."). Accordingly, an item that impacted net leverage by 0.1 point was deemed material enough to re-open books. The walkthrough paper also states, "Net leverage is an important ratio analyzed by the rating agencies and included in Lehman's earnings releases." *Id.*

materiality threshold" in connection with Lehman's own criteria for when to consider reopening and adjusting the closed balance sheet.[3412]

As a result of its quarter-end Repo 105 practice from late 2007 through the second quarter 2008, Lehman publicly reported a net leverage ratio that was 1.7 to 1.9 points lower than what its net leverage ratio would have been if Lehman had used ordinary repo transactions instead of Repo 105 transactions.

(a) Lehman Significantly Expanded Its Repo 105 Practice in Late 2007 and Early 2008

Although Lehman had used Repo 105 transactions since 2001, beginning in mid-2007, Lehman required greater amounts of Repo 105 relief to improve its reported net leverage ratio.[3413] As a result, Lehman's quarter-end use of Repo 105 transactions significantly increased beginning in mid-2007 with the close of Lehman's third quarter 2007 in August 2007, at which time Lehman's combined Repo 105 usage was $36.4

[3412] Examiner's Interview of Ernst & Young, Repo 105 Session, Oct. 16, 2009, at p. 7 (statement of William Schlich). Asked if he could describe what level of impact to Lehman's firm-wide net assets Ernst & Young would have considered "material," Schlich said that Ernst & Young did not have a hard and fast rule defining materiality in the balance sheet context. *Id.* He said that with respect to balance sheet issues, "materiality" depends upon the facts and circumstances. *Id.*

[3413] Andrew Morton, the former Global Head of Lehman's Fixed Income Division, stated that Lehman established limits on Repo 105 usage at the inception of the program in 2001. Examiner's Interview of Andrew J. Morton, Sept. 21, 2009, at p. 4. John Feraca also recalled that Lehman placed limits on Repo 105 usage at the program's inception: "There were limits to Repo 105 going back to the beginning. Sometimes these were more emphatic and sometimes relaxed." Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 8. Feraca recalled a firm-wide limit of between $10 billion and $20 billion when Lehman first conceived its Repo 105 program in 2001. *Id.* Feraca said that a certain level of seniority was required to set the caps on Repo 105 and that these caps/limits were communicated to the trading desks as well as to him at the funding desk. *Id.*

billion.[3414] At the close of Lehman's fiscal year in November 2007, Lehman's total Repo 105 was $38.63 billion, in contrast to the $25 billion internal limit supposedly in effect at that time.[3415]

Total Repo 105/108 at Quarter-End [3416]

	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
Repo 105	n/a	$19.213	$20.578	$23.054	$29.054	$29.727	$42.200	$44.536
Repo 108	n/a	$5.091	$6.4	$8.575	$6.863	$8.854	$6.902	$5.847
Total	$27.153	$24.519	$27.284	$31.943	$36.407	$38.634	$49.102	$50.383

Key:

- Dollar amounts are given in billions.
- For purposes of this chart, Repo 105 amount refers to the total volume of Repo 105 transactions undertaken by the Fixed Income Division.
- For purposes of this chart, Repo 108 amount refers to the total volume of Repo 108 transactions undertaken by the Equities Division.
- Total Repo 105/108 amount may be greater than the sum of Repo 105 and Repo 108 volumes reported in this chart due to intermittent and *de minimis* amount of Repo 105 transactions undertaken by other Lehman divisions or groups.

[3414] Lehman, Total Repo 105/108 Trend (Feb. 20, 2008) [LBHI_SEC07940_1957956].

[3415] *Id.*; Lehman, Total Repo 105 & Repo 108 Report [LBEX-DOCID 3219746] (Dec. 5, 2007) (attached to e-mail from Anuraj Bismal, Lehman, to Marie Stewart, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223384]); e-mail from Michael McGarvey, Lehman, to Kentaro Umezaki, Lehman, *et al.* (May 8, 2007) [LBEX-DOCID 1811432] ("25 bn is the total Lehman Repo 105/108 limit. FID's share is 20bn. Rates has been generally using 16-18bn out of the 20bn with the remainder in credit."); e-mail from Sigrid Stabenow, Lehman, to Clement Bernard, Lehman, *et al.* (Jan. 25, 2008) [LBEX-DOCID 1853428] (recommending that Repo 105 program be expanded from $20 billion to $23 billion).

[3416] E-mail from Mark Ciolli, Lehman, to Michelle Ng, Lehman, *et al.* (Sept. 6, 2006) [LBEX-WGM 748487] (stating that total Repo 105 usage on August 31, 2006, close of third quarter 2006, was $27.1533 billion); Lehman, Total Repo 105 & Repo 108 Report (Jan. 2, 2007) [LBEX-DOCID 2715058] (stating total Repo 105 usage on November 30, 2006, close of fourth quarter 2006, was $24.5192 billion); Lehman, Total Repo 105/108 Trend (Feb. 20, 2008) [LBHI_SEC07940_1957956] (stating total Repo 105 usage on August 30, 2007, close of third quarter 2007, was $36.4 billion); Lehman, Total Repo 105 & Repo 108 Report (Dec. 5, 2007) [LBEX-DOCID 3219746] (stating total Repo 105 usage on November 30, 2007, close of fourth quarter 2007, was $38.634 billion); Lehman, Total Repo 105 & Repo 108 Report (June 11, 2008) [LBEX-DOCID 2078195] (stating total Repo 105 usage on February 29, 2008, close of first quarter 2008, was $49.102 billion and for May 30, 2008, close of second quarter 2008, was $50.3834 billion); *see also* Lehman, Total Repo 105/108 Trend Report (June 20, 2008) [LBEX-DOCID 3363434] (stating total quarter-end Repo 105 usage for fourth quarter 2006 through second quarter 2008).

Lehman Treasurer Paolo Tonucci recalled that Lehman placed a cap on total Repo 105 usage because accounting rules could potentially change and without a limit in place, there was a risk that Lehman's business would become "too dependent" on the Repo 105 off-balance sheet arrangement.[3417] A July 2006 document reveals that, at that time, the limits were: $17 billion for Repo 105 transactions and $5 billion for Repo 108 transactions.[3418] The $17 billion limit on Repo 105 transactions was keyed to tangible equity.[3419] Other documents demonstrate that throughout 2007 and into January 2008, the official internal limits on Lehman's use of Repo 105/108 transactions remained in the mid-$20 billion range, generally $17 to $20 billion for Repo 105 transactions and $5 billion for Repo 108 transactions.[3420]

[3417] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009 at p. 26.

[3418] Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 2 [LBEX-WGM 748489] ("Global Balance Sheet Overview"); *see also* e-mail from Gary Lynn, Lehman, to Kaushik Amin, Lehman, *et al.* (Aug. 22, 2006) [LBEX-DOCID 2786867] (discussing temporary increase of Repo 105 limit to $20 billion from $17.5 billion).

[3419] *See* Duff & Phelps, Repo 105/108 Usage vs. Limit Comment (Oct. 16, 2009), at pp. 1-2 (explaining that the Repo 105 limit was set at 1 x Tangible Equity). The Global Balance Sheet Overview said that "Repo 105 is capped at $15 B (1 x leverage)." Lehman, Global Balance Sheet, Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 2 [LBEX-WGM 748489]. The Overview also implied that "1 x leverage" meant that Repo 105 usage should not exceed Tangible Equity. *Id.* at p. 5.

[3420] E-mail from Gary Lynn, Lehman, to Kaushik Amin, Lehman, *et al.* (Aug. 22, 2006) [LBEX-DOCID 2786868]; e-mail from Clare Christofi, Lehman, to Anuraj Bismal, Lehman, *et al.* (May 8, 2007) [LBEX-DOCID 3234172] ("Limits were $5 bn for Eq[uities] and $17 bn for FID."); e-mail from Michael McGarvey, Lehman, to Kentaro Umezaki, Lehman, *et al.* (May 8, 2007) [LBEX-DOCID 1811432] ("25 bn is the total Lehman Repo 105/108 limit. FID's share is 20bn. Rates has been generally using 16-18bn out of the 20bn with the remainder in credit."); e-mail from Michael McGarvey, Lehman, to Gerard Reilly, Lehman (May 23, 2007) [LBEX-DOCID 4553348] ("We're projecting to land at 24.5bn in Repo 105/108. 18.5bn FID/6.5bn Equities."); e-mail from Sigrid Stabenow, Lehman, to Clement Bernard, Lehman, *et al.* (Jan. 25, 2008) [LBEX-DOCID 1853428] (recommending that Repo 105 program be expanded from $20 billion to $23 billion).

As market conditions worsened and the pressures on Lehman to reduce its net leverage ratio increased, pressure mounted inside Lehman to adjust upward these limits on Repo 105 transactions.[3421] As discussed above, in February 2007, Joseph Gentile (FID Chief Financial Officer) recommended to Grieb that Lehman increase the $22 billion combined Repo 105/108 limit ($17 billion in Repo 105 and $5 billion in Repo 108) by $3 billion to mitigate problems caused by: "[e]xiting large CMBS positions in Real Estate and sub prime loans in Mortgages [that] before quarter would [result in] large losses."[3422]

When interviewed by the Examiner, Grieb had no recollection of receiving this recommendation from Gentile.[3423] Grieb also did not recall what happened as a result of Gentile's request to increase the Repo 105 limit by $3 billion and further disclaimed

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[3421] *See* Sections III.A.4.e.1 and III.A.4.e.4–5 of this Report.

[3422] Lehman, Proposed Repo 105/108 Target Increase for 2007 (Feb. 9, 2007) [LBEX-DOCID 2489498] (attached to e-mail from Joseph Gentile, Lehman, to Edward Grieb, Lehman (Feb. 10, 2007) [LBEX-DOCID 2600714]; *see also* e-mail from Joseph Gentile, Lehman, to Edward Grieb, Lehman (Feb. 8, 2007) [LBEX-DOCID 2604414] ("What is your appetite for us exceeding our repo 105 limit by $1.6 bn at month end? From 17.0 to 18.6?"). Gentile's proposal is discussed at length, *supra*, at Section III.A.4.e.4. When the Examiner interviewed Gentile, he did not recall preparing the February 2007 analysis and recommendation he sent to Grieb in which he requested the $3 billion increase in the firm-wide Repo 105 limit for first quarter 2007 (from $22 billion to $25 billion), though he recalled that authorization was required to exceed the firm-wide Repo 105 limit. Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 8. Gentile speculated that someone from Lehman's Balance Sheet group may have prepared portions of the report for him, but Gentile was absolutely certain that he would have shown the analysis and recommendation to Reilly, to whom he reported, before submitting it to Grieb. *Id.*

[3423] Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 12. Similarly, Grieb claimed to have never before heard the phrase "sticky assets" and claimed to have no recollection of market conditions in 2007. Grieb said that he did not even recollect that the $22 billion combined Repo 105 limit was in place in February 2007, though he said he had no reason to dispute this fact. *Id.* Likewise (and contrary to numerous documents and other witness statements), Grieb said that he had no recollection of balance sheet pressures within Lehman's FID in 2007. *Id.*

knowledge of whether Chris O'Meara and Gerard Reilly received similar petitions.[3424] Though Grieb had no recollection "specifically" of a $3 billion increase in the Repo 105 cap (even when shown later e-mails which confirm that Grieb granted Gentile's request for the $3 billion increase), he recalled "generally" that "at some point in time, as a result of discussions with O'Meara and Reilly, we raised the limit."[3425]

Gentile also did not recall specifically whether Grieb approved the $3 billion increase, which would have pushed Lehman's firm-wide Repo 105 limit to $25 billion.[3426] But when shown an e-mail he sent to Michael Gelband (then-Head of FID) indicating that Grieb had approved the requested increase, Gentile said that he would never have written such an e-mail unless Grieb had in fact authorized the increase.[3427] Consistent with statements in his e-mail to Gelband, Gentile stated that the $3 billion

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[3424] *Id.*

[3425] *Id.*; *see* e-mail from Joseph Gentile, Lehman, to Gerard Reilly, Lehman (Feb. 21, 2007) [LBEX-DOCID 4553220] ("We spoke with grieb and . . . he was ok with a temporary excession of $3. . . ."); e-mail from Gary Lynn, Lehman, to Sharan Mirchandani, Lehman, *et al.* (Feb. 21, 2007) [LBEX-DOCID 1431154] ("As you are aware we are significantly over the Q1 balance sheet limits…with one week to go, and Kaushik has delivered that message to the business heads that we need to come down further as there is no room for us to be over our limits. Please note that the current projected overage…already includes an additional $3bn of Repo 105 that we have been granted above the normal Repo 105 limits, but it has been communicated to me that this additional Repo 105 is to satisfy overages we currently have in other business lines."). Marie Stewart (former Global Head of Accounting Policy) recalled that Repo 105 transactions became more prevalent in late 2007 and 2008, but she did not specifically recall an official "ramping up" policy. Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 10.

[3426] Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 8.

[3427] Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 8; e-mail from Joseph Gentile, Lehman, to Michael Gelband, Lehman, *et al.* (Feb. 20, 2007) [LBEX-DOCID 1808077] ("I have been able to get a temp limit of 3 bn for repo 105 activity, which covers known real estate issues. We have issues in mortgages and liquid markets."). In the same e-mail, Gentile also noted that FID was more than $10 billion over its balance sheet target for the quarter and that consequently, Lehman's firm-wide net leverage ratio was 15.6 rather than the target, 14.8. *Id.*

increase was temporary and intended to apply to Lehman's first quarter 2007 only.[3428] Other e-mails confirm that the $3 billion increase was granted.[3429] As noted in this Report, however, within months of February 2007, Lehman's firm-wide Repo 105 usage was exceeding even that increased limit.[3430]

[3428] E-mail from Joseph Gentile, Lehman, to Kentaro Umezaki, Lehman (Feb. 21, 2007) [LBEX-DOCID 1808077].

[3429] E-mail from Gerard Reilly, Lehman, to Joseph Gentile, Lehman (Feb. 21, 2007) [LBEX-DOCID 4553218] (asking after Gentile informed Reilly of a $3 billion increase to the Repo 105 limit, "Where did the 3b come from? How far over is fid?"); e-mail from Joseph Gentile, Lehman, to Gerard Reilly, Lehman (Feb. 21, 2008) [LBEX-DOCID 4553220] ("We spoke with grieb and did an analysis which showed we did not spike and he was ok with a temporary excession [in the Repo 105 limit] of $3 [billion].").

[3430] No witness was able to explain to the Examiner why Lehman exceeded, by a significant margin, Lehman's self-imposed Repo 105 limits. Martin Kelly was not involved with the setting or increasing of Lehman's Repo 105 limits at any time while he was Financial Controller. Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 6. In fact, Kelly said he would have had no authority to set a firm-wide Repo 105 limit and that "a broader and more senior group than [him]" would have had authority over those limits. *Id.* Gentile stated unequivocally that authorization from senior Lehman personnel was required to exceed Lehman's firm-wide Repo 105 limit during Gentile's tenure at Lehman (June 2006 through May 2007). Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 7. Gentile explained that "You had to go through the chain of command through the legal entity side of the business to get more Repo 105" and that "FID could never blow by the [Repo 105] limits. . .someone had to approve it." *Id.* If an individual or group at Lehman sought to exceed the Repo 105 limit, according to Gentile, they needed to obtain approval from Grieb for the "excession." *Id.* According to Grieb, the limits on Lehman's Repo 105 usage were not exclusively for quarter-end; rather, they represented the limit for any given moment throughout the quarter. Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 9. Accounting rules applicable to Repo 105 transactions did *not* prescribe a firm-wide limit on Repo 105 usage. *Id.* Rather, Grieb, O'Meara, and Reilly set Repo 105 limits as a prophylactic measure to prevent firm personnel from becoming too reliant upon Repo 105 transactions as a tool for balance sheet relief "just in case that funding source drie[d] up and counterparties los[t] interest." *Id.* During his interview with the Examiner, Grieb had no recollection of the quarter-end amounts of assets moved off Lehman's balance sheet via Repo 105 transactions. *Id.* Grieb recalled, however, that at the time he was Lehman's Financial Controller, he would have read, at least several times a month, reports that listed Lehman's firm-wide Repo 105 usage, but that he simply did not recall the volumes at present. *Id.* When the Examiner showed Grieb a Lehman-prepared chart that indicated the total firm-wide Repo 105 usage at the end of fourth quarter 2007 was $38.634 billion – when Grieb was still Lehman's Controller – Grieb stated that he had no recollection of this number but did not dispute its accuracy and said the figure did not "shock" him. Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 12. When asked to explain how Lehman's firm-wide Repo 105 usage got as high as $39 billion in November 2007, approximately six months after Lehman increased its firm-wide Repo 105 limit to $25 billion, Grieb recalled having discussions with O'Meara and Reilly about possibly increasing Lehman's firm-wide repo limit in mid-to-late-2007. *Id.*

By the close of Lehman's first quarter 2008, February 29, 2008, Lehman's total Repo 105 quarter-end usage was $49.1 billion.[3431] And at the close of Lehman's second quarter 2008, May 30, 2008, Lehman's total Repo 105 usage was $50.38 billion.[3432] Thus, Lehman's use of Repo 105 transactions more than doubled in the span of five reporting periods, from approximately $24 billion at fourth quarter 2006 (November 2006) to $49.1 billion and $50.38 billion at first quarter 2008 (February 2008) and second quarter 2008 (May 2008), respectively.[3433] The Examiner tracked Lehman's actual Repo 105 usage and compared it to the limit as a ratio of tangible equity, as seen in the chart below:

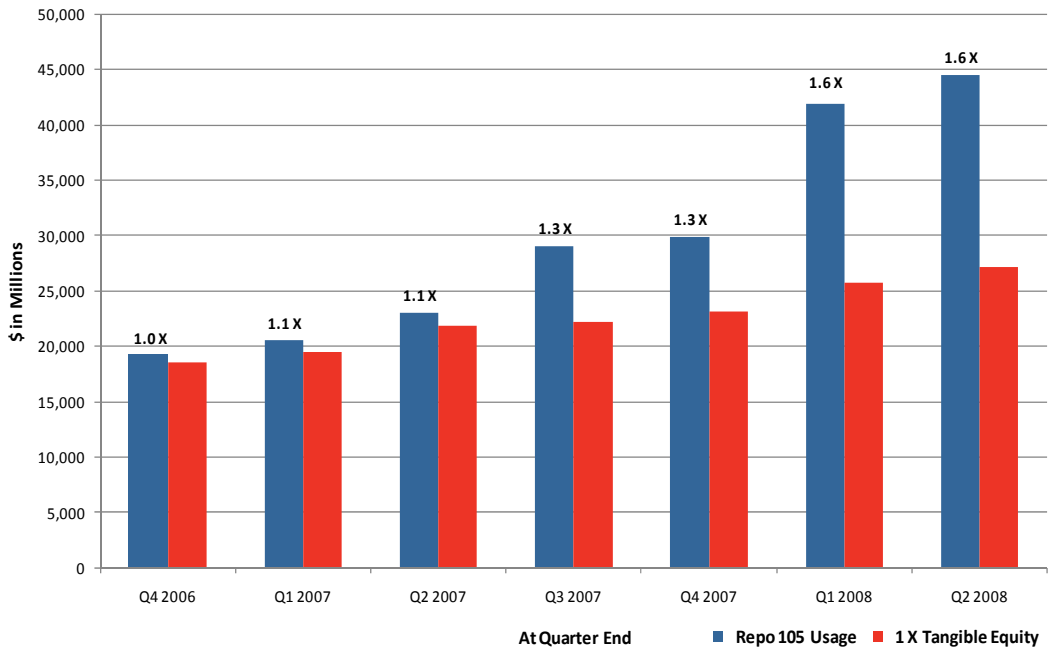
[3431] *See* Lehman, Total Repo 105 & Repo 108 Report (June 11, 2008) [LBEX-DOCID 2078195] (showing February 29 and May 30, 2008 total Repo 105 usage). Note that May 31, 2008 was a Saturday.

[3432] *Id*.

[3433] Lehman, Total Repo 105 & 108 Report (Dec. 13, 2006) [LBEX-DOCID 2521357] (stating November 30, 2006 total Repo 105 usage was $24.519 billion); e-mail from Michael McGarvey, Lehman, to Gerard Reilly, Lehman, *et al.* (May 23, 2007) [LBEX-DOCID 4553348] (stating firm-wide Repo 105 usage projected at $24.5 billion); Lehman, Balance Sheet and Cash Capital (Mar. 27, 2008), at p. 1 [LBEX-DOCID 1698667] (attached to e-mail from Clement Bernard, Lehman to Lisa Rivera, Lehman (Mar. 28, 2008) [LBEX-DOCID 1854835] and showing firm-wide quarter-end Repo 105 usage of $49.1 billion for first quarter 2008); e-mail from Michael McGarvey, Lehman, to Clement Bernard, Lehman, *et al.* (Apr. 15, 2008) [LBEX-DOCID 3221734] ("FID used 42bn in Repo 105 in Q1 and Equities used 7.0b so 49 bn was the total firm number. This was an increase of 24bn from Q4'06.").

Repo 105[1] Usage vs. 1 X Tangible Equity

(Repo 105 Usage as a Multiple of Tangible Equity)



	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
Repo 105 Usage	19,213	20,578	23,054	29,075	29,916	41,844	44,536
1 X Tangible Equity	18,567	19,487	21,881	22,164	23,103	25,696	27,179
Usage X Tangible Equity	1.0 X	1.1 X	1.1 X	1.3 X	1.3 X	1.6 X	1.6 X

1. Please note these amounts refer only to Repo 105, not to combined Repo 105 and Repo 108 amounts.

Sources:

Actual Repo 105/108 Usage:
Q4 2006, Q1, Q2 and Q3 2007: LBEX-DOCID 3363434. Repo 105 Usage is assumed to be the Fixed Income Division's total usage.
Q4 2007: LBEX-DOCID 3219746
Q1 2008: LBEX-DOCID 3219760
Q2 2008: LBEX-DOCID 2078195

Tangible Equity:
Lehman Brothers' SEC 10-K and 10-Q filings.

Repo 105 Limit as 1 X Tangible Equity:
[1] LBEX-WGM 748489: See page 2 for "Operating Rules." See page 5 for suggestion that Tangible Equity is the appropriate measure of leverage.

Clement Bernard, who replaced Gentile in approximately August 2007, did not recall *how* Lehman's firm-wide Repo 105 usage reached $50 billion in early 2008, even though a series of e-mails shown to him revealed that: (1) he was informed of the total Repo 105 usage in 2008; (2) he was informed that the usage had doubled since 2006; and

(3) he pressured FID leaders to meet quarter-end balance sheet targets by means of either sales of assets or Repo 105 transactions.[3434] When asked by the Examiner if the significant increase in Lehman's firm-wide Repo 105 usage in late 2007 and 2008 caused him any alarm, Bernard answered: "no."[3435]

Lehman's Repo 105 usage as of November 30, 2007, February 29, 2008, and May 31, 2008 was "in line with" what John Feraca, the former head of the Secured Funding Desk for Lehman's Prime Services Group, "would have expected" even though it far

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[3434] E-mail from Clement Bernard, Lehman, to Kieran Higgins, Lehman (Feb. 22, 2008) [LBEX-DOCID 1854016] (informing Higgins that "[w]e are currently at 19 bn above our target" and asking him how many Repo 105 transactions he can undertake); e-mail from Clement Bernard, Lehman, to Kaushik Amin, Lehman (Feb. 25, 2008) [LBEX-DOCID 756417] (informing Amin that "[w]e are currently running at 15.0 bn above [net balance sheet target] and we need to go down an extra $5.0 bn for the firm to meet its net leverage limit of 15.2. I need your help on this…"); e-mail from Clement Bernard, Lehman, to Eric Felder, Lehman (Feb. 25, 2008) [LBEX-DOCID 2080410] ("We need to reduce our net Balance sheet to hit the firm target net leverage ratio of 15.2. Currently FID is projected to be $15.0 bn above its limit… Let me know if there is anything you could do to reduce the Balance Sheet and what would [be] the price of doing that."); e-mail from Clement Bernard, Lehman, to Martin Potts, Lehman, *et al.* (Feb. 28, 2008) [LBEX-DOCID 1854189] ("We are looking at selling what ever we can and also doing some more repo 105 [because over balance sheet target by $ 14.3 billion]."); e-mail from Clement Bernard, Lehman, to Mark Cosaitis, Lehman (Feb. 29, 2008) [LBEX-DOCID 2803733] (thanking Cosaitis for his efforts in undertaking Repo 105 transactions using corporate positions during last day of quarter and stating he expects the firm to make the 15.2 net leverage ratio target); Lehman, Balance Sheet and Cash Capital (Mar. 27, 2008), at p. 1 [LBEX-DOCID 1698667] (attached to e-mail from Clement Bernard, Lehman to Lisa Rivera, Lehman (Mar. 28, 2008) [LBEX-DOCID 1854835] and showing $49.1 billion in Repo 105 quarter-end usage first quarter 2008); e-mail from Michael McGarvey, Lehman, to Clement Bernard, Lehman, *et al.* (Apr. 15, 2008) [LBEX-DOCID 3221734] ("FID used 42bn in Repo 105 in Q1 and Equities used 7.0b so 49 bn was the total firm number. This was an increase of 24 bn from Q4'06.").

[3435] Examiner's Interview of Clement Bernard, Oct. 23, 2009, at p. 9. Bernard explained that he had been focused at that time on Lehman's sticky assets – like commercial real estate and leveraged loans – and that he did not pay particular attention to Lehman's use of Repo 105 transactions. *Id.* Bernard did not recall discussions with Reilly, Bernard's supervisor, or anyone else about the volumes of Lehman's Repo 105 usage or discomfort with Lehman's reliance upon Repo 105 transactions. *Id.* Bernard did, however, recall that Reilly wanted Lehman to curtail its use of Repo 105 in 2008, though Bernard could only speculate why. *Id.* Bernard recalled that it would not have been uncommon for Lehman traders to have the ability to move upwards of $2 billion of assets, through Repo 105 transactions, in a single hour as a quarter was ending. *Id.*

exceeded the last known limit of $25 billion, which was in place in early 2007.[3436] The ramp-up in Lehman's firm-wide Repo 105 usage was "probably a combination of an increase in limits and a lack of policing, though probably more of the latter."[3437] Feraca continued: "The fact that we were going to breach the [Repo 105] limit at quarter-end was not an issue for management."[3438] Feraca had no recollection "of anyone saying 'you're over limit,'" nor did he have any recollection of a formal increase of the Repo 105 limit.[3439] "I know why it happened. The business wanted more, needed more, to make targets. The numbers were reported internally, daily, so there was transparency, but there was no stoppage."[3440]

(3) Balance Sheet Targets for FID Businesses Were Unsustainable Without the Use of Repo 105 Transactions

Bart McDade's description of the Repo 105 mechanism for quarter-end balance sheet relief as a "drug" was apt: Repo 105 enhanced Lehman's reported net leverage ratio and without the artificial floor Repo 105 created, balance sheet and net leverage ratio targets were beyond reach. In a March 19, 2008 e-mail to McDade, Andrew Morton, Mark Walsh, and other Lehman personnel, Munir Dauhajire warned that

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[3436] Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 11; *see also* Lehman, Total Repo 105 & Repo 108 Report (Dec. 5, 2007) [LBEX-DOCID 3219746] (showing Repo 105 usage at close of fourth quarter 2007); Lehman, Total Repo 105 & Repo 108 Report (June 11, 2008) [LBEX-DOCID 2078195] (showing Repo 105 usage at close of first quarter and second quarter 2008).

[3437] Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 11.

[3438] *Id.*

[3439] *Id.*

[3440] *Id.*

"RUNNING A FIRM WIDE BALANCE SHEET OF 15.3 X LEVG IS NOT GOING TO BE A SUSTAINABLE BUSINESS MODEL FOR THE FIRM."[3441]

After engaging in over $49.1 billion and $50.38 billion of Repo 105 transactions at the end of the first and second quarters 2008, respectively, by June 2008, when Bart McDade had become President and COO, McDade set a quarter-end Repo 105 target for third quarter 2008 of $25 billion.[3442] The evidence also shows that senior Lehman management sought to completely abolish the firm's use of Repo 105 transactions by the beginning of the fourth quarter 2008.[3443]

The reduction in Repo 105 usage for third became well known throughout the firm.[3444] A July 2008 e-mail noted that "[t]he exec committee wanted the number [of Repo 105] cut in half."[3445] The result of the announced reduction in approved firm-wide

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[3441] E-mail from Munir Dauhajre, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Mar. 19, 2008) [LBEX-DOCID 119728] (all capitals in original).

[3442] One week before close of Lehman's third quarter 2008, Reilly wrote to McGarvey: "How much repo 105 do we have now and how much will we have at 8/31?" E-mail from Gerard Reilly, Lehman, to Michael McGarvey, *et al.* Lehman (Aug. 26, 2008) [LBEX-DOCID 4297834]. McGarvey replied that the forecast at quarter-end was $21 billion in Repo 105 and $3.8 billion in Repo 108. *Id.*; *see also* Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets [Draft] (June 16, 2008) [LBEX-DOCID 012458] (attached to e-mail from Gerard Reilly, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (June 17, 2008) [LBEX-DOCID 011380] and containing balance sheet target and proposing a Repo 105 target of $25 billion for Q3 2008).

[3443] *See* e-mail from Jeff Michaels, Lehman, to Kaushik Amin, Lehman (July 30, 2008) [LBEX-DOCID 613324] ("Repo 105 is going away by Q4…."); e-mail from Jeff Michaels, Lehman, to Kaushik Amin, Lehman, *et al.* (July 31, 2008) [LBEX-DOCID 756327] ("Repo 105 is going to zero in Q4….").

[3444] *See* Section III.A.4.e.2.a of this Report (discussing role of Bart McDade in proposing reduction in Repo 105 usage).

[3445] E-mail from Michael McGarvey, Lehman, to Jormen Vallecillo, Lehman (July 2, 2008) [LBEX-DOCID 3379145]. When questioned about this e-mail, McGarvey could not explain why the Executive Committee had decided to reduce Lehman's Repo 105 usage by half. Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 11.

Repo 105 usage was disquiet. As one internal Lehman presentation put succinctly: "Wean ourselves off Repo 105 ASAP!"[3446]

When in June 2008 Reilly communicated the proposed $25 billion Repo 105 cap for third quarter 2008, Andrew Morton, then-Head of FID, replied: "rates business cannot survive at these levels, ie reducing r105 by 20."[3447] When also in June 2008, Paul Mitrokostas, the Chief Operating Officer of FID, communicated the third quarter 2008 balance sheet target and the fact that FID's Repo 105 limit for that quarter was being reduced to $25 billion, Amin protested that a $55 billion net balance sheet limit for the firm's Rates business, with $22 billion less of Repo 105 capacity available at quarter-end, was unsustainable: "We can't run the business under those parameters."[3448]

Similarly, Jeff Michaels complained to Amin in July 2008 that given the reduction in FID's Repo 105 capacity for third quarter 2008, and the complete curtailment of Repo 105 usage in fourth quarter 2008, "there are not many places we can reallocate balance sheet from if Repo 105 is gone for the inflation book."[3449] In another e-mail, Michaels wrote: "[Repo] 105 is going to zero in Q4, which means we either need more balance

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[3446] Lehman, Global Rates Mid-Year Review 2008 (Sept. 12, 2008) [LBEX-DOCID 659022], at p. 5 (attached to e-mail from Jeff Michaels, Lehman, to Kaushik Amin, Lehman (Sept. 12, 2008) [LBEX-DOCID 679130]). A hard copy of this presentation was also found among Clement Bernard's documents. *See* Lehman, Global Rates Mid-Year Review 2008 (no date) [LBEX-WGM 756153].

[3447] E-mail from Andrew J. Morton, Lehman, to Gerard Reilly, Lehman (June 17, 2008) [LBEX-DOCID 4553446].

[3448] E-mail from Kaushik Amin, Lehman, to Paul Mitrokostas, Lehman, *et al.* (June 20, 2008) [LBEX-DOCID 2319659].

[3449] E-mail from Jeff Michaels, Lehman, to Kaushik Amin, Lehman (July 30, 2008) [LBEX-DOCID 613324]. Inflation book or inventory likely refers to Treasury Inflation Protected Securities ("TIPS"), which are inflation-indexed bonds issued by the United States Treasury.

sheet from FID or we need to make significant reductions in Europe, which has not happened until now. There is no way we can make Q4 balance sheet without Repo 105 unless our inflation inventory is cut by 60-75% from current levels."[3450]

(4) Rating Agencies Advised the Examiner that Lehman's Accounting Treatment and Use of Repo 105 Transactions to Manage Its Net Leverage Ratio Would Have Been Relevant Information

Just as it did in its Forms 10-Q and 10-K, Lehman emphasized its net leverage ratio to the ratings agencies throughout 2008 as Lehman attempted to forestall a ratings downgrade. The concerted effort by Lehman's senior management to cut the balance sheet by half, achieved by reducing the firm's net leverage ratio, and Lehman's public statements about this achievement, improved the firm's standing with at least two of the three rating agencies, Fitch Rating ("Fitch"), and Standard & Poor's ("S&P").[3451]

In May 2008, Lehman gave a presentation to Moody's Investor Service in which one of the key messages in the presentation was that because Lehman had strengthened its capital position through "active deleveraging" including "approximately $50 billion reduction in net assets," no negative rating action for the firm was justified.[3452] The

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[3450] E-mail from Jeff Michaels, Lehman, to Kaushik Amin, Lehman, *et al.* (July 31, 2008) [LBEX-DOCID 756327] (transmitting Lehman, Balance Sheet-Global Rates [LBEX-DOCID 633334], and showing Global Rates business Repo 105 usage).

[3451] Fitch's and S&P's analysis of Lehman took into account the firm's net leverage ratio. Examiner's Interview of Eileen A. Fahey, Sept. 17, 2009, at p. 6; Examiner's Interview of Diane Hinton, Sept. 22, 2009, at p. 5. Moody's, on the other hand, looked primarily to other indicators, particularly risk. Examiner's Interview of Peter E. Nerby, Oct. 8, 2009, at p. 5.

[3452] Lehman, Moody's Investor Service Q2 2008 Update (May 29, 2008), at pp. 1, 4, 6-8 [Moody's Confidential Shared Information 1114-1159].

presentation to Moody's noted that net leverage was expected to decrease from 15.4x to 12.6x and that the net balance sheet reduction of $50.38 billion in second quarter 2008 included key FID high-risk assets, such as commercial and residential mortgages.[3453] Lehman's presentation also noted that the "net leverage ratio" was "heavily quoted by journalists and analysts."[3454]

On June 3, 2008, Lehman gave a similar presentation to Fitch, stating that Lehman did "not believe Q2 '08 results justify any negative rating action for Lehman Brothers."[3455] Lehman told Fitch that its "[c]apital position is stronger than ever with de-levering bringing both net and gross leverage ratios to multi-year lows."[3456]

On June 5, 2008, Lehman made a similar presentation to S&P in which Lehman advanced its position that second quarter 2008 "results [do not] justify any negative rating action for Lehman Brothers"[3457] in part because of Lehman's "shrinkage of the balance sheet."[3458] In that presentation, Lehman advised S&P that "Net balance sheet (primarily inventory) is expected to be almost $70 billion lower than Q1 '08, and gross balance sheet is expected to be almost $140 billion lower."[3459] The presentation also projected that Lehman's net leverage ratio would drop to 12.1x in second quarter

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[3453] *Id.* at pp. 6-7.
[3454] *Id.* at p. 8.
[3455] Lehman, Fitch Ratings Q2 2008 Update (June 3, 2008), at p. 4 [FITCH-LEH BK 00000151].
[3456] *Id.* at p. 40.
[3457] Lehman, S&P Ratings Q2 2008 Update (June 5, 2008), at p. 4 [S&P Examiner 000946].
[3458] *Id.* at p. 6.
[3459] *Id.*

2008.[3460] Another slide in the presentation touted Lehman's historically low net leverage ratio and contrasted it with that of peer investment banks.[3461]

Nowhere in the presentations that Lehman made to the rating agencies in May or June 2008 did Lehman disclose its use of Repo 105 transactions, the impact Repo 105 transactions had on the firm's quarter-end balance sheet, or the impact Repo 105 transactions ultimately had on Lehman's net leverage ratio.[3462]

Following Fitch's decision in June 2008 to downgrade Lehman by one ratings grade, from AA- to A+ (long-term) and F-1+ to F-1 (short-term), Tonucci sent Fitch another Lehman presentation "to consider in the context of a potential appeal."[3463] Lehman marshaled certain facts in defense of its "disagreement" with the ratings downgrade by Fitch. Under the heading "Significant Shrinkage of the Balance Sheet," Lehman informed Fitch that "Net balance sheet (primarily inventory) is expected to be almost $70 billion lower than Q1 '08. . . ."[3464] Not including the impact of the $4 billion common equity and $2 billion non-cumulative preferred offering that Lehman had undertaken in June 2008, Lehman boasted to Fitch that it reduced its net leverage ratio

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[3460] *Id.*

[3461] *Id.* at p. 8.

[3462] *See generally* Lehman, Moody's Investor Service Q2 2008 Update (May 29, 2008) [Moody's Confidential Shared Information 1114-1159]; Lehman, Fitch Ratings Q2 2008 Update (June 3, 2008) [FITCH-LEH BK 00000151]; Lehman, S&P Ratings Q2 2008 Update (June 5, 2008) [S&P Examiner 000946].

[3463] Lehman, Presentation to Fitch Ratings Rating Appeal [Draft] (June 9, 2008) [FITCH-LEH BK 00002449] (attached to e-mail from Paolo R. Tonucci, Lehman, to Eileen A. Fahey, Fitch (June 9, 2008) [FITCH-LEH BK 00002447]).

[3464] *Id.* at p. 2.

from 15.4x in first quarter 2008 to an anticipated 12.0x in second quarter 2008.[3465] Accounting for the equity raise, Lehman touted that it had reached its "lowest leverage ratios since becoming a public firm."[3466]

Lehman, as with its prior presentations to the rating agencies, made no mention in its second presentation to Fitch of its reliance on Repo 105 transactions to manage its balance sheet and net leverage.[3467] Recall that at the end of its second quarter 2008, May 31, 2008 – just weeks before Tonucci sent the presentation to Fitch – Lehman had reduced its net balance sheet by over $50.38 billion using Repo 105 transactions. Yet, despite the significant role of the firm's Repo 105 practice in its balance sheet management, this fact was not disclosed in Lehman's presentations.

The Examiner interviewed representatives from the three leading ratings agencies, Fitch, Standard & Poor's, and Moody's, and none had knowledge of Lehman's use of Repo 105 transactions, either by name or by description.[3468] Not one of the rating agencies was aware that Lehman recorded some volume of repo transactions as true sales to temporarily remove the securities inventory from its balance sheet at quarter-end thereby reducing Lehman's publicly reported leverage ratios.

[3465] *Id.*

[3466] *Id.* at p. 3.

[3467] *See generally id.*

[3468] Examiner's Interview of Eileen A. Fahey, Sept. 17, 2009, at p. 7; Examiner's Interview of Diane Hinton, Sept. 22, 2009, at p. 6; Examiner's Interview of Peter E. Nerby, Oct. 8, 2009, at pp. 5-6.

Eileen Fahey, an analyst at Fitch, said that she had never heard of repo transactions being accounted for as true sales on the basis of a true sale opinion letter or repo transactions known as Repo 105 transactions.[3469] Fahey stated that a transfer of $40 billion or $50 billion of securities inventory – *regardless of the liquidity of that inventory* – from Lehman's balance sheet at quarter-end would be "material" in Fitch's view, and upon having a standard Repo 105 transaction described, Fahey remarked that such a transaction "sounded like fraud."[3470]

The Examiner inquired whether, if Fitch had known about Lehman's use of such transactions to remove assets off its balance sheet at quarter-end, it likely would have affected the Fitch rating of Lehman.[3471] Fahey replied that the transaction spoke to

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[3469] Examiner's Interview of Eileen A. Fahey, Sept. 17, 2009, at p. 7.

[3470] *Id.* While freely admitting that Lehman moved tens of billions of dollars' worth of inventory off the firm's net balance sheet at quarter-end through Repo 105 transactions, and that the moved inventory came back on to the firm's balance sheet a week to ten days later, Kaushik Amin, former Head of Liquid Markets, believed it was immaterial and "completely irrelevant." Examiner's Interview of Kaushik Amin, Sept. 17, 2009, at p. 9. Amin believed that neither the rating agencies nor the investing public would have cared about Lehman's Repo 105 practice because Lehman used liquid inventory. *Id.* In Amin's view, "our risk was not represented any differently because of [Repo] 105." *Id.* Amin's view is belied by the statements of representatives of each of the three main ratings agencies, one of whom said that Lehman's undisclosed Repo 105 activity would have been "material" to the agency's view of Lehman and the other two who said they would have wanted to know of Lehman's Repo 105 activity. Examiner's Interview of Eileen A. Fahey, Sept. 17, 2009, at p. 7; Examiner's Interview of Diane Hinton, Sept. 22, 2009, at p. 6; Examiner's Interview of Peter E. Nerby, Oct. 8, 2009, at p. 5. Like Fahey, when asked whether it would have changed her answers if the securities that were removed from the balance sheet in Repo 105 transactions were liquid, S&P's Hinton responded that it would not. Examiner's Interview of Diane Hinton, Sept. 22, 2009, at p. 6.

[3471] Examiner's Interview of Eileen A. Fahey, Sept. 17, 2009, at p. 7. Fitch used three leverage numbers to assess Lehman, including the net leverage ratio. *Id.* at p. 6.

Lehman's liquidity, and that the impact on Fitch's rating would depend on whether the described transaction was done repeatedly or if it was a one-time occurrence.[3472]

Fahey also remarked that treating a repo transaction as a sale (thereby removing the securities from the transferor's balance sheet) appears to be an accounting manipulation done to make the business look better, as contrasted with an ordinary repo transaction, which she described as a financing transaction done in the regular course of business (and for which the securities remain on the transferor's balance sheet).[3473] Fahey likened this "manipulation" to an investment bank telling regulators that it did not own any mortgage-backed securities when, in fact, it owned them but had temporarily transferred them to a counterparty and was obligated to repurchase them shortly thereafter.[3474]

Diane Hinton, an analyst at Standard & Poor's and the firm's lead analyst for Lehman from April 2007 until July 2008, likewise was unaware of Lehman engaging in Repo 105 transactions.[3475] When the Examiner described the "true sale" accounting treatment of Repo 105 transactions to Hinton, she stated that S&P "would have wanted to know" if Lehman had moved $20 billion, $40 billion, or $50 billion in net assets off its

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[3472] *Id.* at p. 7.
[3473] *Id.*
[3474] *Id.*
[3475] Examiner's Interview of Diane Hinton, Sept. 22, 2009, at p. 6.

balance sheet at quarter-end.[3476] When asked whether it would have changed her answers if the securities that were removed from the balance sheet in Repo 105 transactions were liquid, Hinton responded that it would not.[3477]

Hinton explained that S&P looked at leverage ratios – including the net leverage ratio – in the context of its capital analysis of Lehman. Hinton further explained that S&P began its calculation of the net leverage ratio with information taken solely from Lehman's Forms 10-K and 10-Q, and that "anything that affects the balance sheet is something we would have wanted to know."[3478] She further stated that S&P only tracked Lehman's leverage ratios at quarter-end.[3479] She said that any change in the net leverage ratio would have been relevant, but whether such a change was relevant to S&P's rating of Lehman would depend on other factors and committee deliberations.[3480]

Peter Nerby of Moody's similarly stated that Moody's had no knowledge of Lehman engaging in Repo 105 transactions, either by name or by description.[3481] However, unlike S&P and Fitch, the net leverage ratio did not drive many rating decisions at Moody's.[3482] Nerby said that Lehman would have been aware that Moody's

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[3476] *Id.* While advising the Examiner that she "would have wanted to know" about Lehman's Repo 105 practice, Hinton neither stated nor denied that information about Lehman's use of Repo 105 transactions would have been "material."

[3477] *Id.* at p. 6.

[3478] *Id*. at pp. 5-6.

[3479] *Id.* at p. 6.

[3480] Examiner's Interview of Diane Hinton, Sept. 22, 2009, at p. 6.

[3481] Examiner's Interview of Peter E. Nerby, Oct. 8, 2009, at p. 5.

[3482] *Id.* Moody's focused more on the risk effects of a transaction. *Id.* at p. 6. While a repo transaction that was recorded as a true sale affects a firm's net leverage ratio, it would not affect other ratios (*e.g.*, VaR,

considered net leverage ratio to have "limited usefulness" as revealed by Moody's published rating methodology.[3483] Still, Nerby stated that if Lehman reduced its net balance sheet by $20 billion or up to $50 billion, he would have wanted to know and that Moody's would have looked to see if and where the reduction was captured by some risk measure.[3484]

A number of Lehman witnesses said that Lehman remained at risk for the assets it removed from its balance sheet as a result of Repo 105 transactions because of Lehman's obligation to repurchase the securities and repay the cash borrowing.[3485] A June 2008 e-mail from Dominic Gibb recommended to Martin Kelly that Lehman "have another look" at its definition of "long inventory at risk in the daily balance sheet and disclosure scorecard" because the definition did not include "any of the assets on repo 105/108" even though they are "still at risk."[3486] Gibb concluded: "[W]e are ***understating what we have at risk by a material amount especially around quarter ends***."[3487]

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stress test results, Level III assets to total inventory) and Moody's, according to Nerby, examined all of these ratios. *Id.* Nerby speculated that if the transaction was off balance sheet, it would probably be captured by some other risk measure. *Id.* When the Examiner asked Nerby if Moody's view of Repo 105 transactions would have been impacted if the assets involved were purely liquid assets, Nerby's counsel instructed him not to answer the question, claiming that the question delved into Moody's deliberative process. Examiner's Interview of Peter E. Nerby, Oct. 8, 2009, at p. 6.

[3483] *Id.*

[3484] *Id.*

[3485] Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 11; Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 8; Examiner's Interview of Tejal Joshi, Sept. 15, 2009, at p. 6; Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 9.

[3486] E-mail from Dominic Gibb, Lehman, to Martin Kelly, Lehman, *et al.* (June 19, 2008) [LBEX-DOCID 3233813].

[3487] *Id.* (emphasis added).

(5) Government Regulators Had No Knowledge of Lehman's Repo 105 Program

Lehman did not disclose the fact of its engaging in Repo 105 transactions, or any other information regarding its use of Repo 105 transactions to manage its balance sheet, to Government regulators.[3488]

(a) Officials from the Federal Reserve Bank Would Have Wanted to Know about Lehman's Use of Repo 105 Transactions

From 2003 to 2009, Treasury Secretary Timothy Geithner served as President of the Federal Reserve Bank of New York ("FRBNY"). The Examiner described to Secretary Geithner how Lehman used Repo 105 transactions to remove approximately $50 billion of liquid assets from the balance sheet at quarter-end in 2008 and explained that this practice reduced Lehman's net leverage. Secretary Geithner "did not recall being aware of" Lehman's Repo 105 program, but stated: "If this had been a bank we

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[3488] For example, Lehman's external regulatory reporting did not disclose Lehman's use of Repo 105 transactions to the Office of Thrift Supervision ("OTS") of the Department of the Treasury. OTS was responsible for reviewing Lehman Brothers Bank, FSB ("LBB") and examined the holding company ("LBHI") to determine its influence and connections with LBB. In response to the economic downturn, the OTS decided in 2008 to create a continuous supervision program of Lehman, Merrill Lynch, and Morgan Stanley. Examiner's Interview of Ronald S. Marcus, Nov. 4, 2009, at p. 5. The purpose, as to Lehman, was to obtain a general understanding of Lehman's risk as it related to LBB. *Id.* The OTS documented all of LBHI's repo transactions in its Report of Examination on the secured funding and lending activities of LBI and LBIE, the principal broker-dealer subsidiaries of Lehman Brothers Holdings Inc. ("LBHI"). *See* OTS, Dept. of Treasury, Report of Examination for Lehman Brothers Bank, FSB (Aug. 6, 2007), at pp. 4-5 [LBEX-OTS 000082]. This report was the end-product of an on-site field visit OTS conducted on May 30, 2008. *Id.* Absent from the report is any reference to Repo 105 transactions, either by name or description (*i.e.*, as repo transactions that are treated as true sales for accounting purposes). *Id.* Ronald Marcus, who served as the examiner for the continuous program at Lehman beginning in March 2008 and completed two targeted reviews prior to the bankruptcy, had no knowledge of Lehman's use of Repo 105 transactions. Examiner's Interview of Ronald S. Marcus, Nov. 4, 2009, at p. 11.

were supervising, that [*i.e.*, Lehman's Repo 105 program] would have been a huge issue for the New York Fed."[3489]

Jan Voigts, who was an Examining Officer in FRBNY's Bank Supervision Department, had no knowledge of Lehman removing assets from its balance sheet at or near quarter-end via a repo trade treated as a true sale under a United Kingdom opinion letter.[3490] Voigts was surprised at and unfamiliar with the idea of using a repo to remove assets from the balance sheet under a true sale opinion where those assets would return to the balance sheet the following quarter.[3491] When the Examiner described to Voigts the steps Lehman undertook in a standard Repo 105 transaction, Voigts said that knowledge of such a practice by Lehman would have been "very important" to him.[3492]

After having Repo 105 transactions described to him generally, Voigts differentiated Repo 105 transactions from other forms of balance sheet management like certain matched book repo trading.[3493] Voigts said that he also found interesting that

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[3489] Examiner's Interview of Treasury Secretary Timothy F. Geithner, Nov. 24, 2009, at p. 5. By his comment "if this had been a bank we were supervising," Secretary Geithner meant that the SEC – and not the FRBNY – was the primary regulator of Lehman. *Id.*

[3490] Examiner's Interview of Jan H. Voigts, Oct. 1, 2009, at p. 5.

[3491] *Id.*

[3492] *Id.*

[3493] *Id.* The matched book business consisted of entering into offsetting long and short positions through repo and reverse repo transactions of the same government securities. Under OFFSETTING OF AMOUNTS RELATED TO CERTAIN REPURCHASE AND REVERSE REPURCHASE AGREEMENTS, FASB Interpretation No. 41 (Fin. Accounting Standards Bd. 1994) ("FIN 41"), which may be applied only to repo and reverse repo transactions if certain criteria are satisfied, Lehman could offset the asset (reverse repo) and liability (repo). As a consequence of offsetting the reverse repos and repos, Lehman could include in its balance

Lehman was repoing out treasury securities at a higher haircut than would normally be used for such liquid collateral.[3494] Voigts said he would have wanted to know more about any "off-market" transactions Lehman undertook.[3495]

Arthur Angulo, who was a Senior Vice President in FRBNY's Bank Supervision department, likewise was unaware that Lehman engaged in repo transactions at quarter-end, under a United Kingdom true sale opinion letter, where the assets would be returned to Lehman's balance sheet following the end of the reporting period.[3496] Angulo said that the described repo transactions appeared to go "beyond other types of [permissible] balance sheet management."[3497] Angulo also said that he would have

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sheet totals for repo and reverse repo agreements only as a net amount with each of its counterparties, resulting in a reduction in the size of the gross balance sheet. Offsetting under FIN 41 is optional and permitted only if all of the following requirements (provided in summary form) are met: (1) the repo and reverse are executed with the same counterparty; (2) the repo and reverse have the same explicit settlement date specified at inception of the agreement; (3) the repo and reverse are executed in accordance with a master netting agreement; (4) the securities underlying the repos and reverses exist in "book entry" form; (5) the repos and reverses are settled in a securities transfer system that transfers "book entry" securities and banking arrangements are in place so that the entities must only keep cash on deposit sufficient to cover net payables; and (6) the same account at the clearing bank is used for the cash inflows of the settlement of the reverses and for settlement of the cash outflows of the repos. *See* FIN 41, ¶ 3. "Netting" under FIN 41 is very different from balance sheet reduction achieved by means of Repo 105 transactions. With Repo 105, Lehman: (1) recharacterized a repo transaction (a liability) as a sale, and thereby removed inventory from its balance sheet and (2) borrowed cash without reflecting the borrowing on its financial statements and related disclosures. With FIN 41, two counterparties that owe each other money are simply netting identical transactions and showing the net amounts on the balance sheet.

[3494] Examiner's Interview of Jan H. Voigts, Oct. 1, 2009, at p. 5.

[3495] *Id.*

[3496] Examiner's Interview of Arthur G. Angulo, Oct. 1, 2009, at p. 2.

[3497] *Id.* The question of whether and why some window-dressing may be considered acceptable by the financial community is beyond the scope of the Examiner's Report. The Examiner has investigated Lehman's use of Repo 105 transactions and has concluded that the balance sheet manipulation was intentional, for deceptive appearances, had a material impact on Lehman's net leverage ratio, and,

wanted to know about off-market transactions where Lehman accepted a higher haircut than a repo seller normally would accept for a certain type of collateral.[3498]

Thomas Baxter, FRBNY General Counsel, had no knowledge of Repo 105 transactions, either by name or design.[3499] Baxter was generally aware of firms using quarter-end and month-end "balance sheet window-dressing," but did not recall this being an issue linked to Lehman specifically.[3500]

(b) Securities and Exchange Commission CSE Monitors Were Unaware of Lehman's Repo 105 Program

The Examiner interviewed multiple employees of the Securities and Exchange Commission who had some responsibility to monitor Lehman's business operations as part of the Consolidated Supervised Entity ("CSE") division: Michael Macchiaroli, Phillip Minnick, James Giles, Michelle Danis, Gina Lai, and Raymond Doherty. None had been informed of Lehman's use of Repo 105 transactions.[3501]

The SEC's Matthew Eichner, who was involved with the CSE division, was not aware of Lehman's use of Repo 105 transactions, by name or description, to remove assets from the balance sheet and impact its leverage ratios.[3502] Asked if the SEC – in connection with its monitoring responsibilities under the CSE division – would have

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because Lehman did not disclose the accounting treatment of these transactions, rendered Lehman's Forms 10-K and 10-Q (financial statements and MD&A) deceptive and misleading.

[3498] *Id.*

[3499] Examiner's Interview of Thomas C. Baxter, Jr., Aug. 31, 2009, at pp. 3-4, 9.

[3500] *Id.*

[3501] Examiner's Interview of SEC Staff, Aug. 24, 2009, at pp. 3, 10.

[3502] Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at p. 9.

wanted to know that Lehman's net leverage calculation was based, in part, on "true sale" accounting for certain repo transactions, Eichner explained that because the SEC's CSE monitors did not put much stock in leverage numbers, knowledge of the volumes of Repo 105 transactions would not have signaled to them "that something was terribly wrong."[3503] The SEC's CSE division had the "strong view that, for complicated financial institutions, leverage information is not often going to give you the right answer for a variety of business reasons."[3504]

h) Knowledge of Lehman's Repo 105 Program at the Highest Levels of the Firm

Many former members of senior Lehman management recalled generally Lehman's use of Repo 105 transactions – such as the existence of Lehman's Repo 105 program, that Lehman used these transactions to manage its balance sheet, and that the internal Repo 105 accounting policy had been vetted by outside auditors and lawyers.[3505] These same witnesses, however, disavowed any knowledge on a number of significant topics:[3506]

[3503] *Id.* Note that Eichner was not involved in monitoring public disclosures. His comments about net leverage were made in reference to the SEC's role in monitoring Lehman under the CSE division. *See* Section III.A.6.b of this Report (discussing the SEC's oversight of Lehman and the CSE program).

[3504] Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at p. 9.

[3505] Examiner's Interview of Christopher M. O'Meara, Aug. 14, 2009, at p. 4 (stating he knew that Repo 105 transactions netted down the balance sheet); Examiner's Interview of Herbert H. "Bart" McDade III, Sept. 16, 2009, at p. 4 (stating that Lehman had vetted its Repo 105 policy with Ernst & Young and that inventory was removed from Lehman's balance sheet as a result of Lehman's Repo 105 transactions); Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at pp. 17-19 (acknowledging she was aware, as CFO, that Lehman's Repo 105 practice impacted net balance sheet, that the transactions had to be routed through Europe); Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at pp. 10-12, 14 (acknowledging that he was aware of Lehman's Repo 105 program for many years, that Lehman used the transactions to

- the volumes of Repo 105 transactions that Lehman engaged in at quarter-end;
- that Lehman more than doubled its Repo 105 usage from late 2006 to February and May 2008;
- that Lehman vastly exceeded its self-imposed limits on Repo 105 transactions in 2007 and 2008;
- that Lehman's use of Repo 105 transactions had a material impact on the firm's net leverage ratio; and
- that securities of United States-based Lehman entities were used for Repo 105 transactions.

Notwithstanding the professed ignorance by witnesses of virtually any of these issues central to the scope of Lehman's Repo 105 program, contemporaneous documents demonstrate that many former top executives were regularly apprised of the scope of the firm's Repo 105 usage.[3507] For example, a report entitled the "Balance Sheet

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meet balance sheet targets, that Repo 105 transactions used only liquid inventory, and that Lehman set internal limits on Repo 105 usage but that Chris O'Meara was involved with limit-setting).

[3506] Examiner's Interview of Christopher M. O'Meara, Sept. 23, 2009, at pp. 7-8 (disavowing any knowledge of a cap on Repo 105 usage or volume of Lehman's Repo 105 usage); Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at pp. 17, 20 (disavowing knowledge of the volume of Lehman's Repo 105 transactions and stating she had no awareness of or discussions regarding a cap on Repo 105 usage); Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at pp. 12-13 (stating that he had no recollection of volume of Lehman's Repo 105 usage or that senior management had decided by mid-2008 to reduce Lehman's Repo 105 usage). When the Examiner first interviewed Bart McDade in September 2009, McDade disavowed any knowledge that Lehman's Repo 105 usage every exceeded $20 billion. Examiner's Interview of Herbert H. "Bart" McDade III, Sept. 16, 2009, at p. 4. When the Examiner interviewed McDade a second time, McDade acknowledged that he was aware of the volume of Lehman's Repo 105 usage and that in 2008, he had ordered a firm-wide cap on Repo 105 usage for third quarter 2008 of $25 billion down from more than $50 billion at the end of the second quarter 2008. Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at pp. 2-8.

[3507] The Examiner's role is not to make credibility determinations but rather to point out where a trier of fact would be justified in doing so and, therefore, that a colorable claim exists. The Examiner does not opine one way or another on the credibility of the statements of various officers denying any substantive knowledge of Repo 105 transactions. But the Examiner notes that a trier of fact would have to assess the credibility of individual denials of recollection against the notable, collective lack of memory of a $50

and Disclosure Scorecard," which was circulated to various members of senior Lehman management on a daily basis from April 2008 through September 2008, tracked, among other things, the daily benefit that Repo 105 transactions provided to Lehman's balance sheet.[3508] Lehman created the Daily Balance Sheet and Disclosure Scorecard in April

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billion ongoing program, disclosed on multiple documents, that impacted the report of a critical metric, by the firm's one CEO, a COO and three CFOs.

[3508] This Daily Balance Sheet and Disclosure Scorecard was a more comprehensive PowerPoint version of a daily balance sheet and disclosures scorecard e-mail report that was distributed regularly. The condensed e-mail summary of the report also contained frequent references to Repo 105. The PowerPoint version of the report contained an Executive Summary that also contained frequent references to Repo 105 transactions, as well as global and regional Net Balance Sheet, Gross Balance Sheet, Balance Sheet at Risk, and Cash Capital schedules. This report was regularly distributed to Bart McDade, Chris O'Meara, Erin M. Callan, Ian T. Lowitt, and many other top Lehman executives and members of senior management between April 2008 and September 2008. *See*, *e.g.*, Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 7, 2008 (Apr. 9, 2008) [LBEX-DOCID 520619] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Apr. 9, 2008) [LBEX-DOCID 523578]); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 8, 2008 (Apr. 10, 2008) [LBEX-DOCID 520620] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Apr. 10, 2008) [LBEX-DOCID 523579]); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 9, 2008 (Apr. 10, 2008) [LBEX-DOCID 251339] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Apr. 10, 2008) [LBEX-DOCID 258560]); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 10, 2008 (Apr. 14, 2008) [LBEX-DOCID 251342] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Apr. 14, 2008) [LBEX-DOCID 275231]; Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 11, 2008 (Apr. 14, 2008) [LBEX-DOCID 251344] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Apr. 14, 2008) [LBEX-DOCID 258562]; Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 14, 2008 (Apr. 15, 2008) [LBEX-DOCID 012177] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (Apr. 15, 2008) [LBEX-DOCID 079620]); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 12, 2008 (May 13, 2008) [LBEX-LL 1950262], at p. 1 (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (May 13, 2008) [LBEX-DOCID 3187357] and stating "Rates decreased by $(5.0B) from prior day due to…increased Repo 105 usage. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 22, 2008 (May 27, 2008), at p. 1 [LBEX-LL 1950706] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (May 27, 2008) [LBEX-DOCID 275984] and stating "Global rates net balance sheet decreased ($2.0B), predominantly due to an increase in Repo 105 benefit. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 28, 2008 (May 30, 2008), at p. 1 [LBEX-LL 1950670] (attached to e-mail from Tal Litvin, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (May 30, 2008) [LBEX-DOCID 275995] and stating "Global rates net balance sheet decreased by ($3.1B) primarily due to a decrease in Americas driven by an increased utilization of Repo 105 within the Agency business"); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 29, 2008 (May 30, 2008), at p. 1 [LBEX-LL 1950658] (attached to e-mail from Tal Litvin, Lehman, to

2008 at Bart McDade's specific request and in connection with his role as balance sheet point person.[3509] According to McDade, "I needed a daily scorecard to know where I wanted to push" on balance sheet issues.[3510] McDade recalled that he was focused on the "Repo 105" figures that appeared in many of the Daily Balance Sheet and Disclosure Scorecards.[3511] For example, a column entitled "Repo 105" in the report's Consolidated Balance Sheet Summary clearly documented the volume of Repo 105 transactions undertaken by each Lehman business unit or division.[3512]

(1) Richard Fuld, Former Chief Executive Officer

Richard Fuld, Lehman's former Chief Executive Officer denied any recollection of Lehman's use of Repo 105 transactions.[3513] Fuld said he had no knowledge that Lehman treated any kind of repo transaction as a true sale or that Lehman ever removed from its balance sheet assets transferred in a repo transaction.[3514] In addition, Fuld did not recall having seen any reports referencing the amount of the firm's Repo 105 activity.[3515] Fuld further stated that he did not know that Lehman removed

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Herbert H. (Bart) McDade III, Lehman, *et al.* (June 2, 2008) [LBEX-DOCID 011127] and stating ("Global Rates net balance sheet decreased ($6.5B) . . . [t]he decrease in Europe is coming from increased utilization of Repo 105").

[3509] Examiner's Interview of Herbert H. (Bart) McDade III, Jan. 28, 2010, at p. 8.

[3510] *Id.*

[3511] *Id.* at pp. 8-9.

[3512] *See, e.g.*, Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 8, 2008 (Apr. 10, 2008), at p. 9 [LBEX-DOCID 520620]; Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 18, 2008 (Apr. 21, 2008), at p. 10 [LBEX-DOCID 275233].

[3513] Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at pp. 7-8.

[3514] *Id.*

[3515] *Id.*

approximately $49 and $50 billion in inventory off its balance sheet at quarter-end through the use of Repo 105 transactions in first quarter 2008 and second quarter 2008, respectively.[3516] Fuld said, however, that if he had learned that Lehman was temporarily cleansing its balance sheet of assets at quarter-end through Repo 105 transactions, it would have concerned him.[3517]

Fuld's denial of recollection must be weighed by a trier of fact against other evidence. Fuld recalled having many conversations with his executives about reducing net leverage and emphasized to the Examiner how important it was for Lehman to reduce its net leverage.[3518] The night before the March 28, 2008 Executive Committee meeting, Fuld received materials for the meeting, including an agenda of topics including "Repo 105/108" and "Delever v Derisk" and a presentation that referenced Lehman's quarter-end Repo 105 usage for first quarter 2008 – $49.1 billion.[3519] The materials also were forwarded by Fuld's assistant to other Lehman executives.[3520]

[3516] *Id.*

[3517] *Id.*

[3518] Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at pp. 7-8.

[3519] Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008), at p. 1 [LBEX-DOCID 506399] (attached to e-mail from Angela Judd, Assistant to Richard S. Fuld, Jr., Lehman, to Scott J. Freidheim, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 561761], containing Firm Balance Sheet Details with Repo 105/108 column showing total usage of $49.102 billion and break-out for Repo 105 usage by business group); Lehman, Executive Committee Meeting Material, Agenda (Mar. 28, 2008) [LBEX-DOCID 545869] (attached to e-mail from Angela Judd, Assistant to Richard S. Fuld, Jr., Lehman, to Scott J. Freidheim, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 561761], listing topics for discussion at Executive Committee meeting, including "Repo 105/108" and "Delever v Derisk").

[3520] E-mail from Angela Judd, Assistant to Richard S. Fuld, Jr., Lehman, to Scott J. Freidheim, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 561761]. Fuld's attorney asserted to the Examiner that Fuld does not use a computer, uses only a Blackberry and does not have the ability to open attachments. Examiner's Meeting with Patricia Hynes re: Richard S. Fuld, Jr., Jan. 20, 2010, at p. 2.

It appears that Fuld did not attend the March 28 meeting, but Bart McDade recalled having specific discussions with Fuld about Lehman's Repo 105 usage in June 2008.[3521] Sometime that month, McDade spoke to Fuld about reducing Lehman's use of Repo 105 transactions.[3522] McDade walked Fuld through the Balance Sheet and Key Disclosures document (reproduced in part below) and discussed with Fuld Lehman's quarter-end Repo 105 usage – $38.6 billion at year-end 2007; $49.1 billion at first quarter 2008; and $50.3 billion at second quarter 2008.[3523]

[3521] Richard S. Fuld, Jr., Lehman, Call Log, at pp. 6-7 [LBHI_SEC07940_016911] (showing Fuld had telephone calls the morning of the Executive Committee meeting); Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at pp. 3-4 (stating that Fuld did not attend the March 28, 2008 Executive Committee meeting but that "in quarter three, I certainly talked to Fuld about Repo 105.").

[3522] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 4.

[3523] *Id*. at p. 5; *see also* Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets (Draft) (June 16, 2008), at p. 3 [LBHI_SEC07940_641516].

Other Targets

in $ Billions

Repo 105

	Q4'07	Q1'08	Q2'08	Q3'08 Target
FID Core	$29.7	$42.0	$44.4	$21.0
Equities Core	$1.5	$1.1	$1.4	$1.0
Prime Services	$7.4	$6.0	$4.5	$3.0
Total	**$38.6**	**$49.1**	**$50.3**	**$25.0**

Level III

	Q4'07	Q1'08	Q2'08	Q3'08 Target
Level III Net	$38.9	$40.2	$37.8	$36.0

Other Targets

	Q3'08 Target
Month End Intra Quarter Balance Sheet	
Gross Balance Sheet	$815
Net Balance Sheet	$420
Muni TOB Inventory	$3

LEHMAN BROTHERS

FOIA CONFIDENTIAL TREATMENT
REQUESTED BY LEHMAN BROTHERS HOLDINGS INC.

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LBEX-DOCID 2932594

Based upon their conversation, McDade understood that "Fuld knew, at a basic level, that Repo 105 was used in the firm's bond business" and that Fuld "was familiar with the term Repo 105."[3524] McDade recalled that when he advised Fuld in June 2008 that Lehman should reduce its Repo 105 usage to $25 billion, "Fuld understood that this

[3524] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p.5.

would put pressure on traders."[3525] McDade also recalled that "Fuld knew about the accounting of Repo 105."[3526]

(2) Lehman's Former Chief Financial Officers

Although interview statements given to the Examiner were inconsistent at times, no reasonable dispute exists that each of Lehman's Chief Financial Officers from late 2007 to September 2008 possessed some knowledge of and/or involvement with multiple aspects of Lehman's Repo 105 program, including the existence of firm-wide Repo 105 limits, the volume of Repo 105 activity Lehman engaged in at quarter-end, and Lehman's efforts to manage its balance sheet using Repo 105 transactions.

(a) Chris O'Meara, Former Chief Financial Officer

Chris O'Meara served as Lehman's CFO from December 2004 through December 2007.[3527] No later than July 2006, O'Meara and Ed Grieb, then Global Financial Controller, set a limit or cap on Lehman's firm-wide Repo 105 usage.[3528] According to a July 2006 internal Lehman presentation, O'Meara and Grieb set the limit for Repo 105 at $17 billion or "1 x leverage" and the limit for Repo 108 at $5 billion.[3529] The Examiner

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[3525] *Id.* at p. 6.

[3526] *Id.*

[3527] Examiner's Interview of Christopher M. O'Meara, Aug. 14, 2009, at p. 6.

[3528] Lehman, Global Balance Sheet Overview of Repo 105 (FID)/Repo 108 Equities (July 2006), at p. 2 [LBEX-WGM 748489]; Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 8.

[3529] Lehman, Global Balance Sheet, Overview of Repo 105 (FID)/Repo 108 Equities (July 2006), at p. 2 [LBEX-WGM 748489]. The same document also suggests that total Repo 105 usage should be maintained at 80% tangible equity intra-month. *See* Section III.A.4.f.3 of this Report (discussing continual use rule). When questioned about the calculation of the Repo 105 limit set out in the Global Balance Sheet Overview Presentation, Grieb could not recall the calculation of the limit or whether the "1x leverage or $17 billion"

questioned O'Meara about Lehman's Repo 105 program on two separate occasions. During his first interview, O'Meara disavowed knowledge of the program, stating that he was "not that close to" the Repo 105 issue.[3530] O'Meara further stated during his initial interview that he never instructed Lehman's business units to lower their balance sheets at quarter-end using Repo 105 transactions.[3531]

Internal Lehman documents and interview statements of other witnesses evidence greater involvement than O'Meara recalls. For example, the July 2006 internal Lehman Power Point presentation titled "Overview of Repo 105 (FID)/108 (Equities)" identifies numerous "Operating Rules" related to Lehman's Repo 105 program, including "Repo 105 is capped at $17B (1 x leverage) [per Chris O'Meara and Ed Grieb]"; "Repo 108 is capped at $5B [per Chris O'Meara and Ed Grieb]"; and "Repo 105 transactions must be executed on a continual basis and remain in force throughout the

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definition referred to one of Lehman's leverage ratios or, rather, to tangible equity capital. Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 9. Lehman's Form 10-Q from the same period as the Global Balance Sheet Overview Presentation shows that Lehman's tangible equity capital was $17.4 billion and that the firm's net leverage ratio was 13.8, suggesting that the calculation of Lehman's Repo 105 limit may have been tied to tangible equity capital. Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2006 (Form 10-Q) (filed on July 10, 2006), at p. 58 ("LBHI 10-Q (filed July 10, 2006)"). The Global Balance Sheet Overview Presentation itself suggested that tangible equity is the appropriate measure of leverage. Lehman, Global Balance Sheet, Overview of Repo 105 (FID)/Repo 108 Equities (July 2006), at p. 5 [LBEX-WGM 748489]; *see also* Duff & Phelps, Repo 105/108 Usage vs. Limit Comment (Oct. 16, 2009), at p. 1. Bismal described the "1 x leverage" metric as 1 x the net leverage ratio. Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 10. The conclusion that "1 x leverage" means that the limit was 1 x tangible equity metric is also supported by the fact that the denominator of the net leverage ratio is tangible equity. Duff & Phelps, Repo 105/108 Usage vs. Limit Comment (Oct. 16, 2009), at p. 1 & n. 4. The setting of the Repo 105 limit at 1 x tangible equity implies that senior Lehman management determined Repo 105 usage would be permitted by the firm to reduce Lehman's net leverage ratio by up to one multiple. Duff & Phelps, Repo 105/108 Usage vs. Limit Comment (Oct. 16, 2009), at p. 2.

[3530] Examiner's Interview of Christopher M. O'Meara, Aug. 14, 2009, at p. 29.

[3531] *Id.*

month. To meet this requirement, the amount outstanding at any time should be maintained at approximately 80% of the amount at month-end. [per Chris O'Meara and Ed Grieb]."[3532]

During O'Meara's second interview, the Examiner showed O'Meara the July 2006 presentation.[3533] O'Meara said he had never before seen the presentation and did not know who drafted it.[3534] O'Meara continued that he had "no specific recollection" that he was involved in setting firm-wide limits or caps for Lehman's Repo 105 usage.[3535] When the Examiner asked directly whether he was the "source for the cap on Repo 105," O'Meara said no.[3536] O'Meara further said that he could not recall if anyone ever told him that Repo 105 transactions would help reduce Lehman's balance sheet or net leverage.[3537]

Finally, when asked why Lehman would choose to engage in Repo 105 transactions instead of ordinary repo transactions, given the higher haircut for Repo 105 transactions, O'Meara could not explain, saying only "I'm just not close enough to it."[3538] O'Meara stated also that he could not recall having any conversations regarding

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[3532] Lehman, Global Balance Sheet, Overview of Repo 105 (FID)/Repo 108 Equities (July 2006), at p. 2 [LBEX-WGM 748489].
[3533] Examiner's Interview of Christopher M. O'Meara, Sept. 23, 2009 at p. 6.
[3534] *Id.* at pp. 6-8.
[3535] *Id.*
[3536] *Id.*
[3537] *Id.*
[3538] Examiner's Interview of Christopher M. O'Meara, Sept. 23, 2009, at p. 7.

Lehman's Repo 105 program with Richard Fuld, Joe Gregory, Erin Callan, Ed Grieb, any Government personnel, or anyone from the ratings agencies.[3539]

Grieb, on the other hand, recalled many conversations with O'Meara about Lehman's use of Repo 105 transactions.[3540] Grieb communicated regularly, throughout his tenure as Global Financial Controller – which Grieb recalled lasted for "several years" and ended on December 1, 2007 – with O'Meara and Reilly about firm-wide limits or targets for Lehman's Repo 105 program.[3541]

According to Grieb, he, O'Meara, and Reilly shared responsibilities in setting firm-wide Repo 105 limits for several years, as late as November 2007.[3542] Grieb said that he alone did not have the authority to change or increase the limit or to authorize a person or group to exceed the limit; instead, a change in Lehman's firm-wide Repo 105 limit required consensus among Grieb, O'Meara and Reilly.[3543]

[3539] *Id.*

[3540] Examiner's Interview of Edward Grieb, Oct. 2, 2009, at pp. 10, 12-13.

[3541] *Id.* Grieb stated that he never discussed Repo 105-related issues with Callan or Lowitt, each of whom became CFO after Grieb left his Financial Controller position.

[3542] *Id.*; *see also* Lehman, Global Balance Sheet Overview of Repo 105 (FID)/Repo 108 Equities (July 2006), at p. 2 [LBEX-WGM 748489].

[3543] Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 8. Although acknowledging that he had some role in setting the Repo 105 limits, Grieb denied any recollection of the formula by which Lehman calculated the limits. *Id.* at p. 9. When the Examiner attempted to refresh his recollection with the July 2006 Lehman presentation which stated that the firm-wide cap on Repo 105 was set at "1x leverage," or $17 billion, Grieb stated his belief that the cap was related to firm's "overall leverage ratio." *Id.* But when shown Lehman's Form 10-Q for second quarter 2006 (the same general time period as the July 2006 presentation), which disclosed that Lehman's firm-wide shareholder equity was approximately $17 billion and the firm's net leverage ratio was 13.8x, Grieb stated he was less certain that the Repo 105 limit was calculated on the basis of leverage. *Id.*

A number of other documents show that O'Meara was involved with Lehman's Repo 105 program:

- As CFO, O'Meara regularly received a report titled "Weekly Finance Update," at least one version of which included a reference to the firm's use of Repo 105 transactions.[3544]

- In August 2007, Kentaro Umezaki wrote to O'Meara and others: "FYI: John Feraca is working on Repo 105 for our IG mortgage and real estate assets to reduce our Q3 balance sheet. We've agreed we'd regroup on Tuesday to see to what extent we can utilize that facility for Qend."[3545] The following day, Reilly replied to O'Meara alone: "I thought 105 would be a better answer than the cds structure we talked about. May be no appetite."[3546]

- Another August 2007 e-mail chain regarding Repo 105 usage was forwarded to O'Meara from Reilly.[3547] Around the same time that Grieb recommended to Lehman's Accounting Policy Group that Lehman use the Repo 105 program to remove from the balance sheet certain residual positions from mortgage-backed securitizations, Reilly was pursuing a similar effort.[3548] In a series of e-mails from August 2007, Reilly unsuccessful attempted to transfer non-agency mortgage-backed securities into the Repo 105 program.[3549] Reilly

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[3544] Lehman, Weekly Finance Update, Week Ended August 11, 2006 (Aug. 15, 2006), at p. 11 [LBEX-DOCID 1346667] ("IRP's Net Balance Sheet increased by $5B mostly due to Repo 105.") (attached to e-mail from Polina Savelieva, Lehman to Christopher M. O'Meara, Lehman, *et al.* (Aug. 15, 2006) [LBEX-DOCID 1361132].

[3545] E-mail from Kentaro Umezaki, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Aug. 17, 2007) [LBEX-DOCID 197155].

[3546] E-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman (Aug. 18, 2007) [LBEX-DOCID 197155].

[3547] E-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman (Aug. 19, 2007) [LBEX-DOCID 4553354]; e-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman (Aug. 20, 2007) [LBEX-DOCID 4553358].

[3548] E-mail from Marie Stewart, Lehman, to Brett Beldner, Lehman, *et al.* (Aug. 17, 2007) [LBEX-DOCID 3223803] (discussing Grieb's idea of placing mortgage-backed securities into Repo 105 program).

[3549] E-mail from John Feraca, Lehman, to Gerard Reilly, Lehman (Aug. 18, 2007) [LBEX-DOCID 4553350]; e-mail from Gerard Reilly, Lehman, to John Feraca, Lehman (Aug. 18, 2007) [LBEX-DOCID 4553351]; e-mail from John Feraca, Lehman, to David Sherr, Lehman, *et al.* (Aug. 19, 2007) [LBEX-DOCID 4553352]; e-mail from David Sherr, Lehman, to Gerard Reilly, Lehman, *et al.* (Aug. 19, 2007) [LBEX-DOCID 4553353]; e-mail from Gerard Reilly, Lehman, to John Feraca, Lehman, *et al.* (Aug. 19, 2007) [LBEX-DOCID 4553356]; e-mail from John Feraca, Lehman, to David Sherr, Lehman, *et al.* (Aug. 20, 2007) [LBEX-DOCID 4553357].

enlisted the help of John Feraca and David Sherr in this effort so that Lehman could reduce its mortgage positions through the Repo 105 program.[3550] Notably, Reilly kept O'Meara informed of these efforts by forwarding to him the e-mail communications with Feraca and Sherr.[3551] At the same time, per O'Meara's request, Grieb made inquiries regarding a potential credit default swap structure for Lehman's RMBS and CMBS securities in addition to the plan to move them into the Repo 105 program.[3552] Specifically, O'Meara told Reilly that "the plan is to do both [Repo 105 and credit default swap] if all checks out fine with legal and accounting."[3553]

Documents also establish that O'Meara continued to be involved in Lehman's Repo 105 program after leaving the CFO position in December 2007[3554] and taking on the role of Chief Risk Officer:

[3550] E-mail from John Feraca, Lehman, to Gerard Reilly, Lehman (Aug. 18, 2007) [LBEX-DOCID 4553350]; e-mail from Gerard Reilly, Lehman, to John Feraca, Lehman (Aug. 18, 2007) [LBEX-DOCID 4553351]; e-mail from John Feraca, Lehman, to David Sherr, Lehman, *et al.* (Aug. 19, 2007) [LBEX-DOCID 4553352]; e-mail from David Sherr, Lehman, to Gerard Reilly, Lehman, *et al.* (Aug. 19, 2007) [LBEX-DOCID 4553353]; e-mail from Gerard Reilly, Lehman, to John Feraca, Lehman, *et al.* (Aug. 19, 2007) [LBEX-DOCID 4553356]; e-mail from John Feraca, Lehman, to David Sherr, Lehman, *et al.* (Aug. 20, 2007) [LBEX-DOCID 4553357].

[3551] E-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman (Aug. 19, 2007) [LBEX-DOCID 4553354]; e-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman (Aug. 20, 2007) [LBEX-DOCID 4553358].

[3552] E-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman (Aug. 20, 2007) [LBEX-DOCID 197157].

[3553] *Id.*

[3554] Lehman's fiscal year ended on November 30, 2007. Though Lehman did not file its 2007 10-K – signed by Callan – until January 29, 2008, O'Meara served as CFO for the entire period reflected in the 2007 10-K. Moreover, the Examiner has located evidence suggesting that O'Meara sub-certified the 2007 10-K for Callan and was responsible for certain financial reporting in Lehman's Form 10-Q for first quarter 2008. *See* Lehman Brothers Holdings Inc., Reporting Instructions, Quarter Ended February 29, 2008 (Feb. 22, 2008), at p. 5 ([LBEX-DOCID 3756724] (stating that O'Meara was the certifier for the Review of Risk Management narrative for accuracy of MD&A discussions of credit risk, market risk, operational risk, reputational risk, value at risk, other measures of risk and distribution of trading revenues); e-mail from Martin Kelly, Lehman, to Ian T. Lowitt, Lehman (July 8, 2008) [LBEX-DOCID 2329856] ("[W]ould you like to have Erin sign a sub-certification letter (not necessary strictly speaking but we did have Chris sub-certify to Erin at year end."); e-mail from Martin Kelly, Lehman, to Erin M. Callan, Lehman (July 9, 2008) [LBEX-DOCID 1536331] (asking Callan "if I could have you sub-certify on the quarter[ly report] (Chris [O'Meara] sub-certified to you at year end)"); e-mail from Ian T. Lowitt, Lehman, to Martin Kelly, Lehman (July 9, 2008) [LBEX-DOCID 2329856] ("I spoke to Tom [Russo about sub-certification] and he

- O'Meara received a March 2008 e-mail transmitting an internal presentation, "Balance Sheet and Cash Capital Update," that illustrated the quarter-end volume of Repo 105 transactions for first quarter 2008, $49.102 billion, and broke out the amount of Repo 105 usage by business segment.[3555]

- An April 11, 2008 e-mail from O'Meara to Reilly indicates that the two men were planning to discuss Lehman's Repo 105 program on April 14, 2008.[3556]

- An e-mail from Traversari to O'Meara reveals that O'Meara asked Traversari questions about daily balance sheet management at Lehman "compared to traditional banks."[3557] Traversari wrote to O'Meara that one reason why Lehman's balance sheet was larger intra-month than at month-end was because, unlike other banks, Lehman used Repo 105 transactions "which are UK-based specific transactions on opinions received by LEH from Linklaters."[3558]

- When Lehman was facing "significant reduction in repo 105 availability for month end" only ten days before the close of the second quarter 2008 because certain counterparties "retrenched" and Lehman had already used its available credit line with Mizuho, Matthew Pinnock asked Tonucci to "speak[] with O'Meara for a temp increase [in repo 105] to get us over month end."[3559] Tonucci inquired: "Any room to upsize Mizuho?"[3560] O'Meara thereafter continued the discussion with Tonucci by telephone.[3561]

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thinks better if didn't come from him and better to present as consistent with what Chris did when Erin overlapped.").

[3555] Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008), at p. 1 [LBEX-DOCID 506398] (attached to e-mail from Christopher M. O'Meara, Lehman, to James Emmert, Lehman (Mar. 28, 2008) [LBEX-DOCID 574581]).

[3556] E-mail from Christopher M. O'Meara, Lehman, to Gerard Reilly, Lehman (Apr. 11, 2008) [LBEX-DOCID 4553298].

[3557] E-mail from Ryan Traversari, Lehman, to Christopher M. O'Meara, Lehman (May 16, 2008) [LBEX-DOCID 3233899].

[3558] *Id.*

[3559] E-mail from Matthew Pinnock, Lehman, to Paolo R. Tonucci, Lehman (May 21, 2008) [LBEX-DOCID 1548431]. Tonucci replied that he would speak with O'Meara about a Repo 105 increase. *See* e-mail from Paolo R. Tonucci, Lehman, to Matthew Pinnock, Lehman (May 21, 2008) [LBEX-DOCID 1548433].

[3560] E-mail from Paolo R. Tonucci, Lehman, to Christopher M. O'Meara, Lehman (May 21, 2008) [LBEX-DOCID 1533687]; *see also* e-mail from Jeff Michaels, Lehman, to Kaushik Amin, Lehman (May 21, 2008) [LBEX-DOCID 3234376] (regarding Repo 105 counterparties, Pinnock reports that Tonucci "understands urgency and is discussing with O'Meara"); e-mail from Jeff Michaels, Lehman, to Kaushik Amin, Lehman

- A June 17, 2008 e-mail from Reilly to O'Meara, McDade, Lowitt, and Morton, attached a "strawman target doc for Q3" entitled "Balance Sheet and Key Disclosures 2008 3Q Targets."[3562] The attachment, dated June 16, 2008, identified not only net and gross balance sheet targets for various Lehman business groups, but also contained a Repo 105 target chart.[3563] The Repo 105 target chart noted the total volume of Repo 105[3564] transactions Lehman engaged in at quarter-end for fourth quarter 2007 ($38.6 billion), first quarter 2008 ($49.1 billion), and second quarter 2008 ($50.3 billion).[3565] On June 17, 2008, O'Meara replied to Reilly and the other recipients of Reilly's e-mail, stating: "A meeting is being set up to discuss this, this week."[3566]

- When Bank of France terminated a Repo 105 trade in September 2008, O'Meara received an e-mail with subject line "IRP LBI inventory risk" informing him of the fail.[3567]

- In addition, O'Meara received a recurring report between April and September 2008, the "Daily Balance Sheet Disclosure Scorecard," which often referenced Repo 105 activity and its impact on Lehman's balance sheet.[3568]

(May 21, 2008) [LBEX-DOCID 3234378] (stating, in response to Amin's request, that Amin can get an additional $3.5 billion of Repo 105 with Mizuho "[i]f O'Meara and Paolo let us").

[3561] E-mail from Christopher M. O'Meara, Lehman, to Paolo R. Tonucci, Lehman (May 21, 2008) [LBEX-DOCID 1533688].

[3562] Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets [Draft] (June 16, 2008) [LBEX-DOCID 3363493] (attached to e-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (June 17, 2008) [LBEX-DOCID 3383643].

[3563] Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets [Draft] (June 16, 2008), at p. 3 [LBEX-DOCID 3363493].

[3564] The chart refers only to Repo 105, but Lehman frequently used "Repo 105" to refer to both Repo 105 and Repo 108. The figures used in the chart are consistent with the total combined Repo 105/108 amounts reported in other documents.

[3565] Brothers, Balance Sheet and Key Disclosures 2008 3Q Targets [Draft] (June 16, 2008), at p. 3 [LBEX-DOCID 3363493].

[3566] E-mail from Christopher M. O'Meara, Lehman, to Gerard Reilly, Lehman, *et al.* (June 17, 2008) [LBEX-DOCID 033813]. The meeting appears to have taken place on Thursday, June 19, 2008. *See* e-mail from Gerard Reilly, Lehman, to Janet Marrero, Lehman (June 19, 2008) [LBEX-DOCID 4553465] ("Can you print me 6 copies of this [Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets] for the meeting at 3:30 [?]").

[3567] E-mail from Jeffrey Goodman, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Sept. 17, 2008) [LBEX-DOCID 182776] (Jeff Michaels: "Just to be clear, I am not hedging this risk because I know it is substantially wrong. Bank of France terminated a repo 105 trade yesterday as it went through LBIE…." Goodman: "Can we get ops/mo to book terminates/sales for positions that we know to be terminated so we can have a semblance of reality in what we are showing in the systems?")

[3568] *See, e.g.*, Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 7, 2008 (Apr. 9, 2008) [LBEX-DOCID 520619], at p. 9 (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 9, 2008) [LBEX-DOCID 523578] and showing consolidated FID and Equities balance sheet reduced by $18.527 billion and Prime Services balance sheet reduced by $4.458 billion through Repo 105 transactions as of April 7, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 8, 2008 (Apr. 10, 2008) [LBEX-DOCID 520620], at p. 9 (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 10, 2008) [LBEX-DOCID 523579] and showing consolidated FID and Equities balance sheet reduced by $18.853 billion and Prime Services balance sheet reduced by $4.562 billion through Repo 105 transactions as of April 8, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 9, 2008 (Apr. 10, 2008) [LBEX-DOCID 251339], at p. 9 (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 10, 2008) [LBEX-DOCID 258560] and showing consolidated FID and Equities balance sheet reduced by $19.688 billion and Prime Services balance sheet reduced by $4.548 billion through Repo 105 transactions as of April 9, 2008); Balance Sheet and Disclosure Scorecard for Trade Date April 10, 2008 [LBEX-DOCID 251342], at p. 9 (attached to e-mail from Tal Litvin, Lehman to Christopher M. O'Meara, Lehman, *et al.* (Apr. 14, 2008) [LBEX-DOCID 275231] and showing consolidated FID and Equities balance sheet reduced by $19.967 billion and Prime Services balance sheet reduced by $4.491 billion through Repo 105 transactions as of April 10, 2008); Balance Sheet and Disclosure Scorecard for Trade Date April 11, 2008 [LBEX-DOCID 251344], at p. 9 (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 14, 2008) [LBEX-DOCID 258562] and showing consolidated FID and Equities balance sheet reduced by $20.260 billion and Prime Services balance sheet reduced by $4.517 billion through Repo 105 transactions as of April 11, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 12, 2008 (May 13, 2008) [LBEX-LL 1950262], at p. 1 (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (May 13, 2008) [LBEX-DOCID 3187357] and stating "Rates decreased by $(5.0B) from prior day due to . . . increased Repo 105 usage. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 22, 2008 (May 27, 2008), at p. 1 [LBEX-LL 1950706] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (May 27, 2008) [LBEX-DOCID 275984] and stating "Global rates net balance sheet decreased ($2.0B), predominantly due to an increase in Repo 105 benefit. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 28, 2008 (May 30, 2008), at p. 1 [LBEX-LL 1950670] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (May 30, 2008) [LBEX-DOCID 275995] and stating "Global rates net balance sheet decreased by ($3.1B) primarily due to a decrease in Americas driven by an increased utilization of Repo 105 within the Agency business"); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 29, 2008 (May 30, 2008), at p. 1 [LBEX-LL 1950658] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (June 2, 2008) [LBEX-DOCID 011127] and stating ("Global Rates net balance sheet decreased ($6.5B)…[t]he decrease in Europe is coming from increased utilization of Repo 105"); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date June 18, 2008 (June 20, 2008) [LBEX-LL 1950514] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (June 20, 2008) [LBEX-DOCID 275942] and stating that "Global rates net balance sheet decreased . . . driven by a[n] . . . increase in Repo 105 utilization. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date August 13, 2008 (Aug. 14, 2008) [LBEX-LL 782812] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Aug. 14, 2008) [LBEX-DOCID 4214810] and stating that "Global rates net balance sheet decreased . . . driven by an increase in Repo 105 benefit. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date August 25, 2008 (Aug. 26, 2008) [LBEX-LL 782924] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Aug. 26, 2008) [LBEX-DOCID 079536] and stating that "Global Rates net balance sheet

(b) Erin Callan, Former Chief Financial Officer

Erin Callan served as Lehman's CFO from December 1, 2007 until June 12, 2008.[3569] In her interview with the Examiner, Callan recalled very little about Lehman's Repo 105 program.[3570] Callan said she had little to no independent recollection of Lehman's use of Repo 105 transactions, but that her memory had been refreshed to a limited extent by documents the Examiner provided to her in advance of her interview.[3571]

Martin Kelly told the Examiner that he spoke to Callan about Kelly's discomfort with Lehman's use of Repo 105 transactions, raising five discrete concerns about Repo 105: (1) Kelly's discomfort with the possible "reputational risk" Lehman would suffer if the investing public and analysts learned that Lehman used Repo 105 transactions solely to reduce its balance sheet; (2) the size of Lehman's Repo 105 program, that is, the volume of Repo 105 transactions that Lehman undertook at quarter-end to reduce its balance sheet; (3) the "technical basis," from an accounting perspective, by which Lehman was authorized to engage in Repo 105 transactions; (4) Kelly's belief that none of Lehman's peer investment banks used Repo 105 transactions; and (5) the fact that Lehman's Repo 105 activity was "skewed at quarter-end," in other words, that the

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decreased…driven by an increase in repo 105 usage …."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date August 28, 2008 (Aug. 29, 2008) [LBEX-LL 782966] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Aug. 29, 2008) [LBEX-DOCID 275880] and stating that "Global rates [net balance sheet] was down…driven by increased Repo 105 benefit….").

[3569] Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at pp. 7-9.

[3570] *Id.* at p. 17.

[3571] *Id.*

firm's Repo 105 usage spiked at quarter-end, during Lehman's reporting periods.[3572] Kelly recalled having several conversations with Callan about Lehman's use of Repo 105 transactions.[3573]

With regard to Kelly's discussion with Callan of the very technical accounting basis underlying Lehman's reliance on Repo 105 transactions, Kelly "wanted Callan to make sure Repo 105 transactions were being accounted for properly."[3574] Indeed, Kelly recalled a detailed discussion with Callan about each of SFAS 140's requirements for a transaction to receive "true sale" accounting treatment.[3575] Kelly "wanted to present [to Callan] a balanced analysis of the transactions . . . what GAAP requires and . . . [whether] we compl[ied] with GAAP."[3576]

With respect to the issue that none of Lehman's peer investment banks used Repo 105 transactions, Kelly informed Callan of this understanding because he "was trying to give Callan a balanced presentation or analysis" and "wanted to frame the quantum of risk involved in the program."[3577]

Callan recalled speaking to Kelly in late February or March 2008 about Repo 105 transactions, and recalled that Kelly advised her that he was unsure whether Lehman's

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[3572] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 8; *see also* Section III.A.4.f of this Report.
[3573] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 9.
[3574] *Id.*
[3575] *Id.*
[3576] *Id.*
[3577] *Id.* at p. 10.

peer CSE firms were also engaging in Repo 105 transactions at that time.[3578] Callan did not dispute Kelly's account of his conversations with her about the potential "reputational risk" Lehman's Repo 105 program might have posed to the firm, but did not specifically recall Kelly's comments.[3579] Callan speculated that Kelly's concerns about "reputational risk" likely were subsumed in his concerns about whether Lehman was the only Wall Street firm using Repo 105-type transactions.[3580]

According to Callan, she and Kelly agreed that Kelly should determine whether Lehman was the lone user of Repo 105-type transactions on Wall Street and, if so, to ensure the practice was appropriate.[3581] In addition, Callan recalled that she and Kelly agreed that Kelly would consult with Ernst & Young and certain of Lehman's business units about the firm's Repo 105 practices.[3582] Callan, however, could not recall whether Kelly followed through on their conversation or whether he ever reported back to Callan with his findings.[3583] Callan suggested that Kelly's concerns about Lehman's Repo 105 program likely fell by the wayside, given Bear Stearns' near collapse shortly after their conversation, and that she and Kelly became deeply engaged in more pressing issues at that time, such as capital raises and setting balance sheet limits.[3584]

[3578] Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at p. 17.
[3579] *Id.*
[3580] *Id.*
[3581] *Id.*
[3582] *Id.*
[3583] Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at p. 17.
[3584] *Id.*

Kelly advised the Examiner that, based upon Callan's reaction to his concerns about Lehman's use of Repo 105 transactions, Kelly "inferred general awareness of what the program was and how it was used" at the senior management level within Lehman and that assuaged his concerns at least to a certain extent.[3585] According to Kelly, Callan's initial response was to "gather facts and think about it" but she eventually "acknowledged there was risk and that [Kelly] felt discomfort."[3586] Kelly "[couldn't] say she [Callan] shared the concern."[3587]

Specifically as regards the issue of quarter-end spikes in Repo 105 usage, Kelly recalled that Callan merely "acknowledged" or "understood" Kelly's concern that "the program increased significantly at quarter-end," but that Callan appeared not to be surprised at the quarter-end increases.[3588] All told, Kelly said that it was his impression that Callan understood each of the issues he raised, but nonetheless that Callan authorized Lehman's continued use of Repo 105 transactions.[3589] Although one

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[3585] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at pp. 8, 10.

[3586] *Id.*

[3587] *Id.*

[3588] *Id.* Although he agreed that the volume of Lehman's Repo 105 transactions gave him concern as a general matter, Kelly was unable to specifically recall the approximate volume of Lehman's Repo 105 usage at each quarter-end. *Id.* Kelly had no specific recollection of the tens of billions of dollars in Lehman's total Repo 105 usage at quarter-end for fourth quarter 2007, first quarter 2008 and second quarter 2008, even though those figures were reported in numerous charts and e-mails Kelly received and which the Examiner used as exhibits during the interview. Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 11; *see also* Repo 105 & Repo 108 Current Day Report (Nov. 30, 2007) [LBEX-DOCID 3238268] (showing over $38 billion of total Repo 105 usage on November 30, 2007 and attached to e-mail from Anuraj Bismal, Lehman, to Martin Kelly, Lehman, *et al.* (Dec. 5, 2007) [LBEX-DOCID 3223389] (stating "We ended the year with $38 Billion of repo 105/8 nettings")).

[3589] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 10.

December 2007 document states that "Repo 105 [was] a conversation at the CFO level,"[3590] Callan said that Lehman's use of Repo 105 transactions was "not high on [her] list," and that she did not recall spending "any meaningful amount of time on the topic at all."[3591] Asked if she recalled Lehman having engaged in $50 billion worth of Repo 105 transactions at the end of first quarter 2008, Callan said no, and said that she had thought the total amount was approximately "twenty something."[3592]

Callan told the Examiner that she did not recall engaging in any discussions about Repo 105 transactions with Fuld, McDade, Gregory, Tonucci, Lehman's Executive Committee, or Ernst & Young.[3593] Callan said she had no recollection of any internally set caps or limits on Lehman's Repo 105 usage.[3594]

Callan, however, attended the March 28, 2008 Executive Committee meeting requested by McDade to make certain balance sheet reduction recommendations.[3595] The night before the meeting, McDade's assistant circulated to Callan and other members of the Executive Committee two documents in connection with the meeting:

[3590] E-mail from Marie Stewart, Lehman, to Dominic Gibb, Lehman, *et al.* (Dec. 21, 2007) [LBEX-DOCID 3223846] ("[O]ur use of Repo 105 is a conversation at the CFO level at this point….Also, I think anymore on this topic is best by conversations and not email.").

[3591] Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at p. 17.

[3592] *Id.*

[3593] *Id.*

[3594] *Id.* Callan and Kelly's direct predecessors, O'Meara and Grieb, respectively set the firm's Repo 105 limits. *See* Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 2 [LBEX-WGM 754587] ("Repo 105 is capped at $17B (1x leverage) [per Chris O'Meara and Ed Grieb]" and "Repo 108 is capped at $5 B [per Chris O'Meara and Ed Grieb].").

[3595] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 4 (stating that the entire Executive Committee, except for Fuld, and *ex officio* members Lowitt and Friedheim attended the March 28, 2008 meeting).

(1) an agenda, listing "Repo 105/108" as one of seven topics to be discussed, and (2) a "Balance Sheet and Cash Capital Update," the first page of which included various firm-wide financial data, including a column titled "Repo 105/108," which listed the $49.1 billion in Repo 105 transactions that Lehman had undertaken at the end of the first quarter 2008.[3596] The presentation also broke out the volumes of Repo 105 usage by business segment.[3597] McDade specifically recalled discussing with Executive Committee members on March 28, 2008, Lehman's use of Repo 105 transactions and recommending that Lehman place a cap on Repo 105.[3598] On April 9, 2008, twelve days after McDade's presentation to the Executive Committee, Callan signed Lehman's quarterly report for first quarter 2008.[3599]

During her tenure as CFO, Callan received numerous other documents that referenced Lehman's use of Repo 105 transactions to meet balance sheet targets.

- In a January 2008 e-mail, Reilly forwarded Callan an e-mail in which McGarvey informed Bernard that Rates (a business within the Fixed Income Division) was running over its balance sheet target for December 2007 by $72.3 billion and that a contributing factor was that Rates was using $18 billion less in Repo 105 transactions in December 2007 because there was

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[3596] Herbert H. (Bart) McDade III, Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008), at p. 1 [LBEX-DOCID 095966] (attached to e-mail from Gerard Reilly, Lehman, to Erin M. Callan, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 124422] and indicating that the attachment is for the Executive Committee meeting)); *see also* Herbert H. (Bart) McDade III, Lehman, Executive Committee Meeting Material, Agenda (Mar. 28, 2008) [LBEX-DOCID 115827] (attached to e-mail from Patricia Lombardi, Assistant to Herbert H. (Bart) McDade III, to Lehman Executive Committee Members, Lehman (Mar. 28, 2008) [LBEX-DOCID 120929] and listing among seven topics of discussion for March 28, 2008 Executive Committee meeting "Repo 105/108" and "Delever v Derisk"). Callan was a member of the Executive Committee.

[3597] Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008), at p. 1 [LBEX-DOCID 095966].

[3598] *Id.* at pp. 3-4.

[3599] LBHI, 10-Q (filed Apr. 9, 2008), at p. 92, 31.02.

little counterparty appetite.[3600] In his e-mail to Callan, Reilly referenced the balance sheet overage and stated, "Repo 105 liquidity was very tight (this should only be a year end issue but I don't recall it being this material in the past)."[3601]

- In February 2008, Reilly again wrote Callan, forwarding to her an e-mail with an attached FID Balance Sheet PowerPoint presentation that "was used to educate sr fid guys on the bs and generate ideas to make the bs target."[3602] The e-mail forwarded to Callan noted that the FID team working on balance sheet issues had reached the "recommendation that Repo 105 program is expanded."[3603]

- In March 2008, Reilly e-mailed Callan, as well as Lowitt and McDade, to report on the net balance sheet trend since the end of the first quarter. Reilly wrote: "Rates is way up w PT trade and drop off in Repo 105."[3604]

- From April through the end of June 2008, Callan received the "Daily Balance Sheet Scorecard," which routinely referenced the impact of Lehman's Repo 105 transactions on the firm's daily balance sheet.[3605]

[3600] E-mail from Gerard Reilly, Lehman, to Erin M. Callan, Lehman (Jan. 3, 2008) [LBEX-DOCID 3383445].

[3601] *Id*.

[3602] E-mail from Gerard Reilly, Lehman, to Erin M. Callan, Lehman (Feb. 1, 2008) [LBEX-DOCID 3383459] (transmitting Lehman Brothers, FID - Balance Sheet (Jan. 17, 2007) [LBEX-DOCID 3363222]).

[3603] E-mail from Gerard Reilly, Lehman, to Erin M. Callan, Lehman (Feb. 1, 2008) [LBEX-DOCID 3383459]

[3604] E-mail from Gerard Reilly, Lehman, to Erin M. Callan, Lehman (Mar. 20, 2008) [LBEX-DOCID 3221723] (transmitting Daily Net Average Assets March 2008 schedule [LBEX-DOCID 3215629]).

[3605] *See, e.g.*, Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 7, 2008 (Apr. 9, 2008), at p. 9 [LBEX-DOCID 520619] (attached to e-mail from Tal Litvin, Lehman, to Erin M. Callan, Lehman, *et al.* (Apr. 9, 2008) [LBEX-DOCID 523578] and showing consolidated FID and Equities balance sheet reduced by $18.527 billion and Prime Services balance sheet reduced by $4.458 billion through Repo 105 transactions); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 10, 2008 (Apr. 14, 2008), at p. 9 [LBEX-DOCID 251342] (attached to e-mail from Tal Litvin, Lehman, to Erin M. Callan, Lehman, *et al.* (Apr. 14, 2008) [LBEX-DOCID 275231] and showing consolidated FID and Equities balance sheet reduced by $19.967 billion and Prime Services balance sheet reduced by $4.491 billion through Repo 105 transactions); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 11, 2008 (Apr. 14, 2008), at p. 9 [LBEX-DOCID 251344] (attached to e-mail from Tal Litvin, Lehman, to Erin M. Callan, Lehman, *et al.* (Apr. 14, 2008) [LBEX-DOCID 258562] and showing consolidated FID and Equities balance sheet reduced by $20.260 billion and Prime Services balance sheet reduced by $4.517 billion through Repo 105 transactions); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 12, 2008 (May 13, 2008), at p. 1 [LBEX-LL 1950262] (attached to e-mail from Tal Litvin, Lehman, to Erin M. Callan, Lehman, *et al.* (May 13, 2008) [LBEX-DOCID 3187357] and stating "Rates decreased by $(5.0B) from prior day due to . . . increased Repo 105 usage. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date

(c) Ian Lowitt, Former Chief Financial Officer

Ian Lowitt served as Lehman's CFO from June 12, 2008 through LBHI's bankruptcy filing on September 15, 2008.[3606] Prior to his appointment to the CFO position, Lowitt served as Lehman's co-CAO.[3607]

Lowitt acknowledged that Lehman initiated its Repo 105 program "at some point in the early 2000s."[3608] Asked to describe how he came to be aware of Lehman's Repo 105 program, Lowitt recalled that Lehman had established a "regime" of month-end balance sheet targets for each business unit, and that each business unit had the discretion to determine how to meet that target with support from Product Control and Finance.[3609] One means available to the Fixed Income and Equities Divisions for reaching balance sheet targets, Lowitt recalled, was by "sell[ing] down assets" through Lehman's Repo 105 program.[3610] Lowitt recalled senior Lehman management setting aggressive targets to reduce commercial and residential real estate inventory, but he

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May 22, 2008 (May 27, 2008), at p. 1 [LBEX-LL 1950706] (attached to e-mail from Tal Litvin, Lehman, to Erin M. Callan, Lehman, *et al.* (May 27, 2008) [LBEX-DOCID 275984] and stating "Global rates net balance sheet decreased ($2.0B), predominantly due to an increase in Repo 105 benefit. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 28, 2008 (May 30, 2008), at p. 1 [LBEX-LL 1950670] (attached to e-mail from Tal Litvin, Lehman, to Erin M. Callan, Lehman, *et al.* (May 30, 2008) [LBEX-DOCID 275995] and stating "Global rates net balance sheet decreased by ($3.1B) primarily due to a decrease in Americas driven by an increased utilization of Repo 105 within the Agency business"); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 29, 2008 (May 30, 2008), at p. 1 [LBEX-LL 1950658] (attached to e-mail from Tal Litvin, Lehman, to Erin M. Callan, Lehman, *et al.* (June 2, 2008) [LBEX-DOCID 011127] and stating "Global Rates net balance sheet decreased ($6.5B) . . . [t]he decrease in Europe is coming from increased utilization of Repo 105").

[3606] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 7.

[3607] *Id.*

[3608] *Id.* pp. 10-11.

[3609] *Id.*

[3610] *Id.*

stated that he had no specific recollection of Repo 105 targets even though he recalled that Repo 105 was "one of the things that the businesses were doing to operate at their [balance sheet] limits."[3611]

Lowitt believed that Ernst & Young had approved the firm's use of Repo 105 transactions early in the Repo 105 process (sometime in the early 2000s), and as a result, Lowitt never was concerned about Lehman's use of the transactions.[3612] Lowitt also said he was unaware of any geographical limitations with respect to Repo 105 – for instance, he did not know that Lehman's internal Repo 105 Accounting Policy limited the transactions to LBIE.[3613] Lowitt had no recollection of ever having read the Accounting Policy, but he recalled that only the most liquid assets could be used in Repo 105 transactions.[3614]

Despite recalling very little specific information about his own involvement in Lehman's Repo 105 program, Lowitt generally recalled that O'Meara played a role in Lehman's Repo 105 program.[3615] Lowitt stated that O'Meara and Grieb were responsible for setting firm-wide limits on Repo 105 usage.[3616] In addition, when Lowitt

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[3611] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 13.

[3612] *Id.* at p. 3.

[3613] *Id.* at p. 11.

[3614] *Id.* at pp. 11, 14.

[3615] *Id.* at pp. 11, 14.

[3616] *Id.* As explained elsewhere in the Report, O'Meara told the Examiner that he had no involvement in the setting of Repo 105 limits. Examiner's Interview of Christopher M. O'Meara, Aug. 14, 2009 at pp. 28-29 (stating he was "not close to" Lehman's Repo 105 program); Examiner's Interview of Christopher M. O'Meara, Sept. 23, 2009, at pp. 6-7 (stating, with respect to Lehman's Repo 105 usage and limits "I don't have a recollection of any of this"). On the other hand, Grieb recalled O'Meara's involvement in the Repo

was Lehman's Chief Administrative Officer in Europe, between 2005 and 2006, he recalled that O'Meara "felt some need to establish guidelines for Repo 105" usage in Lehman's European offices.[3617]

Kelly raised with Lowitt the same Repo 105-related concerns that Kelly raised with Callan, including concerns about Lehman's reliance on Repo 105 transactions for balance sheet relief, the expanding nature of that reliance, the technical accounting basis for the transactions, the quarter-end spikes in usage, and the possible "reputational risk" to Lehman.[3618] Kelly noted, however, that his Repo 105 discussions with Lowitt were "more truncated" because, unlike Callan, Kelly viewed Lowitt as "quite familiar with the program and [Lowitt] understood its details."[3619]

Kelly recalled that after he "expressed the same reservations" to Lowitt about Lehman's use of Repo 105 transactions that Kelly had previously expressed to Callan, his concerns met a similar result with Lowitt: "Even [after a] consideration of the size of

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105 program. Examiner's Interview of Edward Grieb, Oct. 2, 2009, at pp. 10, 12-13; *see also* Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 2 [LBEX-WGM 754587].

[3617] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 13.

[3618] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at pp. 8-10. Kelly continued to press his concerns with Lehman's Repo 105 program following his discussion with Callan. *Id.* In a May 2008 internal Lehman Power Point presentation to Finance Control entitled "Information, Controls and Issues," discussing problems faced by Finance Control and strategies for dealing with them, Kelly included "Repo 105/108" as an issue for discussion in the third quarter 2008. Martin Kelly, Lehman, Information, Control and Issues (May 2008), at p. 10 [LBEX-DOCID 1999716].

[3619] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 10.

the program and the risks involved did not change the fact that the program should continue."[3620]

Lowitt said that "no one raised [Repo 105] to me as something I should be spending any more attention on" and he did not recall any conversations with Kelly on the subject.[3621] Similarly, Lowitt did not recall discussing Lehman's use of Repo 105 transactions with Fuld, McDade, Gregory, Callan, O'Meara, Lehman's Executive Committee, or Ernst & Young.[3622]

Lowitt, however, attended as an *ex officio* member the March 28, 2008 Executive Committee meeting, and received the agenda and balance sheet document circulated by McDade's assistant.[3623] Lowitt received two other copies of the balance sheet

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[3620] *Id.*

[3621] Examiner's Interview of Ian T. Lowitt, Oct. 28 2009, at p. 11.

[3622] *Id.* The Examiner attempted to refresh Lowitt's recollection of his involvement in the Repo 105 program through documents (including e-mails in which Lowitt specifically inquired about Repo 105 transactions), and by recounting communications that Kelly told the Examiner he had with Lowitt. But, Lowitt's memory was not revived and he continually stated that he "knew [Repo 105] was something the firm engaged in" but that it was not an issue he focused on or understood. *Id.*

[3623] Herbert H. (Bart) McDade III, Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008), at p. 1 [LBEX-DOCID 095961] (attached to e-mail from Gerard Reilly, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 120929] and indicating that the attachment is for the Executive Committee meeting)); *see also* Herbert H. (Bart) McDade III, Lehman, Executive Committee Meeting Material, Agenda (Mar. 28, 2008) [LBEX-DOCID 115827] (attached to e-mail from Patricia Lombardi, Assistant to Herbert H. (Bart) McDade III, to Ian T. Lowitt, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 120929] and listing among seven topics of discussion for March 28, 2008 Executive Committee meeting "Repo 105/108" and "Delever v Derisk").

presentation on March 28, 2008 – one set sent personally by McDade[3624] and the other sent by Reilly.[3625]

On June 17, 2008, Reilly sent to Lowitt the "Balance Sheet and Key Disclosures" document that incorporated McDade's planned directive to reduce Lehman's firm-wide Repo 105 usage by half – from $50 billion to $25 billion in third quarter 2008.[3626] The report also stated that Lehman's firm-wide Repo 105 usage at quarter-end for second quarter 2008 was $50.3 billion.[3627] Lowitt met with McDade, Reilly, O'Meara, and Morton to discuss the Balance Sheet and Key Disclosures document, which was then updated and redistributed to Lowitt and the others.[3628] These discussions and meeting took place only weeks before Lehman filed its second quarter 2008 Form 10-Q, signed by Lowitt, on July 10, 2008.

[3624] Herbert H. (Bart) McDade III, Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008) [LBEX-DOCID 095965] (attached to e-mail from Herbert H. (Bart) McDade III, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 110658]).

[3625] *Id.*

[3626] Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets [Draft] (June 16, 2008), at p. 3 [LBEX-DOCID 3363493] (attached to e-mail from Gerard Reilly, Lehman, to Ian T. Lowitt, Lehman, *et al.* (June 17, 2008) [LBEX-DOCID 3383643]).

[3627] *Id.*

[3628] E-mail from Christopher M. O'Meara, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (June 17, 2008) [LBEX-DOCID 033813] (replying to receipt of Balance Sheet and Key Disclosures 2008 3Q Targets [Draft] (June 16, 2008) and stating that "meeting is being set up to discuss" the Balance Sheet and Key Disclosure 2008 3Q Targets document); e-mail from Gerard Reilly, Lehman, to Ian T. Lowitt, Lehman, *et al.* (June 19, 2008) [LBEX-DOCID 2962369] (transmitting updated version of Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets (June 19, 2008) [LBEX-DOCID 2932594]).

In addition, Lowitt received a number of other documents that referenced Lehman's use of Repo 105 transactions both prior to and during his tenure as Lehman's CFO:

- In an August 2007 e-mail, Kentaro Umezaki informed Lowitt about John Feraca's attempts to place real estate securities into the Repo 105 program.[3629]
- On February 28, 2008, Feraca notified Lowitt and Tonucci that Lehman had executed $11 billion in Repo 105 trades via LBIE with Barclays, UBS, and Mizuho, using agencies securities.[3630] Feraca later informed Lowitt that the final tally of Repo 105 trades using United States Liquid Markets Products was close to $13 billion[3631] and by the next day reported yet again another revised number of $17 billion.[3632] Lowitt questioned Feraca why the amount of Repo 105 changed from quarter to quarter.[3633]

When Lowitt was asked about the February 28, 2008 e-mail, he said that he was "wondering if we were doing more or less of it [*i.e.*, Repo 105 transactions]," that he was attempting to gauge how "material" Lehman's Repo 105 usage was.[3634] Asked why as co-Chief Administrative Officer, he would have been communicating with Feraca of the Secured Funding Desk about Lehman's Repo 105 program, Lowitt replied that Feraca likely thought it was important to report on the status of Lehman's Repo 105 usage to

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[3629] E-mail from Kentaro Umezaki, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Aug. 17, 2008) [LBEX-DOCID 1533678].

[3630] E-mail from John Feraca, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Feb. 28, 2008) [LBEX-DOCID 3207903].

[3631] E-mail from John Feraca, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Feb. 28, 2008) [LBEX-DOCID 3207907].

[3632] E-mail from John Feraca, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Feb. 29, 2008) [LBEX-DOCID 3207911].

[3633] E-mail from Ian T. Lowitt, Lehman, to John Feraca, Lehman (Feb. 28, 2008) [LBEX-DOCID 3207905]; e-mail from John Feraca, Lehman, to Ian T. Lowitt, Lehman (Feb. 28, 2008) [LBEX-DOCID 3207908]; e-mail from John Feraca, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Feb. 29, 2008) [LBEX-DOCID 3207910].

[3634] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 12.

Lowitt and Tonucci because of their involvement in Lehman's Asset Liability Committee ("ALCO").[3635]

- In March 2008, Reilly informed Lowitt that the Rates Business' balance sheet was "way up" since the close of the first quarter because of a "drop off in Repo 105."[3636] Reilly later provided more color to Lowitt regarding the "breakdown" of the $95 billion increase in the Rates Business's balance sheet since close of first quarter, $22.4 billion of which was a reduction in Repo 105 usage since quarter-end.[3637]

- In May 2008, Lowitt asked Feraca if Lehman was experiencing any funding issues with its secured transactions.[3638] Feraca replied to Lowitt and Tonucci, "There were a few counterparties last week who had at least noted some of the rumblings in the press last week. . . . Daiwa who [was] contemplating a Repo 105 trade with us. Not a big funder for us. I think counterparties will reserve judgment for now. . ."[3639]

- In a July 2008 e-mail to Lowitt and Tonucci regarding FID's plans for cash capital limits and balance sheet targets in third quarter 2008, Robert Azerad said that FID's plan to "shrink[] the repo book potentially a lot (20 bn). . .is not consistent with B/S targets given to FID (flat excluding Repo 105)."[3640]

[3635] *Id.* When shown the same e-mail, Feraca could not recall, specifically, why Lowitt and Tonucci would have asked him for information about Repo 105. Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 11. Feraca recalled generally that "[b]alance sheet targets were more important at this time. There was more heightened concern regarding balance sheet and leverage ratio." *Id.*

[3636] E-mail from Gerard Reilly, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Mar. 20, 2008) [LBEX-DOCID 103526] (transmitting March Net Balance Sheet Daily Trend Excel Sheet (Mar. 20, 2008) [LBEX-DOCID 103961]).

[3637] E-mail from Gerard Reilly, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Mar. 20, 2008) [LBEX-DOCID 2973597].

[3638] E-mail from Ian T. Lowitt, Lehman, to John T. Feraca, Lehman, *et al.* (May 27, 2008) [LBEX-DOCID 070831].

[3639] E-mail from John Feraca, Lehman, to Ian T. Lowitt, Lehman, *et al.* (May 27, 2008) [LBEX-DOCID 070831].

[3640] E-mail from Robert Azerad, Lehman, to Ian T. Lowitt, Lehman, *et al.* (July 9, 2008) [LBEX-DOCID 8961].

- Lowitt also received the "Daily Balance Sheet and Disclosures Scorecard" between April and September 2008, which frequently referred to the impact of Repo 105 transactions on Lehman's firm-wide balance sheet.[3641]

[3641] *See, e.g.*, Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 7, 2008 (Apr. 9, 2008), at p. 9 [LBEX-DOCID 520619] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 9, 2008) [LBEX-DOCID 523578] and showing consolidated FID and Equities balance sheet reduced by $18.527 billion and Prime Services balance sheet reduced by $4.458 billion through Repo 105 transactions as of April 7, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 8, 2008 (Apr. 10, 2008), at p. 9 [LBEX-DOCID 520620] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 10, 2008) [LBEX-DOCID 523579] and showing consolidated FID and Equities balance sheet reduced by $18.853 billion and Prime Services balance sheet reduced by $4.562 billion through Repo 105 transactions as of April 8, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 9, 2008 (Apr. 10, 2008), at p. 9 [LBEX-DOCID 251339] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 10, 2008) [LBEX-DOCID 258560] and showing consolidated FID and Equities balance sheet reduced by $19.688 billion and Prime Services balance sheet reduced by $4.548 billion through Repo 105 transactions as of April 9, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 10, 2008 [LBEX-DOCID 251342], at p. 9 (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 14, 2008) [LBEX-DOCID 275231] and showing consolidated FID and Equities balance sheet reduced by $19.967 billion and Prime Services balance sheet reduced by $4.491 billion through Repo 105 transactions as of April 10, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 11, 2008 (Apr. 14, 2008), at p. 9 [LBEX-DOCID 251344] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 14, 2008) [LBEX-DOCID 258562] showing consolidated FID and Equities balance sheet reduced by $20.260 billion and Prime Services balance sheet reduced by $4.517 billion through Repo 105 transactions as of April 11, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 12, 2008 (May 13, 2008), at p. 1 [LBEX-LL 1950262] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (May 13, 2008) [LBEX-DOCID 3187357] and stating "Rates decreased by $(5.0B) from prior day due to . . . increased Repo 105 usage . . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 22, 2008 (May 27, 2008), at p. 1 [LBEX-LL 1950706] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (May 27, 2008) [LBEX-DOCID 275984] and stating "Global rates net balance sheet decreased ($2.0B), predominantly due to an increase in Repo 105 benefit . . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 28, 2008 (May 30, 2008), at p. 1 [LBEX-LL 1950670] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (May 30, 2008) [LBEX-DOCID 275995] and stating "Global rates net balance sheet decreased by ($3.1B) primarily due to a decrease in Americas driven by an increased utilization of Repo 105 within the Agency business"); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 29, 2008 (May 30, 2008), at p. 1 [LBEX-LL 1950658] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (June 2, 2008) [LBEX-DOCID 011127] and stating "Global Rates net balance sheet decreased ($6.5B) . . . [t]he decrease in Europe is coming from increased utilization of Repo 105"); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date June 18, 2008 (June 20, 2008) [LBEX-LL 1950514] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (June 20, 2008) [LBEX-DOCID 275942] and stating that "Global rates net balance sheet decreased . . . driven by a[n] . . . increase in Repo 105 utilization . . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date August 13, 2008 (Aug. 14, 2008) [LBEX-LL 782812] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Aug. 14, 2008) [LBEX-DOCID

(3) Lehman's Board of Directors

Without exception, former Lehman directors were unaware of Lehman's Repo 105 program and transactions.[3642]

As discussed in greater detail below, Lehman's own Corporate Audit group led by Beth Rudofker, together with Ernst & Young, investigated allegations about balance sheet substantiation problems made in a May 16, 2008 "whistleblower" letter sent to senior management by Matthew Lee.[3643] On June 12, 2008, during the investigation, Lee informed Ernst & Young about Lehman's use of $50 billion of Repo 105 transactions in the second quarter of 2008.[3644] At a June 13, 2008 meeting, Ernst & Young failed to disclose that allegation to the Board's Audit Committee.[3645]

Former Lehman director Cruikshank recalled that he made very clear he wanted a full and thorough investigation into each allegation made by Lee, whether the

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4214810] and stating that "Global rates net balance sheet decreased . . . driven by an increase in Repo 105 benefit . . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date August 25, 2008 (Aug. 26, 2008) [LBEX-LL 782924] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Aug. 26, 2008) [LBEX-DOCID 079536] and stating that "Global Rates net balance sheet decreased . . . driven by an increase in repo 105 usage . . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date August 28, 2008 (Aug. 29, 2008) [LBEX-LL 782966] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Aug. 29, 2008) [LBEX-DOCID 275880] and stating that "Global rates [net balance sheet] was down . . . driven by increased Repo 105 benefit . . . .").

[3642] Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at p. 21; Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 10; Examiner's Interview of Roland Hernandez, Oct. 2, 2009, at p. 22; Examiner's Interview of Sir Christopher Gent, Oct. 21, 2009, at p. 22; Examiner's Interview of Roger Berlind, Dec. 18, 2009, 4; Examiner's Interview of Michael L. Ainslie, Dec. 22, 2009, at p. 4; Examiner's Interview of Thomas Cruikshank, Jan. 20, 2010, at p. 2; Examiner's Interview of Sir Christopher Gent, Jan. 20, 2010, at p. 4.

[3643] *See* Section III.A.4.i.4 of this Report (discussing Matthew Lee's statements to Ernst & Young).

[3644] *Id.*

[3645] *Id.*

allegation was contained in Lee's May 16, 2008 letter or raised by Lee in the course of the investigation.[3646] Another former Lehman director, Berlind, similarly stated that the Audit Committee explicitly instructed Lehman's Corporate Audit Group and Ernst & Young to keep the Audit Committee informed of all of Lee's allegations.[3647] Berlind also said that he would have wanted to know about Lehman's Repo 105 program and that if he had known about Lehman's Repo 105 transactions, he would have asked Lehman's auditors to test the transactions to ensure they were appropriate.[3648] Upon learning from the Examiner the volume of Repo 105 transactions at quarter-end in late 2007 and 2008, Sir Christopher Gent said that he believed the volume mandated disclosure to the Audit Committee and further investigation.[3649]

Dr. Kaufman, on the other hand, stated that he would have wanted to know about Repo 105 transactions only if they were "huge" and fraudulent, by which he meant in violation of specific accounting rules or in violation of the law.[3650] Dr. Kaufman did not believe that $50 billion in Repo 105 transactions was significant even if that volume changed Lehman's net leverage ratio by approximately two points.[3651] Dr.

[3646] Examiner's Interview of Thomas Cruikshank, Oct. 8, 2009, at p. 7.
[3647] Examiner's Interview of Roger Berlind, Dec. 18, 2009, at p. 4.
[3648] *Id.*
[3649] Examiner's Interview of Sir Christopher Gent, Jan. 20, 2010, at p. 3.
[3650] Examiner's Interview of Henry Kaufman, Dec. 22, 2009.
[3651] *Id.*

Kaufman considered a four or five point change in the net leverage ratio to be significant.[3652]

In late 2007 and 2008, management made numerous presentations to the Board regarding balance sheet reduction and deleveraging; in no case was the use of Repo 105 transactions disclosed in those presentations.[3653]

[3652] *Id.*

[3653] *See, e.g.*, Lehman Brothers Holdings Inc., Minutes of Meeting of the Board of Directors (Sept. 11, 2007), at p. 3 [LBHI_SEC07940_026364] (including O'Meara statements regarding leverage ratios); Lehman Brothers Holdings Inc., Minutes of Meeting of the Board of Directors (Oct. 15, 2007), at p. 3 [LBHI_SEC07940_026407]; Lehman Brothers Holdings Inc., Minutes of Meeting of the Board of Directors (Nov. 8, 2007), at p. 4 [LBHI_SEC07940_026650] (same); Lehman Brothers Holdings Inc., Minutes of Meeting of the Finance and Risk Committee (Jan. 29, 2008), at pp. 2 [LBEX-AM 067022]; Lehman Brothers, Confidential Presentation to Finance and Risk Committee of the Board of Directors, 2008 Financial Plan (Jan. 29, 2008), at p. 8 [LBHI_SEC07940_068559] (stating "We plan to deploy the capital created to reduce leverage and support $60 billion of asset growth" and that "[b]alance sheet growth in December [2007] was largely in highly liquid asset classes for which we were able to source repo financing."); Lehman Brothers, Confidential Presentation to Finance and Risk Committee, Additional Materials (Jan. 29, 2008), at pp. 1-2 [LBEX-AM 067269] (stating "We have been able to grow repo financing to meet the balance sheet and leverage increases," and that Lehman's net assets and leverage grew in 2007 across all asset classes and leverage increased at a lesser rate than peer firms); Eric Felder, Lehman, 2008 Financial Supply/Demand Dynamics, Presentation to Lehman Board of Directors (Jan. 28, 2008), at p. 10 [LBHI_SEC07940_027353] (noting rise in leverage ratios among the five big investment banks); Lehman Brothers Holdings Inc., Minutes of Meeting of the Finance and Risk Committee (Mar. 25, 2008), at p. 2 [LBEX-AM 003592] (informing the Board of "industry-wide pressure to delever" and that the firm was working on a plan for reducing total assets which would most likely focus on the Fixed Income and Principal Investment business units); Erin M. Callan, Lehman, Estimated March 2008 Financial Information, Confidential Presentation to Lehman Brothers Board of Directors (Apr. 15, 2008), at p. 8 [LBHI_SEC07940_027952] (explaining that as part of the "de-levering plan," Lehman's "[t]argeted balance sheet reduction by Q2 '08" included a reduction of net assets by $55 billion to $342 billion); Lehman Brothers Holdings Inc., Finance and Risk Committee of the Board, Liquidity and Risk Management Update (May 7, 2008), at p. 10 [LBEX-AM 067320] ("The Firm has set aggressive targets to reduce balance sheet and cash capital usage below their Q4 2007 levels by the end of this quarter. This should result in bringing net leverage to 12x, gross leverage to 25x and generating a cash capital surplus of $8-10 billion – large enough to avoid the need to issue in public debt markets for the rest of the year."); *id.* at p. 16 (stating "lower leverage going forward will help reduce the Firm's liquidity risk"); Lehman Brothers Holdings Inc., Minutes of Meeting of the Board of Directors (June 19, 2008), at p. 3 [LBEX-AM 003764] (discussing Lehman's plans regarding leverage, and "potential changes in GAAP which would potentially require companies to bring certain assets back onto the balance sheet"); Lehman Brothers Holdings Inc., Minutes of Meeting of the Board of Directors (July 22, 2008), at p. 7 [LBEX-AM 003866]

i) Ernst & Young's Knowledge of Lehman's Repo 105 Program

During several Rule 30(b)(6)-type[3654] interview sessions, the Examiner interviewed members of Ernst & Young's Lehman audit team regarding Ernst & Young's knowledge of and involvement in Lehman's Repo 105 program.

(1) Ernst & Young's Comfort with Lehman's Repo 105 Accounting Policy

The Examiner interviewed Ernst & Young's lead partner on the Lehman audit team, William Schlich, regarding Lehman's Repo 105 program. According to Schlich, Ernst & Young had been aware of Lehman's Repo 105 policy and transactions for many years.[3655] Consistent with the statements of Lehman's John Feraca (Secured Funding Desk), Schlich stated that Lehman introduced its Repo 105 Accounting Policy on the heels of the FASB's promulgation of SFAS 140.[3656] During that time, Ernst & Young "discussed" the Repo 105 Accounting Policy (including Lehman's structure for Repo 105 transactions) and Ernst & Young's team had a number of additional conversations with Lehman about Repo 105 over the years.[3657] However, according to Schlich, Ernst &

(informing the Board that "it was important to size the Firm's financial leverage to maintain the Firm's 'A' credit rating in order to maintain the value of the Firm's franchise").

[3654] Federal Rule of Civil Procedure Rule 30(b)(6) governs depositions of a corporation or organization. The organization designates one or more representatives to testify on the identified areas of inquiry. The representative speaks for the organization.

[3655] Examiner's Interview of Ernst & Young, Repo 105 Session, Oct. 16, 2009, at p. 4.

[3656] *Id.* at p. 5.

[3657] *Id.*

Young had no role in the drafting or preparation of Lehman's Repo 105 Accounting Policy.[3658]

Schlich stated definitively that Ernst & Young had no advisory role with respect to Lehman's use of Repo 105 transactions and that Ernst & Young did not "approve" the Accounting Policy.[3659] Rather, according to Schlich, Ernst & Young "bec[a]me comfortable with the Policy for purposes of auditing financial statements."[3660]

Following "consultation and dialogue" about the proper interpretation and application of SFAS 140, Ernst & Young "clearly. . .concurred with Lehman's approach" to SFAS 140 and subsequent literature by FASB on the issue of "control" of assets involved in a repo transactions.[3661] Ernst & Young's view, however, was not based upon an analysis of whether actual Repo 105 transactions complied with SFAS 140.[3662] Rather, Ernst & Young's review of Lehman's Repo 105 Accounting Policy was purely "theoretical."[3663] In other words, Ernst & Young solely assessed Lehman's understanding of the requirements of SFAS 140 in the abstract and as reflected in its Accounting Policy; Ernst & Young did not opine on the propriety of the transactions as

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[3658] *Id.*
[3659] *Id.*
[3660] Examiner's Interview of Ernst & Young, Repo 105 Session, Oct. 16, 2009, at p. 5.
[3661] *Id.* at pp. 5-6.
[3662] *Id.* at p. 6.
[3663] *Id.*

a balance sheet management tool.[3664] Ernst & Young did not review the Linklaters letter, referenced in the Accounting Policy Manual.[3665]

According to Martin Kelly, it was not unusual for him to discuss various issues, including Repo 105, with Ernst & Young.[3666] Indeed, Kelly recalled specifically speaking with Schlich about Repo 105 transactions soon after becoming Financial Controller on December 1, 2007, in an effort to learn more about the program and "to understand [Ernst & Young's] approach before talking to Callan."[3667]

Kelly "wanted to ensure that Ernst & Young analyzed the program in the same way that [Marie] Stewart [Global Head of Accounting Policy] had analyzed it."[3668] Kelly's conversations with Ernst & Young focused on the accounting treatment of Repo 105 transactions.[3669] According to Kelly, Ernst & Young "was comfortable with the treatment under GAAP for the same reasons that Lehman was comfortable."[3670] Kelly also discussed with Ernst & Young Lehman's inability to get a true sale opinion under

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[3664] *Id.*

[3665] The Examiner asked Schlich a series of questions to establish whether a good faith basis existed for showing him the Linklaters letter. Schlich told the Examiner that he did not know if anyone at Ernst & Young LLP (*i.e.*, the United States-based Ernst & Young) ever reviewed the Linklaters letter. Examiner's Interview of Ernst & Young, Repo 105 Session, Oct. 16, 2009, at p. 10. Schlich further stated that LBIE's books and records were audited by Ernst & Young United Kingdom, not Ernst & Young LLP, though he acknowledged that LBIE's financials rolled up into LBHI's publicly filed financial statements, which Ernst & Young LLP audited. *Id.* at pp. 10-11. Because, based upon Schlich's statements, the Examiner did not have a good faith basis to believe Ernst & Young LLP previously had seen the Linklaters letter (as is required under the Examiner's protective order with Alvarez & Marsal/LBHI to show the letter to Ernst & Young LLP), the Examiner did not show Schlich the Linklaters letter.

[3666] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 11.

[3667] *Id.*

[3668] *Id.*

[3669] *Id.*

[3670] *Id.*

United States law for Repo 105 transactions.[3671] Kelly could not recall whether he discussed with Ernst & Young his discomfort with Lehman's Repo 105 program.[3672]

(2) The "Netting Grid"

Throughout 2007, Lehman maintained a document entitled "Accounting Policy Review Balance Sheet Netting and Other Adjustments," known colloquially among Lehman's Accounting Policy and Balance Sheet Groups, as well at Ernst & Young, as the "Netting Grid." The Netting Grid identified and described various balance sheet netting mechanisms employed by Lehman: one such balance sheet mechanisms was Lehman's use of Repo 105 transactions.[3673]

Lehman provided the Netting Grid to Ernst & Young at least in August 2007 (the close of Lehman's third quarter 2007) and in November 2007 (the close of Lehman's fiscal year 2007).[3674] Notably, the Netting Grid provided by Lehman to Ernst & Young in August 2007 and November 2007 only contained Repo 105 volumes from November 30,

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[3671] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 11.

[3672] *Id.*

[3673] *See, e.g.*, Lehman, Accounting Policy Review Balance Sheet Netting and Other Adjustments (Aug. 2007) [LBEX-DOCID 2720761] (attached to e-mail from Marie Stewart, Lehman, to Martin Kelly, Lehman (Nov. 6, 2007) [LBEX-DOCID 2736621] ("[T]his is the doc that summarizes every reason we net down the b/sheet. As discussed, E&Y are in the process of reviewing it."); Lehman, Accounting Policy Review Balance Sheet Netting and Other Adjustments (Nov. 2007) [LBEX-DOCID 2720762] (attached to e-mail from Marie Stewart, Lehman, to Martin Kelly (Nov. 6, 2007) [LBEX-DOCID 2736622]).

[3674] E-mail from Margaret Sear, Lehman, to Jerry Gruner, Ernst & Young, *et al.* (Aug. 15, 2007) [LBEX-DOCID 3235498] ("Here is the netting grid as you requested."); Lehman, Accounting Policy Review Balance Sheet Netting and Other Adjustments (Aug. 2007) [LBEX-DOCID 3213803] (attached to e-mail from Margaret Sear, Lehman, to Jerry Gruner, Ernst & Young, *et al.* (Aug. 15, 2007) [LBEX-DOCID 3235498]); e-mail from Margaret Sear, Lehman, to Jerry Gruner, Ernst & Young, *et al.* (Nov. 6, 2007) [LBEX-DOCID 3235499] (transmitting, Accounting Policy Review Balance Sheet Netting and Other Adjustments [Draft] (Nov. 2007) [LBEX-DOCID 3213271]).

2006 and February 28, 2007.[3675] Schlich was unaware whether Ernst & Young asked Lehman to provide its second quarter 2007 and third quarter 2007 Repo 105 usage figures or a forecast of Lehman's fourth quarter 2007 Repo 105 numbers.[3676]

Ernst & Young reviewed the Netting Grid, analyzed the various balance sheet netting mechanisms identified in the Netting Grid, and used the document in connection with its 2007 year-end audit of Lehman.[3677] According to Schlich, Ernst & Young, as part of its review of Lehman's Netting Grid, approved of Lehman's internal Repo 105 Accounting Policy only, and did not pass upon the actual practice.[3678]

The Netting Grid described the transactions and United States GAAP reference as follows: "Under certain conditions that meet the criteria described in paragraphs 9 and 218 of SFAS 140, Lehman policy permits reverse repo and repo agreements to be recharacterized as purchases and sales of inventory."[3679] With respect to Lehman's use of Repo 105 transactions to reduce its net balance sheet, the Netting Grid sets forth the

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[3675] Lehman, Accounting Policy Review Balance Sheet Netting and Other Adjustments (Aug. 2007), at p. 26 [LBEX-DOCID 3213803] (stating total Repo 105 usage for November 30, 2006 was $24.519 billion and total Repo 105 usage for February 28, 2007 was $29.258 billion); Lehman, Accounting Policy Review Balance Sheet Netting and Other Adjustments [Draft] (Nov. 2007), at p. 26 [LBEX-DOCID 3213271] (same).

[3676] Examiner's Interview of Ernst & Young, Repo 105 Session (Oct. 16, 2009), at p. 9 (statement of William Schlich).

[3677] *Id.* at p. 8. By this, Ernst & Young referred to its audit of other balance sheet netting mechanisms. Ernst & Young United States did not audit Repo 105 transactions.

[3678] *Id*.

[3679] Lehman Brothers, Accounting Policy Review Balance Sheet Netting and Other Adjustments (Aug. 2007), at p. 26 [LBEX-DOCID 3213803]; Lehman, Accounting Policy Review Balance Sheet Netting and Other Adjustments [Draft] (Nov. 2007), at p. 26 [LBEX-DOCID 3213271].

conclusion that Lehman's "current practice [for Repo 105] is correct."[3680] Schlich noted that this conclusion about the Repo 105 practice was Lehman's, not Ernst & Young's.[3681] To test Lehman's conclusion, however, Ernst & Young "reviewed how Lehman applied the control provisions of the accounting rules."[3682]

Ernst & Young's review, however, applied only to the accounting basis for these transactions, not to their volume or purpose. Specifically, Ernst & Young's review and analysis of Lehman's Repo 105 program did not account for the volumes of Repo 105 transactions Lehman undertook at quarter-end.[3683] Indeed, Schlich was unable to confirm or deny the volumes of Repo 105 transactions Lehman undertook at Lehman's fiscal year-end 2007, or in the first two quarter-ends of 2008.[3684] Nor was Schlich able to confirm or deny that Lehman's use of Repo 105 transactions was increasing in late 2007 and into mid 2008.[3685]

(a) Quarterly Review and Audit

Through Schlich, Ernst & Young maintained that its duties as Lehman's auditor required it to ensure that transactions were accounted for correctly (*i.e.*, that they complied with accounting rules) and that Lehman's financial disclosures were not

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[3680] *Id.* Although Lehman's internal Repo 105 Accounting Policy could have theoretically been applied to reverse repos, the policy explicitly stated that Lehman did not, in fact, use the Repo 105 mechanism for reverse repos. *See* Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at p. 1 [LBEX-DOCID 3213286].

[3681] Examiner's Interview of Ernst & Young, Repo 105 Session, Oct. 16, 2009, at p. 8.

[3682] *Id.*

[3683] *Id.*

[3684] *Id.*

[3685] *Id.*

materially misstated.[3686] According to Schlich, Ernst & Young's audit did not require Ernst & Young to consider or review the volume or timing of Repo 105 transactions.[3687] Accordingly, as part of its year-end 2007 audit, Ernst & Young did not ask Lehman about any directional trends, such as whether its Repo 105 activity was increasing during fiscal year 2007.[3688] Notably, as part of its quarterly review process, Ernst & Young did not audit any of Lehman's Repo 105 transactions.[3689]

(3) Ernst & Young Would Not Opine on the Materiality of Lehman's Repo 105 Usage

Ernst & Young, through Schlich, was unwilling to comment to the Examiner on the materiality of the volume of Lehman's quarter-end Repo 105 transactions.[3690] Asked whether, as part of its responsibility to ensure Lehman's financial statements were not materially misstated, Ernst & Young should have considered the possibility that strict technical adherence to SFAS 140 or any other specific accounting rule could nonetheless lead to a material misstatement in Lehman's publicly-reported financial statements, Schlich refrained from comment.[3691]

When pressed further, Schlich stated that the volume of any particular transaction impacts neither the question of whether accounting rules are applied

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[3686] Examiner's Interview of Ernst & Young, Repo 105 Session, Oct. 16, 2009, at pp. 6-7.
[3687] *Id.* at p. 6.
[3688] *Id.* at p. 9.
[3689] *Id.* at p. 3.
[3690] *Id.* at p. 6.
[3691] Examiner's Interview of Ernst & Young, Repo 105 Session, Oct. 16, 2009, at p. 6.

correctly, nor the question of whether a financial statement is materially misleading.[3692] However, Schlich eventually acknowledged that "when you look at a balance sheet issue, volume is a factor."[3693]

Notably, the definition of "materiality" contained in a "walk-through" document related to Ernst & Young's 2007 fiscal year-end audit of Lehman was: "any transaction that would move Lehman's firm-wide net leverage by 0.1 or more."[3694] This definition reflected "Lehman's determination of a materiality threshold" in connection with Lehman's own criteria for when to consider reopening and adjusting its balance sheet.[3695]

When Schlich was asked what level of impact to Lehman's firm-wide net assets Ernst & Young would have considered "material," Schlich replied that Ernst & Young did not have a hard and fast rule defining materiality in the balance sheet context, and that, with respect to balance sheet issues, "materiality" depends upon the facts and circumstances.[3696] Schlich agreed that Lehman made no specific disclosures about Repo

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[3692] *Id.*

[3693] *Id.* at p. 7.

[3694] Ernst & Young, LBHI/LBI Walkthrough Template for Balance Sheet Close Process (Nov. 30, 2007), at p. 14 [EY-LE-LBHI-CORP-GAMX-07-033384] ("Materiality is usually defined as any item individually, or in the aggregate, that moves net leverage by 0.1 or more (typically $1.8 billion)."). Accordingly, an item that impacted net leverage by 0.1 point was deemed material enough to re-open the books. The walkthrough paper also stated, "Net leverage is an important ratio analyzed by the rating agencies and included in Lehman's earnings releases." *Id.*

[3695] Examiner's Interview of Ernst & Young, Repo 105 Session, Oct. 16, 2009, at p. 7.

[3696] *Id.*

105 transactions in its Forms 10-K and Form 10-Q, including the MD&A section.[3697] Schlich believed, however, that Lehman's public filings would have included general language regarding secured borrowings and compliance with SFAS 140.[3698] Schlich was not aware whether Ernst & Young ever discussed Lehman's disclosures *vel non* of Repo 105 activity with senior Lehman management.[3699]

(4) Matthew Lee's Statements Regarding Repo 105 to Ernst & Young

On May 16, 2008, Matthew Lee, then-Senior Vice President in the Finance Division responsible for Lehman's Global Balance Sheet and Legal Entity Accounting, sent a letter to certain members of Lehman's senior management identifying possible violations of Lehman's Ethics Code related to accounting/balance sheet issues.[3700]

[3697] *Id.*

[3698] *Id.* As noted in Section III.A.4.j.2.c.ii.a, however, language regarding SFAS 140 in Lehman's Forms 10-K and 10-Q relate solely to Lehman's securitization activities.

[3699] Examiner's Interview of Ernst & Young, Repo 105 Session, Oct. 16, 2009, at p. 7.

[3700] Letter from Matthew Lee, Lehman, to Martin Kelly, Lehman, *et al.* (May 16, 2008) [EY-LE-LBHI-KEYPERS 5826885]. Lee's letter contained the following six allegations: (1) on the last day of each month, Lehman's books and records contained approximately $5 billion of net assets in excess of what was managed on the last day of the month, thereby suggesting that the firm's senior management was not in control of its assets to be able to present full, fair, and accurate financial statements to the public; (2) Lehman had "tens of billions of dollars of unsubstantiated balances, which may or may not be 'bad' or non-performing assets or real liabilities;" (3) Lehman had tens of billions of dollars of illiquid inventory and did not value its inventory in a "fully realistic or reasonable" way; (4) given Lehman's rapid growth and increased number of accounts and entities, it had not invested sufficiently in financial systems and personnel to cope with the balance sheet; (5) the India Finance office lacked sufficient knowledgeable management, resulting in the real possibility of potential misstatements of material facts being distributed by that office; and (6) certain senior level audit personnel were not qualified to "properly exercise the audit functions they are entrusted to manage." *Id.*

Lehman involved Ernst & Young in its investigation of the concerns raised in Lee's May 16, 2008 letter.[3701]

Subsequently, less than a month later, on June 12, 2008, Ernst & Young – Schlich and Hillary Hansen – interviewed Lee.[3702] Hansen's notes of the interview reveal that Lee made certain statements to Ernst & Young about Lehman's Repo 105 practice, including, most notably, the volume of Repo 105 activity that Lehman engaged in at quarter-end (May 31, 2008).[3703] Hansen's notes specifically recount Lee's allegation that Lehman moved $50 billion of inventory off its balance sheet at quarter-end through Repo 105 transactions and that these assets returned to the balance sheet approximately a week later.[3704]

[3701] Examiner's Interview of Thomas Cruikshank, Oct. 8, 2009, at p. 7 (stating that although Beth Rudofker led the investigation, as Chair of the Audit Committee, he made sure Ernst & Young was involved as well); Examiner's Interview of Michael L. Ainslie, Dec. 22, 2009, at p. 3; Examiner's Interview of Roger Berlind, Dec. 18, 2009, at pp. 2-3; Examiner's Interview of Sir Christopher Gent, Jan. 20, 2010, at p. 2; Examiner's Interview of Beth Rudofker, Dec. 15, 2009, at p. 7; *see also* Employee Letter Review, Presentation to the Audit Committee (July 22, 2008), at p. 2 [LBEX-AM 067664] (noting that "Corporate Audit has largely completed an evaluation of [Lee's] observations in partnership with Financial Control and Ernst and Young").

[3702] Examiner's Interview of Ernst & Young, Nov. 3, 2009, at p. 14 (statement of William Schlich) (noting that Lehman's counsel Joe Polizzotto was present initially but left so Schlich and Hansen could interview Lee privately); *see also* e-mail from William Schlich, Ernst & Young, to Hillary Hansen, Ernst & Young (June 10, 2008) [EY-LE-LBHI-KEYPERS 0853892 (scheduling meeting with Lee for June 12, 2008).

[3703] Hansen's notes indicate that Lehman's "Rates [and] Liquid Markets" businesses engaged in "Repo 105/Repo 108 [to] reduce[] assets by 50B [by] moving off B/S [i.e., balance sheet] in Europe & back in 5 days later." Hillary Hansen, Ernst & Young, Handwritten Notes (June 12, 2008), at p. 1 [EY-LE-LBHI-KEYPERS 5826869]. This is consistent with the Examiner's conclusions that at quarter-end in second quarter 2008, Lehman reduced its balance sheet by slightly more than $50 billion through Repo 105 transactions.

[3704] *Id.*

When interviewed by the Examiner, Schlich did not recall Lee saying anything about Repo 105 transactions during that interview, although he did not dispute the authenticity of Hansen's notes from the Lee interview.[3705] In spite of Hansen's notes, Schlich maintained that Ernst & Young did not know that Lehman engaged in the following Repo 105 activity during the listed time periods: $49.1 billion at first quarter 2008 (Feb. 29, 2008); and $50.38 billion at second quarter 2008 (May 31, 2008).[3706]

During the Examiner's interview of Hansen, Hansen recalled that while Ernst & Young questioned Lee about his May 16, 2008 letter, Lee "rattled off" a list of additional issues and concerns he held, one of which was Lehman's use of Repo 105 transactions.[3707] Ernst & Young had no further conversations with Lee about Repo 105 transactions.[3708] Prior to her interview of Lee in June 2008, Hansen had heard the term Repo 105 "thrown around" but she did not know its meaning; according to Hansen, Schlich described Repo 105 transactions to her shortly after they met with Lee.[3709]

Following Ernst & Young's June 12, 2008 interview of Lee, Schlich and Hansen met with Lehman's Gerard Reilly to discuss Lee's assertions regarding improper

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[3705] Examiner's Interview of Ernst & Young, Oct. 9, 2009, at p. 5; Examiner's Interview of Ernst & Young, Repo 105 Session, Oct. 16, 2009, at p. 5; Examiner's Interview of Ernst & Young, Nov. 3, 2009, at p. 16.

[3706] Examiner's Interview of Ernst & Young, Repo 105 Session, Oct. 16, 2009, at p. 12 (Schlich (1) disavowed any knowledge on the part of Ernst & Young of Lehman's actual Repo 105 usage for the first and second quarter of 2008 and (2) said he was not personally aware of Lehman's Repo 105 usage at the close of fiscal year 2007).

[3707] Examiner's Interview of Ernst & Young, Nov. 3, 2009, at p. 14.

[3708] *Id.*

[3709] *Id.* Schlich maintains that he does not recall discussing Repo 105 either during or after Lee's interview. *Id.*

valuations.[3710] During that meeting, Hansen informed Reilly of the $50 billion Repo 105 figure Lee provided during Ernst & Young's interview of Lee.[3711] According to Schlich, Reilly (now deceased) told the auditors that he had no knowledge that Lehman used Repo 105 transactions to move $50 billion in assets off its balance sheet.[3712] "Hillary [Hansen] took away from the meeting with Reilly that he did not know and it was not $50 billion."[3713]

On June 13, 2008 – *the day after* Lee informed Ernst & Young of the $50 billion in Repo 105 transactions that Lehman undertook at the end of the second quarter 2008 – Ernst & Young spoke to Lehman's Audit Committee but did not inform the committee of Lee's allegation, even though the Chairman of the Audit Committee had clearly stated that he wanted *every* allegation made by Lee – whether in Lee's May 16 letter or during the course of the investigation – to be investigated.[3714] Ernst & Young met with the Audit Committee on July 8, 2008, to review the second quarter financial statements

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[3710] Examiner's Interview of Ernst & Young, Oct. 9, 2009, at p. 6 (statement of William Schlich); Examiner's Interview of Ernst & Young, Nov. 3, 2009, at p. 16 (statement of William Schlich).

[3711] Examiner's Interview of Ernst & Young, Repo 105 Session, Oct. 16, 2009, at p. 11 (statement of William Schlich).

[3712] *Id.*

[3713] *Id.* at p. 12 (statement of William Schlich). Schlich had no personal recollection of discussing Repo 105 with Reilly during the meeting. *Id.* at p. 11. He said he only knew that Hansen recalled discussing the issue with Reilly and Reilly's response. *Id.* There are no notes from Schlich and Hansen's meeting with Reilly. Examiner's Interview of Ernst & Young, Nov. 3, 2009, at p. 17 (statement of Hillary Hansen).

[3714] Examiner's Interview of Thomas Cruikshank, Oct. 8, 2009, at p. 7 (stating that Internal Audit and Ernst & Young were explicitly instructed to report and investigate any allegation made by Lee during course of investigation); Examiner's Interview of Roger Berlind, Dec. 18, 2009, at p. 2 (same); Examiner's Interview of Michael L. Ainslie, Dec. 22, 2009, at p. 3 (same); Examiner's Interview of Sir Christopher Gent, Jan. 20, 2010, at p.2 (same); Examiner's Interview of Thomas Cruikshank, Jan. 20, 2010, at p. 3; Examiner's Interview of Beth Rudofker, Dec. 15, 2009, at pp. 6-7; *see also* Lehman Brothers Holdings Inc., Minutes of the Meeting of Audit Committee (June 13, 2008) [LBEX-AM 003759].

and again did not mention Lee's allegations regarding Repo 105.[3715] On July 22, 2008, Ernst & Young was also present when Beth Rudofker, Head of Corporate Audit, gave a presentation to the Audit Committee on the results of the investigation into Lee's allegations.[3716]

Ernst & Young did not disclose to the Audit Committee – either during the meetings or in private executive sessions after – that Lee made an allegation related to Repo 105 transactions being used to move assets off Lehman's balance sheet at quarter-end.[3717] Cruikshank told the Examiner that he would have expected to be told about Lee's Repo 105 allegations.[3718] Similarly, Sir Gent told the Examiner that the alleged

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[3715] Lehman Brothers Holdings Inc., Minutes of Meeting of Audit Committee (July 8, 2008), at pp. 1-2 [LBEX-AM 003831].

[3716] Lehman Brothers Holdings Inc., Minutes of Meeting of Audit Committee (July 22, 2008), at p. 4 [LBEX-AM 003861]; *see also* Employee Letter Review, Presentation to the Audit Committee (July 22, 2008), at p. 2 [LBEX-AM 067664] (concluding that "[n]o material issues have been identified during the review [of Lee's allegations] and this report to the Audit Committee summarizes the findings and recommendations"). The presentation contains no reference to Lee's allegation regarding Repo 105. *Id.* Ernst & Young did not inform Rudofker about Lee's allegation regarding Repo 105. Examiner's Interview of Beth Rudofker, Dec. 15, 2009, at p. 7.

[3717] Examiner's Interview of Thomas Cruikshank, Jan. 20, 2010, at p. 3; Examiner's Interview of Roger Berlind, Dec. 18, 2009, at p. 4; Examiner's Interview of Michael L. Ainslie, Dec. 22, 2009, at p. 3; Examiner's Interview of Sir Christopher Gent, Jan. 20, 2010, at pp. 2, 3; Examiner's Interview of Beth Rudofker, Dec. 15, 2009, at p. 7.; *see also* Lehman Brothers Holdings Inc., Minutes of Meeting of Audit Committee (June 13, 2008) [LBEX-AM 003759]; Lehman Brothers Holdings Inc., Minutes of Meeting of Audit Committee (July 8, 2008) [LBEX-AM 003831]; Lehman Brothers Holdings Inc., Minutes of Meeting of Audit Committee (July 22, 2008) [LBEX-AM 003861].

[3718] Examiner's Interview of Thomas Cruikshank, Jan. 20, 2010, at p. 3. Cruikshank, who had no knowledge of Lehman's internal Repo 105 Accounting Policy, said that it was the responsibility of Ernst & Young and Lehman management to analyze the accounting treatment for Repo 105 transactions and ensure the standards were properly applied to these transactions. *Id.* at pp. 2-3.

volume of Lehman's Repo 105 transactions mandated disclosure to the Audit Committee as well as further investigation.[3719]

Ernst & Young did not follow-up on either Lee's allegations regarding Lehman's Repo 105 activity or Reilly's claim that he had no knowledge of Lehman's alleged $50 billion Repo 105 usage figure.[3720] Ernst & Young signed a Report of Independent Registered Public Accounting Firm for Lehman's second quarter 2008 Form 10-Q on July 10, 2008, less than four weeks after Schlich and Hansen interviewed Lee.[3721]

[3719] Examiner's Interview of Sir Christopher Gent, Jan. 20, 2010, at p. 3.

[3720] Examiner's Interview of Ernst & Young, Nov. 3, 2009, at p. 16 (statement of William Schlich)

[3721] LBHI 10-Q (filed July 10, 2008), at p. 53 (stating that "[b]ased upon our review, we are not aware of any material modifications that should be made to the consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles"); Examiner's Interview of Ernst & Young, Nov. 3, 2009, at p. 17 (statement of William Schlich) (stating that Ernst & Young "signed off" on Lehman's second quarter 2008 10-Q). On June 5, 2008, only a few days after the close of Lehman's second quarter 2008 and a few days before Lehman's $6 billion equity raise, Schlich wrote to Ernst & Young's Carmine DiSibio and Stephen Howe about Lehman's second quarter financial results and a general report on Lehman's performance. E-mail from William Schlich, Ernst & Young, to Carmine DiSibio, Ernst & Young, *et al.* (June 5, 2008) [EY-LE-LBHI-KEYPERS 0853883]. Schlich's note to DiSibio and Howe also referenced Matthew Lee's letter to senior Lehman management, as well as certain off-balance sheet items:

> [W]e are also dealing with a whistleblower letter, that is on its face pretty ugly and will take us a significant amount of time to get through. I am confident from what I have seen it shouldn't result in any significant issues around financial reporting, but again there is a lot of work to do yet. This combined with some very difficult accounting issues around off-balance sheet items is adding stress to everyone.

Id. Schlich denied that the "off-balance sheet items . . . adding stress to everyone" referenced in his note were Repo 105 transactions. Examiner's Interview of Ernst & Young, Oct. 9, 2009, at p. 10 (statement of William Schlich). Rather, Schlich maintained, the "stress" referenced in his message was due to the public criticism Lehman was then facing over its sale of certain assets to the R3 hedge fund, an approximately $4.5 billion deal. *Id.* The total dollar amount of off-balance sheet items resulting from Lehman's Repo 105 transactions at the end of second quarter 2008, when Schlich wrote his note, was over $50 billion, or more than eleven times the size of the R3 deal.

(5) Accounting-Motivated Transactions

Ernst & Young did not evaluate the possibility that Repo 105 transactions were accounting-motivated transactions that lacked a business purpose.[3722] Schlich characterized the off-balance sheet treatment of Lehman's assets in Repo 105 transactions as a consequence of the accounting rules, rather than a motive for the transactions.[3723]

j) The Examiner's Conclusions

There is sufficient evidence to support a determination by a trier of fact that Lehman's failure to disclose that it relied upon Repo 105 transactions to temporarily reduce the firm's net balance sheet and net leverage ratio was materially misleading. In addition, a trier of fact could find that Lehman affirmatively misrepresented its accounting treatment for repos by stating that Lehman treated repo transactions as financing transactions rather than sales for financial reporting purposes, despite the fact that Lehman treated tens of billions of dollars in repo transactions – namely, Repo 105 transactions – as true sale transactions.

[3722] Examiner's Interview of Ernst & Young, Repo 105 Session, Oct. 16, 2009, at p. 13 (statement of William Schlich). An SEC staff paper discourages "accounting-motivated structured transactions" because a company engaging in such transactions runs the risk of presenting an inaccurate picture of its true financial condition. *See* OFFICE OF THE CHIEF ACCOUNTANT, SEC, REPORT AND RECOMMENDATIONS PURSUANT TO SECTION 401(C) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES AND TRANSPARENCY OF FILINGS BY ISSUERS, at p. 100 (2005) ["SEC SOX Off Balance Sheet Report"]. According to this report, "accounting-motivated structured transactions" are "transactions that are structured in an attempt to achieve reporting results that are not consistent with the economics of the transaction, and thereby impair the transparency of financial reports." *Id.* "[A]ttempt[s] to portray the transactions differently from their substance do not operate in the interests of investors, and may be in violation of the securities laws." *Id.*

[3723] *Id.*

The Examiner thus concludes that sufficient evidence exists from which a trier of fact could find the existence of a colorable claim that certain Lehman officers breached their fiduciary duties to Lehman and its shareholders by causing the company to file deficient and materially misleading financial statements, thereby exposing the company to potential liability. Certain officers of Lehman not only failed to inform the public of its reliance on Repo 105 transactions to reduce its balance sheet, they also failed to advise Lehman's Board of Directors of the firm's Repo 105 practice. Thus, the Examiner concludes that a trier of fact could find that certain Lehman officers breached their fiduciary duties to Lehman's Board of Directors by failing to inform them of: (1) the firm's reliance upon Repo 105 to reduce the balance sheet at quarter-end, (2) the ramp-up in Repo 105 usage in mid-to-late 2007 and 2008, (3) the impact of these transactions on Lehman's publicly reported net leverage ratio, or (4) the fact that Lehman did not disclose its Repo 105 practice in its publicly reported financials statements and MD&A.

(1) Materiality

The materiality of information is evaluated from the perspective of a reasonable investor.[3724] Information is deemed material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as

[3724] *See SEC v. Stanard*, No. 06 Civ. 7736(GEL), 2009 WL 196023, at *26 (S.D.N.Y. Jan. 27, 2009) (citations omitted).

having significantly altered the 'total mix' of information made available."[3725] Materiality does not require, however, that the information be of a type that would cause an investor to change his investment decision.[3726]

(a) Whether Lehman's Repo 105 Transactions Technically Complied with SFAS 140 Does Not Impact Whether a Colorable Claim Exists

This Report does not reach the question of whether Lehman's Repo 105 transactions technically complied with the relevant financial accounting standard, SFAS 140, because the answer to that question does not impact whether a colorable claim exists regarding Lehman's failure to disclose its Repo 105 practice and whether that failure rendered the firm's financial statements materially misleading.

Even if Lehman's use of Repo 105 transactions technically complied with SFAS 140, financial statements may be materially misleading even when they do not violate GAAP.[3727] The Second Circuit has explained that "GAAP itself recognizes that technical compliance with particular GAAP rules may lead to misleading financial statements,

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[3725] *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

[3726] *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162 (2d. Cir. 2000). Lehman's audit walk-through papers defined as material any item that alone or in the aggregate had a one-tenth (0.1) of a point impact on firm-wide net leverage ratio (or $1.8 billion). *See* Ernst & Young, LBHI/LBI Walkthrough Template for Balance Sheet Close Process (Nov. 30, 2007), at p. 14 [EY-LE-LBHI-CORP-GAMX-07-033384] (defining materiality in the context of re-opening a closed balance sheet).

[3727] *See generally United States v. Ebbers*, 458 F.3d 110 (2d Cir. 2006), *cert. denied*, 127 S.Ct. 1483 (2007).

and imposes an overall requirement that the statements as a whole accurately reflect the financial status of the company."[3728]

Similarly, as noted in *In re Global Crossing Ltd. Securities Litigation*, even if a defendant established that its accounting practices "were in technical compliance with certain individual GAAP provisions . . . this would not necessarily insulate it from liability. This is because, unlike other regulatory systems, *GAAP's ultimate goals of fairness and accuracy in reporting require more than mere technical compliance*."[3729] The court explained that "when viewed as a whole," GAAP has no "loopholes" because its purpose, shared by the securities laws, is "to increase investor confidence by ensuring transparency and accuracy in financial reporting."[3730] Technical compliance with specific accounting rules does not automatically lead to fairly presented financial statements. "Fair presentation is the touchstone for determining the adequacy of disclosure in financial statements. While adherence to generally accepted accounting principles is a tool to help achieve that end, it is not necessarily a guarantee of fairness."[3731] Moreover, registrants are "*required to provide whatever additional information*

[3728] *Id.* at 126.

[3729] *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp.2d 319, 339 (S.D.N.Y. 2004) (emphasis added).

[3730] *Id.*

[3731] *Id.* at 340 (internal citations omitted).

would be necessary to make the statements in their financial reports fair and accurate, and not misleading."[3732]

This view is echoed in an SEC enforcement order, concluding that GAAP compliance does not excuse a misleading or less than full disclosure regarding a transaction, especially if the transaction's purpose is "the attainment of a particular financial reporting result."[3733] "[E]ven if the transactions comply with GAAP, the issuer is required to evaluate the material accuracy and completeness of the presentation made by its financial statements."[3734] Issuers must "ensure that the way they publicly portray themselves discloses, as required, the material elements of [their] economic and business realities and risks."[3735]

[3732] *Id.* (citing 17 C.F.R. § 240.10b-5(b) and 17 C.F.R. § 230.408 (requiring that "in addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading") (emphasis added); *see also SEC v. Seghers*, 298 Fed. App'x 319, 331 (5th Cir. 2008) ("The Commission's proof of Segher's misrepresentations and omissions does not depend on compliance with GAAP, but instead depends on evidence that Segher's statements and omissions were false or misleading to investors."); *United States v. Olis*, Civil Action No. H-07-3295, Criminal No. H-03-217-01, 2008 WL 5046342, at *20 (S.D. Tex. Nov. 21, 2008) ("The scheme to defraud alleged and proved in this case did not turn on whether the treatment accorded to Project Alpha in Dynegy's financial statements technically complied with GAAP or whether Olis and his co-conspirators intended to violate GAAP but, instead, on whether the defendants' disclosures about Project Alpha intentionally omitted material facts that caused Dynegy's financial statements to be materially false and misleading.") (citing *United States v. Rigas*, 490 F.3d 208, 221 (2d Cir. 2007), and *United States v. Ebbers*, 458 F.3d 110, 125-26 (2d Cir. 2006)).

[3733] *In re PNC Fin. Servs. Group, Inc.*, 2002 WL 1585523, at *14 (Securities Act Release No. 33-8112, Exchange Act Release No. 34-46225) (July 18, 2002).

[3734] *Id.*

[3735] *Id.*

(2) Disclosure Requirements and Analysis

Section 13(a) of the Securities Exchange Act of 1934 required Lehman to file periodic reports with the SEC, including its annual reports on Form 10-K and quarterly reports on Form 10-Q.[3736] Lehman also filed registration statements under the Securities Act with respect to its public offerings of securities in the United States. Each of these filings required certain disclosures, in each instance subject to the requirement that Lehman provide such "further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading."[3737]

A review of Lehman's public filings confirms that Lehman did not disclose its use of Repo 105 transactions, either by name or characterization, in its Forms 10-K or 10-Q. Moreover, Lehman affirmatively represented that it treated its repo transactions as financing transactions – that is, not as sales – for purposes of financial reporting. Further, the net leverage ratio Lehman reported was misleading because Lehman did not disclose how it achieved this result.[3738] Lehman's MD&A statements about its

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[3736] Section 13(a) is codified at 15 U.S.C. § 78m(a). It requires the filing of such annual and quarterly reports as the SEC prescribes. 17 C.F.R. 249.310 prescribes the Form 10-K and 17 C.F.R. 249.308a prescribes the Form 10-Q.

[3737] Securities Exchange Act Rule 12b-20, 17 C.F.R. § 240.12b-20; Securities Act Rule 408, 17 C.F.R. § 230.408.

[3738] According to two of Lehman's former Global Financial Controllers and Lehman's former Global Head of Accounting Policy, each of whom was responsible in some fashion for preparing and/or reviewing Lehman's public filings, Lehman did not in any way disclose or report its Repo 105 activity in its Forms 10-K or 10-Q. Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 15; Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 9; Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 14. In

liquidity and liabilities (*i.e.*, obligation to repurchase the securities) were also deficient and misleading; in contrast to a borrowing under an ordinary repurchase agreement, the amount borrowed under a Repo 105 was not reflected in Lehman's MD&A statements.[3739]

(a) Disclosure Obligations: Regulation S-K and the MD&A

Item 303 of Regulation S-K, Management's Discussion and Analysis of Financial Condition and Results of Operations (the "MD&A"), requires management to discuss the issuer's financial condition, changes in financial condition, and results of operations. MD&A in each periodic report (Form 10-K/10-Q) must contain the following:[3740]

- MD&A requires not only a "discussion," but also an "analysis" of known material trends, events, demands, commitments, and uncertainties. The

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particular, Martin Kelly, who served as Lehman's Global Financial Controller from December 1, 2007 until September 20008, stated that if an individual read Lehman's Forms 10-K and 10-Q from cover to cover, "they would have no transparency into the Repo 105/108 program." Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 9. Kelly himself met regularly with the SEC and the New York Federal Reserve Bank as a matter of course in his role as Global Financial Controller, both before the near collapse of Bears Stearns in March 2008 and after federal regulators arrived on-site at Lehman following Bears Stearns' collapse. *Id.* Kelly stated that he personally never disclosed to the regulators the fact that Lehman engaged in Repo 105 transactions. *Id.* Grieb, who served as Lehman's Global Financial Controller for several years until November 30, 2007 and then served as Lehman's Director of Investor Relations, similarly said that Lehman did not disclose its Repo 105 practice in its Forms 10-K or 10-Q. Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 14. Nor did Grieb recall ever discussing Lehman's Repo 105 program, or the fact of its Repo 105 transactions, with any analyst who covered Lehman. *Id.*

[3739] In an ordinary repurchase agreement, as demonstrated by the accounting entries in Section III.A.4.d.2 of this Report, a liability would have been created reflecting an obligation to repay the borrowing, and securities used as collateral would have remained on the balance sheet in securities inventory.

[3740] 17 C.F.R. § 229.303 (2009).

MD&A should not be merely a restatement of financial statement information in a narrative form.[3741]

- When a description of known material trends, events, demands, commitments, and uncertainties is set forth, companies should consider including, and may be required to include, an analysis explaining the underlying reasons or implications, interrelationships between constituent elements, or the relative significance of those matters.[3742]

As set forth in SEC guidance regarding MD&A, the principal objectives of MD&A are to provide: (1) a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management; (2) context within which financial information should be analyzed; and (3) information about the quality of, and potential variability of, a company's earnings and cash flow so that investors can ascertain the likelihood that past performance is indicative of future performance.[3743]

Regulation S-K – together with SEC guidance – supports the Examiner's conclusion that the trier of fact could find that Lehman had an obligation to disclose certain aspects of its Repo 105 program in the MD&A:

Liquidity:

- "Identify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way… Also

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[3741] Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operation, Securities Act Release No. 8350, Exchange Act Release No. 48,960, 81 SEC Docket 2905 (Dec. 19, 2003).

[3742] *Id.*

[3743] *Id.*

identify and separately describe internal and external sources of liquidity…."[3744]

- Identifying the intermediate effects of trends, events, demands, commitments and uncertainties alone, without describing the reasons underlying these effects, may not provide sufficient insight for a reader to see the business through the eyes of management.[3745]

Capital Resources:

- "Describe any known material trends, favorable or unfavorable, in the registrant's capital resources. Indicate any expected material changes in the mix and relative cost of such resources. The discussion shall consider changes between equity, debt and ***any off-balance sheet financing arrangements***."[3746]

Results of Operations of the MD&A:

- "Describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."[3747]

Off-balance sheet arrangements:

- "In a separately-captioned section, discuss the registrant's off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors."[3748]

- The disclosure of off-balance sheet arrangements shall include the following items "to the extent necessary to an understanding of such arrangements and

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[3744] Item 303(a)(1) of Regulation S-K.

[3745] Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operation, Securities Act Release No. 8350, Exchange Act Release No. 48,960, 81 SEC Docket 2905 (Dec. 19, 2003).

[3746] Item 303(a)(2)(ii) of Regulation S-K (emphasis added).

[3747] Item 303(a)(3) of Regulation S-K.

[3748] Item 303(a)(4)(i) of Regulation S-K.

effect and shall also include such other information that the registrant believes is necessary for such an understanding"[3749]:

- "The nature and business purpose to the registrant of such off-balance sheet arrangements;"[3750]
- "The importance to the registrant of such off-balance sheet arrangements in respect of its liquidity, capital resources, market risk support, credit risk support or other benefits;"[3751]
- "The amounts of revenues, expenses and cash flows of the registrant arising from such arrangements; […]; and the nature and amounts of any other obligations or liabilities (including contingent obligations or liabilities) of the registrant arising from such arrangements that are or are reasonably likely to become material and the triggering events or circumstances that could cause them to arise;"[3752]
- "Any known event, demand, commitment, trend or uncertainty that will result in or is reasonably likely to result in the termination or material reduction in availability to the registrant, of its off-balance sheet arrangements that provide material benefits to it, and the course of action that the registrant has taken or proposes to take in response to any such circumstances."[3753]

SEC guidance explains when disclosure is required:

- Where the reported financial information is NOT indicative of the future – *i.e.*, where additional explanation is required to enhance the indicative value of reported results.[3754]
- To describe unusual events and transactions, demands, commitments, and uncertainties in order to reveal, identify, or further define apparent trends.[3755]

[3749] *Id.*

[3750] Item 303(a)(4)(i)(A) of Regulation S-K.

[3751] Item 303(a)(4)(i)(B) of Regulation S-K.

[3752] Item 303(a)(4)(i)(C) of Regulation S-K.

[3753] Item 303(a)(4)(i)(D) of Regulation S-K.

[3754] Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operation, Securities Act Release No. 8350, Exchange Act Release No. 48,960, 81 SEC Docket 2905 (Dec. 19, 2003).

[3755] *Id.*

- If management determines that a trend, demand, commitment, event or uncertainty is reasonably likely to occur, disclosure is required unless management determines that a material effect on the company's financial condition or results of operation is not reasonably likely to occur.[3756]

Disclosure of the agreement to repurchase component of Repo 105 transactions was required in the MD&A. Lehman's repurchase of the securities was a known event that was reasonably likely to occur and would have had a material effect on the company's financial condition or results of operations. Lehman's disclosure in the Liquidity and Capital Resources section should have included a discussion of what was known with respect to the timing and/or amounts of the cash flow created by the repayment of the Repo 105 cash borrowing in the first seven to ten days after quarter-end, specifically: (1) the availability of cash as a result of the repayment of the Repo 105 cash borrowing; (2) the ability to borrow more capital because of a reduction in debt rating or deterioration in leverage ratio due to the repayment of the Repo 105 cash borrowing; (3) the effect of the repayment of the Repo 105 cash borrowing on the cost of capital/credit rating; and (4) the economic substance and business purpose of the Repo 105 arrangements.

(b) Duty to Disclose

SEC Rule 12b-20 requires that all filings contain such additional information necessary to make the information contained in the filing not misleading. Moreover,

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[3756] Management's Discussion and Analysis of Financial Condition and Results of Operation; Certain Investment Company Disclosures, Securities Act Release 33-6835, Exchange Act Release No. 26,831, Investment Company Act Release No. 16,461, 43 SEC Docket 1330 (May 18, 1989).

"Once defendants choose to speak about their company, they undertake a duty to 'speak truthfully and to make such additional disclosures as…necessary to avoid rendering the statements misleading.'"[3757]

(c) Lehman's Public Filings

An investor reviewing Lehman's 2007 Form 10-K and two 2008 Forms 10-Q would not have been able to discern that Lehman was engaged in Repo 105 transactions.[3758] Indeed, Lehman made no disclosures in its Statement of Income, Statement of Financial Condition, Statement of Cash Flows, or MD&A sections (including its section on liquidity) from which an investor could infer that Lehman treated a certain volume of repo transactions as sales under SFAS 140, thereby decreasing its net assets and its net leverage ratio.[3759]

[3757] *Hall v. The Children's Place*, 580 F. Supp.2d 212, 226 (S.D.N.Y. 2008) (citing *In re Par Pharm., Inc. Sec. Litig.*, 733 F. Supp. 668, 675 (S.D.N.Y. 1990); *see also Lapin v. Goldman Sachs Group, Inc.*, 506 F. Supp.2d 221, 237 (S.D.N.Y. 2006) (holding that "upon choosing to speak one 'has a duty to be both accurate and complete'") (quoting *Caiola v. Citibank, N.A.*, 295 F.3d 312, 331 (2d Cir. 2002); *In re Alstom SA Sec. Litig.*,, 406 F. Supp.2d 433, 445 (S.D.N.Y. 2005) ("The Second Circuit has held that 'one circumstance creating a duty to disclose arises when disclosure is necessary to make prior statements not misleading.'") (quoting *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259, 268 (2d Cir. 1993)).

[3758] Former Lehman Global Financial Controllers Grieb and Kelly, as well as the former Lehman Global Head of Accounting Policy, confirmed that Lehman made no disclosures in its Forms 10-K and 10-Q about its Repo 105 practice. Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 15; Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 9; Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 14.

[3759] As discussed in Section III.A.4.d.2 of this Report, Lehman used incoming cash from Repo 105 transactions to pay down other liabilities, so an investor reading Lehman's publicly-filed statements would not have seen an increase in Lehman's cash holdings. *See* LBHI 2007 10-K, at p. 86 (reporting that Lehman had $7.286 billion in cash and cash equivalents as of November 30, 2007); LBHI 10-Q (filed Apr. 9, 2008), at p. 5 (reporting that Lehman had $7.564 billion in cash and cash equivalents as of February 29, 2008); LBHI 10-Q (filed July 10, 2008), at p. 5 (reporting that Lehman had $6.513 billion in cash and cash equivalents as of May 31, 2008). While Lehman's Repo 105 transactions spiked at quarter-ends, Lehman's

(i) Summary of Lehman's 2000 through 2007 Public Filings

The Examiner reviewed Lehman's Forms 10-K and Forms 10-Q from 2000 through third quarter 2007. Several items are worth noting:

- FASB issued SFAS 140 in September 2000. Lehman's first disclosure regarding SFAS 140 is found in its Form 10-K405 for 2000.[3760] In its Form 10-K405 (Nov. 30, 2000), Lehman explained that SFAS 140 changed the criteria used to evaluate whether a financial asset is controlled and whether a vehicle constitutes a Qualifying Special Purpose Entity ("QSPE").[3761]

- Lehman never disclosed in any of its Forms 10-K and 10-Q from 2000 through third quarter 2007 that it treated some repo transactions as sales pursuant to SFAS 140.[3762] Because Lehman treated Repo 105 transactions as

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ordinary repo balances dropped off significantly during the same time periods. Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 5.

[3760] Lehman Brothers Holdings Inc., Annual Report for 2000 as of Nov. 30, 2000 (Form 10-K405) (filed on Feb. 28, 2001), at p. 52 ("LBHI 2000 10-K405").

[3761] *Id.*; *see also* Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2002 (Form 10-Q) (filed on July 15, 2002), at p. 7 ("LBHI 10-Q (filed July 15, 2002)").

[3762] *See generally* Lehman Brothers Holdings Inc., Annual Report for 2001 as of Nov. 30, 2001 (Form 10-K405) (filed on Feb. 28, 2002) ("LBHI 2001 10-K405"); Lehman Brothers Holdings Inc., Annual Report for 2002 as of Nov. 30, 2002 (Form 10-K) (filed on Feb. 28, 2003) ("LBHI 2002 10-K"); Lehman Brothers Holdings Inc., Quarterly Report as of Aug. 31, 2003 (Form 10-Q) (filed on Oct. 15, 2003) ("LBHI 10-Q (filed Oct. 15, 2003)"); Lehman Brothers Holdings Inc., Annual Report for 2003 as of Nov. 30, 2003 (Form 10-K) (filed on Feb. 26, 2004) ("LBHI 2003 10-K"); Lehman Brothers Holdings Inc., Quarterly Report as of Feb. 29, 2004 (Form 10-Q) (filed on Apr. 14, 2004) ("LBHI 10-Q (filed Apr. 14, 2004)"); Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2004 (Form 10-Q) (filed on July 14, 2004) ("LBHI 10-Q (filed July 14, 2004)"); Lehman Brothers Holdings Inc., Quarterly Report as of Aug. 31, 2004 (Form 10-Q) (filed on Oct. 15, 2004) ("LBHI 10-Q (filed Oct. 15, 2004)"); Lehman Brothers Holdings Inc., Annual Report for 2004 as of Nov. 30, 2004 (Form 10-K) (filed on Feb. 14, 2005) ("LBHI 2004 10-K"); Lehman Brothers Holdings Inc., Quarterly Report as of Feb. 28, 2005 (Form 10-Q) (filed on Apr. 11, 2005) ("LBHI 10-Q (filed Apr. 11, 2005)"); Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2005 (Form 10-Q) (filed on July 11, 2005) ("LBHI 10-Q (filed July 11, 2005)"); Lehman Brothers Holdings Inc., Quarterly Report as of Aug. 31, 2005 (Form 10-Q) (filed on Oct. 11, 2005) ("LBHI 10-Q (filed Oct. 11, 2005)"); Lehman Brothers Holdings Inc., Annual Report for 2005 as of Nov. 30, 2005 (Form 10-K) (filed on Feb. 13, 2006) ("LBHI 2005 10-K"); Lehman Brothers Holdings Inc., Quarterly Report as of Feb. 28, 2006 (Form 10-Q) (filed on Apr. 10, 2006) ("LBHI 10-Q (filed Apr. 10, 2006)"); Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2006 (Form 10-Q) (filed on July 10, 2006) ("LBHI 10-Q (filed July 10, 2006)"); Lehman Brothers Holdings Inc., Quarterly Report as of Aug. 31, 2006 (Form 10-Q) (filed on Oct. 10, 2006) ("LBHI 10-Q (filed Oct. 10, 2006)"); Lehman Brothers Holdings Inc., Annual Report for 2006 as of Nov. 30, 2006 (Form 10-K)

sales rather than borrowings (as it treated other repo transactions), Lehman did not disclose its liabilities arising from the obligation to repay the cash borrowing.

- Lehman consistently represented that it treated repo transactions as "secured financing" transactions "for financial reporting purposes," without disclosing that it treated some repos as sales.[3763]

- Lehman repeatedly disclosed that SFAS 140 required it to classify in its financial statements certain collateral that Lehman owned, but pledged to its counterparty, as "financial instruments and other inventory owned but pledged as collateral."[3764] One example of collateral that is owned but pledged consists of securities that are transferred in an ordinary repo transaction. Lehman stated that it was required to classify as a separate line item ("Securities Owned Pledged as Collateral") on the balance sheet under "Assets" those securities that were owned by Lehman but pledged to its counterparty if the counterparty had "the right, by contract or custom, to sell or repledge the securities."[3765] Accordingly, securities that Lehman

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(filed on Feb. 13, 2007) ("LBHI 2006 10-K"); Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2007 (Form 10-Q) (filed on July 10, 2007) ("LBHI 10-Q (filed July 10, 2007)"); Lehman Brothers Holdings Inc., Quarterly Report as of Aug. 31, 2007 (Form 10-Q) (filed on Oct. 10, 2007) ("LBHI 10-Q (filed Oct. 10, 2007)").

[3763] LBHI 2001 10-K405, at p. 67; LBHI 2002 10-K, at p. 69; LBHI 10-Q (filed Oct. 15, 2003), at pp. 10-11; LBHI 2003 10-K, at p. 76; LBHI 10-Q (filed Apr. 14, 2004), at p. 10; LBHI 10-Q (filed July 14, 2004), at p. 11; LBHI 10-Q (filed Oct. 15, 2004), at p. 11; LBHI 2004 10-K, at p. 89; LBHI 10-Q (filed Apr. 11, 2005), at pp. 11-12; LBHI 10-Q (filed July 11, 2005), at pp. 11-12; LBHI 10-Q (filed Oct. 11, 2005), at p. 11; LBHI 2005 10-K, at p. 81; LBHI 10-Q (filed Apr. 10, 2006), at p. 11; LBHI 10-Q (filed July 10, 2006), at p. 12; LBHI 10-Q (filed Oct. 10, 2006), at pp. 11-12; LBHI 2006 10-K, at pp. 85-86; LBHI 10-Q (filed July 10, 2007), at p. 12; LBHI 10-Q (filed Oct. 10, 2007), at p. 12.

[3764] LBHI 2000 10-K405, at p. 2; Lehman Brothers Holdings Inc., Quarterly Report as of Feb. 28, 2001 (Form 10-Q) (filed on Apr. 16, 2001), at p. 26 ("LBHI 10-Q (filed Apr. 16, 2001)"); Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2001 (Form 10-Q) (filed on July 16, 2001), at p. 29 ("LBHI 10-Q (filed July 16, 2001)"); LBHI 2001 10-K405, at p. 57.

[3765] LBHI 2001 10-K405, at p. 66; Lehman Brothers Holdings Inc., Quarterly Report as of Aug. 31, 2002 (Form 10-Q) (filed on Oct. 15, 2002), at p. 17 ("LBHI 10-Q (filed Oct. 15, 2002)"); LBHI 2002 10-K, at p. 91; Lehman Brothers Holdings Inc., Quarterly Report as of Feb. 28, 2003 (Form 10-Q) (filed on Apr. 14, 2003), at pp. 12-13 ("LBHI 10-Q (filed Apr. 14, 2003)"); Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2003 (Form 10-Q) (filed on July 15, 2003), at pp. 14-15 ("LBHI 10-Q (filed July 15, 2003)"); LBHI 10-Q (filed Oct. 15, 2003), at p. 20; LBHI 10-Q (filed Apr. 14, 2004), at p. 16; LBHI 10-Q (filed July 14, 2004), at pp. 16-17; LBHI 10-Q (filed Oct. 15, 2004), at p. 17; LBHI 2004 10-K, at p. 99; LBHI 10-Q (filed Apr. 11, 2005), at p. 19; LBHI 10-Q (filed July 11, 2005), at p. 19; LBHI 10-Q (filed Oct. 11, 2005), at p. 18; LBHI 10-Q (filed Apr. 10, 2006), at p. 21; LBHI 10-Q (filed July 10, 2006), at p. 20; LBHI 10-Q (filed Oct. 10, 2006), at p. 21; LBHI 2006 10-K (filed Nov. 30, 2006), at p. 95.

transferred in ordinary repo transactions where the repo counterparty had the right to sell or repledge the securities should have been included among the assets reported on Lehman's balance sheet under "Securities Owned Pledged as Collateral."

- Because Lehman treated financial instruments transferred and pledged in Repo 105 transactions as "sold," those securities were ***not*** included in the line item for "Securities Owned Pledged as Collateral."

- Lehman repeatedly disclosed that it obtained short-term financing on a secured basis through the use of repo transactions, which were primarily collateralized by government, agency, and equity securities.[3766]

- In a few of its financial statements, Lehman stated that "The Company accounts for transfers of financial assets in accordance with SFAS 140" and followed this statement with a summary of SFAS 140's three criteria for recognizing the transfer of financial assets as sales.[3767] In these instances where Lehman made the general disclosure regarding SFAS 140: (1) the SFAS 140 disclosure was listed under "Consolidation Accounting Policies" along with a disclosure regarding Special Purpose Entities or was part of a "Securitization activities" disclosure; (2) Lehman did ***not*** state that it treated some repo transactions as sales under SFAS 140; ***and*** (3) the financial statement contained other disclosure(s) stating that Lehman treats repo transactions as secured financings (*i.e.*, not as sales) and/or regarding securities owned and pledged as collateral (as described above).[3768]

[3766] *See, e.g.*, LBHI 2000 10-K405, at p. 62; LBHI 2001 10-K405, at pp. 67-68; LBHI 2002 10-K, at p. 69; LBHI 10-Q (filed Oct. 15, 2003), at pp. 10-11; LBHI 2003 10-K, at p. 76; LBHI 10-Q (filed Apr. 14, 2004), at p. 10; LBHI 10-Q (filed Oct. 15, 2004), at p. 11; LBHI 2004 10-K, at p. 89 (filed Feb. 14, 2005); LBHI 10-Q, at p. 11-12 (filed Apr. 11, 2005); LBHI 10-Q, pp. 11-12 (filed July 11, 2005); LBHI 10-Q, at p. 11 (filed Oct. 11, 2005); LBHI 2005 10-K, at p. 81; LBHI 10-Q, at pp. 11-12 (filed Apr. 10, 2006); LBHI 10-Q, at p. 12 (filed July 10, 2006); LBHI 10-Q, at pp. 11-12 (filed Oct. 10, 2006); LBHI 2006 10-K, at pp. 85-86; LBHI 10-Q, at p. 12 (filed Apr. 9, 2007); LBHI 10-Q, at p. 12 (filed Jul 10, 2007); LBHI 10-Q, at p. 12 (filed Oct. 10, 2007).

[3767] LBHI 10-Q (filed July 15, 2002), at p. 8; *see also id.* at p. 42 (discussing SFAS 140 in the context of securitizations and special purpose entities).

[3768] *See* LBHI 10-Q (filed July 15, 2002), at pp. 8, 14; LBHI 10-Q (filed Oct. 15, 2002), at pp. 9-10, 17; LBHI 2002 10-K, at pp. 69, 71, 91; LBHI 10-Q (filed Oct. 15, 2003), at pp. 10-11, 12-13, 20; Lehman Brothers Holdings Inc., Quarterly Report as of Feb. 28, 2007 (Form 10-Q) (filed on Apr. 9, 2007), at pp. 11-12 ("LBHI 10-Q (filed Apr. 9, 2007)"); LBHI 10-Q (filed July 10, 2007), at pp. 11-12; LBHI 10-Q (filed Oct. 10, 2007), at pp. 11-12.

At no time did Lehman disclose that it recharacterized certain repo transactions as sales or the impact this accounting treatment had on its net balance sheet or leverage ratios. In addition, although Lehman in its 2006 Form 10-K disclosed that "[t]he overall size of our balance sheet will fluctuate from time to time and, at specific points in time, may be higher than the year-end or quarter-end amounts," and that "[o]ur net assets at quarter-ends were, on average, approximately 5% and 6% lower than amounts based on a monthly average over the four and eight quarters ended November 30, 2006," Lehman removed any such disclosure in its 2007 Form 10-K and first and second quarter 2008 Forms 10-Q, at the very time Lehman escalated its quarter-end Repo 105 usage.[3769]

(ii) Lehman's 2007 Form 10-K, First Quarter 2008 Form 10-Q, and Second Quarter 2008 Form 10-Q

Nowhere in Lehman's 2007 Form 10-K or Forms 10-Q for the first and second quarter 2008 did Lehman disclose that it engaged in Repo 105 transactions. Moreover, Lehman affirmatively misrepresented how it treated repo transactions for financial reporting purposes. As a result of omitting information regarding its Repo 105 practice, Lehman's statements regarding its net leverage were rendered misleading. Furthermore, Lehman's omissions, including its lack of disclosures regarding Repo 105 derivatives, precluded a reader of the periodic reports from ascertaining that Lehman used temporary off-balance sheet repo transactions to impact its net leverage.

[3769] LBHI 2006 10-K, at p. 51; *see generally* LBHI 2007 10-K; LBHI 10-Q (filed Apr. 9, 2008); LBHI 10-Q (filed July 10, 2008).

a. Treatment of Repo Transactions and SFAS 140

In its 2007 Form 10-K, first quarter 2008 Form 10-Q, and second quarter 2008 Form 10-Q, Lehman affirmatively represented that it treated repurchase agreements as financings – not as sales. In Note 1 to Lehman's Consolidated Financial Statements in each filing, Lehman stated that it treated "[r]epurchase and resale agreements," as "***collateralized agreements and financings for financial reporting purpose***" which Lehman described were "collateralized primarily by government and government agency securities."[3770] In addition, Lehman further stated in each filing: "Other secured borrowings principally reflect transfers ***accounted for as financings*** rather than sales under SFAS 140."[3771]

Lehman disclosed that it recognized the transfer of financial assets as sales pursuant to SFAS 140 – but it said so only with respect to "securitization activities."[3772] Securitization activities, however, bear no relation to repo transactions generally, or to

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[3770] LBHI 2007 10-K, at p. 97; LBHI 10-Q (filed Apr. 9, 2008), at p. 13; LBHI 10-Q (filed July 10, 2008), at p. 16 (emphasis added). This disclosure is under the heading "Collateralized Lending Agreements and Financings."

[3771] LBHI 2007 10-K, at p. 97; LBHI 10-Q (filed Apr. 9, 2008), at p. 13; LBHI 10-Q (filed July 10, 2008), at p. 16 (emphasis added). In Note 5 to its financial statements, Lehman disclosed that it pledged its own assets to collateralize financing arrangement. LBHI 2007 10-K, at p. 110. It further stated that "[t]hese pledged securities, where the counterparty has the right by contract or custom to sell or repledge the financial instruments, were approximately $63 billion…at November 30, 2007…." *Id.*; *see also* LBHI 10-Q (filed Apr. 9, 2008), at p. 26 (same); LBHI 10-Q (filed July 10, 2008), at p. 34 (same). Note 5 refers to a subset of ordinary repo transactions – *not to Repo 105 transactions*, which Lehman treated as sales rather than financing arrangements and did not identify or disclose.

[3772] LBHI 2007 10-K, at p. 96; LBHI 10-Q (filed Apr. 9, 2008), at p. 13; LBHI 10-Q (filed July 10, 2008), at pp. 15-16. "Securitization activities" is a separate heading in the Note.

Repo 105 transactions specifically.[3773] Just as Lehman's disclosures dealt with securitization activities and repo transactions separately, SFAS 140 addressed these distinct transactions separately as well.[3774]

Lehman's MD&A for its 2007 Form 10-K and Forms 10-Q for the first and second quarter 2008 were also misleading with respect to Lehman's liabilities, *i.e.*, the obligation to repay the Repo 105 cash borrowing. Lehman's repayment of the Repo 105 cash borrowing (the "repurchase" of the Repo 105 securities) was a known event that would have a material impact on Lehman's cash flow and liabilities.[3775]

[3773] Securitization occurs when a pool of "financial assets such as mortgage loans, automobile loans, trade receivables, credit card receivables, and other revolving charge accounts" is created and then securities representing interests in that pool are sold. ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Financial Accounting Standards No. 140, ¶ 73 (Fin. Accounting Standards Bd. 2000) ("SFAS 140"). The pool is created by transferring the financial assets to a special purpose entity ("SPE"). "An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to an SPE, commonly a trust." SFAS 140, ¶ 74. "Beneficial interests in the SPE are sold to investors and the proceeds are used to pay the transferor for the assets transferred." SFAS 140, ¶ 75. When the criteria of SFAS 140 are met, a company can remove from its balance sheet the loans, receivables or other assets that it transferred to the special purpose vehicle as the first step in the securitization activity. In contrast, and as discussed at length at the beginning of this Report, a repo transaction allows a repo borrower to borrow cash from a repo lender in exchange for the transfer of securities. When the term of the repo matures, the repo borrower repurchases the securities from the repo lender and pays an additional interest rate on the borrowed cash. *See* SFAS 140, ¶ 96.

[3774] SFAS 140 deals with securitizations in Paragraphs 73 through 84, and with repo agreements in Paragraphs 96 through 101.

[3775] If a Repo 105 transaction technically complied with SFAS 140, SFAS 140 did not require that the cash borrowing be recorded as a liability because the repo transaction was recharacterized as a sale. However, because Lehman made no disclosures in its periodic reports regarding its accounting treatment for and volume of Repo 105 transactions, sufficient evidence exists for a finding that Lehman's MD&A was deficient because it did not disclose that Lehman had borrowed tens of billions of dollars it was required to repay in the short-term and that repayment of the Repo 105 borrowing would require Lehman to find financing.

b. Net Leverage

As discussed earlier in the Report, Lehman's MD&A discussion of Capital Ratios stated that a "more meaningful" ratio than "leverage ratio" is "net leverage, which is the result of net assets divided by tangible equity capital."[3776] According to Lehman's MD&A, Lehman "calculates net assets by excluding from total assets: (i) cash and securities segregated and on deposit for regulatory and other purposes; (ii) collateralized lending agreements; and (iii) identifiable intangible assets and goodwill."[3777] Lehman informed the investing public that it viewed "net leverage based on net assets to be a more useful measure of leverage, because it excludes certain low-risk, non-inventory assets and utilizes tangible equity capital as a measure of equity base."[3778]

Lehman's net leverage ratio on November 30, 2007, as reported in its 2007 Form 10-K, was 16.1x.[3779] If Lehman had used ordinary repos instead of its undisclosed Repo 105 transactions for the approximately $38 billion in Repo 105 transactions that Lehman

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[3776] LBHI 2007 10-K, at p. 63; LBHI 10-Q (filed Apr. 9, 2008), at p. 72; LBHI 10-Q (filed July 10, 2008), at p. 88.
[3777] LBHI 2007 10-K, at p. 63; LBHI 10-Q (Apr. 9, 2008), at p. 72; LBHI 10-Q (July 10, 2008), at p. 88.
[3778] LBHI 2007 10-K, at p. 63; LBHI 10-Q (filed Apr. 9, 2008), at p. 72; LBHI 10-Q (filed July 10, 2008), at p. 88.
[3779] LBHI 2007 10-K, at p. 29.

undertook at the close of its fiscal 2007, Lehman's net leverage at close of fiscal year 2007 would have been 17.8x.[3780]

Lehman's net leverage ratio on February 29, 2008, as reported in its first quarter 2008 Form 10-Q, was 15.4x.[3781] If Lehman had used ordinary repo transactions rather than its undisclosed Repo 105 transactions for the $49.1 billion in Repo 105 transactions that Lehman undertook at the close of the first quarter 2008, Lehman's net leverage at close of its first quarter 2008 would have been 17.3x.[3782]

Lehman's net leverage ratio on May 31, 2008, as reported in its second quarter 2008 Form 10-Q, was 12.06x.[3783] If Lehman had used ordinary repo transactions rather than its undisclosed Repo 105 transactions for the approximately $50.38 billion in Repo 105 transactions that Lehman undertook at the close of the second quarter 2008, Lehman's net leverage at close second quarter 2008 would have been 13.9x.[3784]

c. Derivatives

As discussed *supra* at Section III.A.4.d.2.d of the Report, when Lehman employed Repo 105 transactions, it established a long inventory derivative asset representing the

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[3780] *See* Section III.A.4.g.2 of this Report (discussing the impact of Lehman's Repo 105 practice upon its net leverage); Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 8.

[3781] LBHI 10-Q (filed Apr. 9, 2008), at p. 72.

[3782] *See* Section III.A.4.g.2 of this Report (discussing the impact of Lehman's Repo 105 practice upon its net leverage); Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 8.

[3783] LBHI 10-Q (filed July 10, 2008), at p. 89.

[3784] *See* Section III.A.4.g.2 of this Report (discussing the impact of Lehman's Repo 105 practice upon its net leverage); Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 8.

obligation under a forward contract to repurchase the full amount of securities "sold" in a Repo 105 transaction.[3785] Assuming Lehman borrowed $100 cash in exchange for a pledge of $105 of fixed income collateral, Lehman booked a $5 derivative, which represented Lehman's obligation to repurchase the securities at the end of the term of the repo transaction.[3786] The $5 reflected the market value of the overcollateralization of the Repo 105 transaction.

A comprehensive review of Lehman's 2007 Form 10-K, first quarter 2008 Form 10-Q, and second quarter 2008 Form 10-Q does not allow a user – even one who knows of the existence of Lehman's Repo 105 practice, including the creation of a derivative –to identify the amount of the Repo 105 borrowing, or the existence of and size of the derivative asset created that would represent Lehman's obligation to repurchase the securities.[3787]

[3785] Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108, at p. 2 [LBEX-DOCID 3213293].

[3786] *Id.*

[3787] Lehman's former Global Financial Controller, Martin Kelly, advised the Examiner that the "risk" of a Repo 105 transaction was represented in the derivatives created by these transactions, which were aggregated with other derivatives. Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 13. Kelly stated that "risk reporting was just an aggregate – you could *not* have known about Repo 105 from risk disclosures." *Id.* Lehman's 2007 10-K MD&A discussion of Off-Balance Sheet Arrangements included a disclosure of the notional amount of off-balance sheet arrangements including derivative contracts. LBHI 2007 10-K, at p. 66. A footnote to the table included in this MD&A discussion states that the fair value of Lehman's derivative contracts as of November 30, 2007, was $38.6 billion. *Id.* at p. 67. No mention (by name or description) or break out of Repo 105 derivatives is included. The 2007 10-K MD&A's risk management discussion also references derivatives, breaking out the fair value of OTC derivatives by maturity. *Id.* at p. 72. Lehman stated that the fair value of its OTC derivative assets at November 30, 2007 was $41.3 billion. *Id.* Again, there is no mention or break out of Repo 105 derivatives. The volume of Repo 105 derivative assets (roughly $4 billion) would presumably feed into the $313.129 billion line item "Financial Instruments and Other Positions Owned" on Lehman's Consolidated Statement of Financial

Condition as of November 30, 2007, but again, no mention or break out of Repo 105 is given. *Id.* at p. 86. Note 1 to the financial statements discusses "Derivative Financial Instruments" without mention or break out of Repo 105 derivatives. *Id.* at p. 95. Note 3 regarding "Financial Instruments and Other Inventory Positions" provides detail on the single line item from the balance sheet, mentioned above. It states that $44.595 billion of the $313.129 billion line item is comprised of derivatives and other contractual agreements. LBHI 2007 10-K, at p. 103. No break out or disclosure of the Repo 105 derivative exists. Later in the same Note, Lehman broke out individual derivative segments in a table on "Fair Value of Derivatives and Other Contractual Agreements." *Id.* at p. 106. Again, there is no disclosure regarding Repo 105 derivatives. Note 4 to the financial statements breaks out the fair value of derivatives according to FAS 157 level. *Id.* at p. 107. Lehman stated that its total derivative assets at fair value as of November 30, 2007 was $44.595 billion. *Id.* Repo 105 derivatives are not identified or broken out. Derivatives are mentioned in Note 8 solely as interest rate liability tools. *See id.* at 116 ("End-User Derivative Activities"). Note 9 on "Commitments, Contingencies and Guarantees" discusses derivative contracts that are guarantees and duplicates the table from the MD&A's discussion of Off-Balance Sheet Arrangements (discussed above and at LBHI 2007 10-K, p. 67). *Id.* at p. 120. The notional amount of derivatives is broken out by year and discussed in the context of guarantor accounting of those derivatives considered to be guarantees. *Id.* The Note contains no mention or break out of Repo 105 derivatives. Lehman's quarterly reports similarly failed to disclose any information regarding the Repo 105 derivative. *See* LBHI 10-Q (filed Apr. 9, 2008), at p. 5 (balance sheet line item "Financial instruments and other inventory positions owned" was $326.569 billion and contains no mention or break out of Repo 105 derivatives); *id.* at p. 12 (Note 1's discussion of "Derivative financial instruments" makes no reference to Repo 105 derivatives); *id.* at p. 19 (Note 3's discussion of "Financial Instruments and Other Inventory Positions" contains derivatives and other contractual agreements line item of $55.612 billion, but no break out or mention of Repo 105 derivative); *id.* at p. 21 (Note 3 table "Fair Value of Derivatives and Other Contractual Agreements" breaks out some derivative segments but makes no mention of Repo 105 derivative); *id.* at p. 31 (Note 8 on "Commitments, Contingencies and Guarantees" discusses derivative contracts that are guarantees with no mention of Repo 105 derivatives); LBHI 10-Q (filed Apr. 9, 2008), at p. 75 (MD&A Off-Balance-Sheet Arrangements contains disclosure of the notional amount of off-balance sheet arrangements including derivative contracts, but no break out or mention of Repo 105 derivatives); *id.* at p. 80 (discussion of derivatives, breaking out the fair value of OTC derivatives by maturity, but no break-out or mention of Repo 105 derivatives); *see also* LBHI 10-Q (filed July 10, 2008), at p. 5 (balance sheet line item "Financial instruments and other inventory position owned" was $269.409 billion and contains no mention or break out of Repo 105 derivatives); *id.* at p. 12 (Note 1's discussion of "Derivative financial instruments" makes no reference to Repo 105 derivatives); *id.* at p. 24 (Note 3's discussion of "Financial Instruments and Other Inventory Positions" contains derivatives and other contractual agreements line item of $46.991 billion, but no break out or mention of Repo 105 derivative); *id.* at p. 26 (Note 3 table "Fair Value of Derivatives and Other Contractual Agreements" breaks out some derivative segments but makes no mention of Repo 105 derivative); *id.* at p. 40 (Note 8 on "Commitments, Contingencies and Guarantees" discusses derivative contracts that are guarantees with no mention of Repo 105 derivatives); LBHI 10-Q (filed July 10, 2008), at p. 91 (MD&A Off-Balance-Sheet Arrangements contains disclosure of the notional amount of off-balance sheet arrangements including derivative contracts, but no break out or mention of Repo 105 derivatives); *id.* at p. 97 (discussion of derivatives, breaking out the fair value of OTC derivatives by maturity, but no break-out or mention of Repo 105 derivatives).

d. A Reader of Lehman's Forms 10-K and 10-Q Would Not Have Been Able to Ascertain That Lehman Engaged in Temporary Sales Using Liquid Securities

In addition, even a sophisticated reader of Lehman's financial statements would not have been able to ascertain from Lehman's 2007 Form 10-K or its first and second quarter 2008 Forms 10-Q the amount of Lehman's Repo 105 usage, nor even ascertain the fact that Lehman was engaged in these transactions, by attempting to quantify the amount of liquid securities temporarily removed from the balance sheet, as reported in Lehman's public financial statements.

- Note 3 of Lehman's financial statements provided a break out of the "Financial Instruments and Other Inventory Positions" balance sheet line item.[3788] Note 3 presented Lehman's long and short inventory using very high-level, generalized descriptions of security type.[3789] The securities inventory that Lehman "sold" through Repo 105 transactions were excluded from the aggregate numbers in the financials, and Lehman's Forms 10-K and 10-Q contained no textual disclosures about the exclusions (or the subsequent obligation to repurchase the temporarily "sold" assets). Even if a user of the financials was aware of the existence of Repo 105 transactions, the user would be unable to deduce the size of the Repo 105 program or the securities being used. Since Repo 105 transactions were done on a continual basis and were indistinguishable from ordinary asset sales for the purposes of financial presentation, and since maturities of Repo 105 were staggered, *i.e.*, one week, two week, multi-month or multi-quarter, it would have been impossible to disaggregate the fluctuations in assets without being privy to additional information that is not presented in the financial statements.

- Further, a reader of Lehman's Forms 10-K and 10-Q would have had no idea that Lehman was selling highly liquid securities in Repo 105 transactions on

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[3788] LBHI 2007 10-K, at p. 103; LBHI 10-Q (filed Apr. 9, 2008), at p. 19; LBHI 10-Q (filed July 10, 2008), at p. 24.

[3789] LBHI 2007 10-K, at p. 103; LBHI 10-Q (filed Apr. 9, 2008), at p. 19; LBHI 10-Q (filed July 10, 2008), at p. 24.

a temporary basis. The categories of asset classes were very broad, and the disclosures are snapshots of quarter-end only, which do not allow the user to determine balances of securities moving on or off balance sheet on an intra-quarter basis. Additionally, to the extent that the reader could see various security balances increasing or decreasing, *i.e.*, that Lehman sold liquid securities, the reader would not know the sales were temporary from the information provided.

- Moreover, sophisticated readers of financial statements – the professional analysts who covered Lehman – asked Lehman officers during earnings calls what Lehman was selling in order to ascertain what types of assets Lehman was moving in its efforts to deleverage.[3790] Former CFO Erin Callan informed analysts that Lehman was selling illiquid positions to deleverage.[3791]

(d) Conclusions Regarding Lehman's Failure to Disclose

SEC Filings. As discussed above, Section 13(a) of the Securities Exchange Act of 1934 required Lehman to file periodic reports with the SEC, including its annual report on Form 10-K and quarterly reports on Form 10-Q. Those filings must contain the information required by the SEC's Rules and Interpretations, including the MD&A requirement discussed above. In addition, SEC Rule 12b-20 requires that all filings contain such additional information necessary to make the information contained in the filing not misleading. There is sufficient evidence to support a determination by the trier of fact that Lehman's filings were deficient and misleading. In the wake of the Enron scandal, at the request of four major accounting firms, the SEC provided additional guidance with respect to the duty to provide meaningful discussion of a company's financial statements. Among other things, SEC guidance from 2002 stated:

[3790] *See* Section III.A.4.e.6.a of this Report (discussing analyst statements).

[3791] *Id.*

> The Commission has long recognized the need for a narrative explanation of the financial statements, because numerical presentations and brief accompanying footnotes alone may be insufficient for an investor to judge the quality of earnings and the likelihood that past performance is indicative of future performance. MD&A is intended to give the investor an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company.
>
> And, as we said in 1989, '[t]he MD&A requirements are intended to provide in one section of a filing, material historical and prospective textual disclosure enabling investors and other users to assess the financial condition and results of operations of the registrant, with particular emphasis on the registrant's prospects for the future.'[3792]

Lehman made no disclosure with respect to its use of Repo 105 transactions. Lehman had a duty to disclose this information because the omission rendered several statements misleading.

Lehman's MD&A stated that the firm considered the net leverage ratio to be a more meaningful measurement of leverage than other calculations. When Lehman embarked on an aggressive deleveraging campaign, it announced improvements to this net leverage ratio to shareholders on its periodic reports, as well as press releases, particularly during the run-up to an equity raise. The point of these announcements was to indicate to current and potentially new shareholders that Lehman was financially healthy and a good investment.

[3792] Statement About Management's Discussion and Analysis of Financial Condition and Results of Operation, Securities Act No. 8056, Exchange Act No. 45,321, 67 Fed. Reg. 3746 (Jan. 22, 2002).

Sufficient evidence exists to support a finding by the trier of fact that as a result of failing to disclose its use of and accounting treatment for Repo 105 transactions, Lehman misled readers of its Forms 10-K and 10-Q about its financial condition. Typically, seven or ten days after executing Repo 105 transactions, Lehman had to repay the Repo 105 cash borrowing (*i.e.*, repurchase the assets). In order to repay the cash borrowing (plus an interest rate) shortly after the reporting period, Lehman had to obtain financing. The obligation to repay the cash borrowing (repurchase the assets) was not reflected in Lehman's periodic reports. As a result, Lehman's statements in its MD&A regarding liquidity were rendered misleading. This is exactly the kind of information the SEC has expressly required:

> Disclosure is mandatory where there is a known trend or uncertainty that is reasonably likely to have a material effect on the registrant's financial condition or results of operations. Accordingly, the development of MD&A disclosure should begin with management's identification and evaluation of what information, including the potential effects of known trends, commitments, events, and uncertainties, is important to providing investors and others and accurate understanding of the company's current and prospective financial position and operating results.[3793]

For the reasons outlined above, sufficient evidence exists from which a finder of fact could conclude that the picture Lehman painted of its financial position in late 2007 and into 2008 was materially misleading because Lehman failed to inform investors and the market that it managed its balance sheet by accounting for a large volume of repo transactions as true sales on the basis of an English opinion letter. Lehman employed

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[3793] *Id.*

temporary accounting-motivated transactions, *i.e.* Repo 105 transactions, and then failed to disclose them in order to publicly report a reverse-engineered net leverage ratio in its periodic reports. Consequently, Lehman's statement that the net leverage ratio was a "more meaningful" measurement of leverage was rendered misleading because that ratio – as reported by Lehman – was not an accurate indicator of Lehman's actual leverage, and in fact, understated Lehman's leverage significantly. In light of the market's focus on the leverage of investment banks in late 2007 and 2008, sufficient evidence exists from which a trier of fact could conclude that Lehman's reported net leverage ratio was materially misleading during that period.

In addition, Lehman was required by law to disclose, in its MD&A, off-balance sheet arrangements "that have or are reasonably likely to have a current or future effect on the registrant's financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors."[3794] Lehman made no such disclosure in the MD&A of its use of Repo 105 transactions even though the use of these off-balance sheet arrangements impacted Lehman's financial reporting by lowering its net leverage ratio by almost two entire points, thereby improving its credit rating, and its liquidity by requiring Lehman to finance the cost of repurchasing all the assets when the repo transaction matured.

[3794] Item 303(a)(4)(i) of Regulation S-K.

Moreover, Lehman made affirmative misstatements about its practice for recording repo transactions on its financial statements. Lehman stated in its publicly-filed financial statements that "securities sold under agreements to repurchase are collateralized primarily by government and government agency securities" and are "treated as collateralized agreements and financings for financial reporting purposes."[3795]

Earnings Calls. In its earnings calls from late 2007 through mid 2008, Lehman spoke extensively about the size of its firm-wide balance sheet, balance sheet management, and a firm-wide deliberate, aggressive effort to deleverage. Though Callan stated during the first quarter 2008 earnings call that Lehman was being "transparent" with its management of the balance sheet, at no time did Lehman disclose to analysts that it used Repo 105 transactions, either by name or characterization, to manage its balance sheet – even though Lehman transferred approximately $50 billion in inventory temporarily off its balance sheet at quarter-end in the first quarter of 2008 through the use of Repo 105 transactions. As Lehman continued to boast of its deleveraging success during earnings calls in the second quarter of 2008, neither Callan nor Lowitt disclosed that Lehman managed its balance sheet and leverage, in part, through Repo 105 transactions, which were only temporary.

[3795] LBHI 2007 10-K, at p. 97; LBHI 10-Q (filed Apr. 9, 2008), at p. 13; LBHI 10-Q (filed July 10, 2008), at p. 16. This disclosure is under the heading "Collateralized Lending Agreements and Financings."

(3) Colorable Claims

The Examiner finds that sufficient evidence exists to support the finding of colorable claims against Richard Fuld, Christopher O'Meara, Erin Callan, and Ian Lowitt in connection with their actions in causing or allowing Lehman to file periodic reports that did not disclose Lehman's use of Repo 105 transactions and against Ernst & Young for its failure to meet professional standards in connection with that lack of disclosure.

After reaching the tentative conclusion that claims existed against Fuld, O'Meara, Callan, Lowitt, and Ernst & Young, the Examiner reached out to counsel for each, advised them of the basis for the potential finding, and invited each of them to present any additional facts or materials that might bear on the final conclusion. All counsel accepted the Examiner's offer. In the weeks leading up to the submission of this Report, the Examiner had individual, face to face meetings with counsel for Fuld, O'Meara, Callan, Lowitt, and Ernst & Young, and carefully considered the materials raised by each. While there were credible facts and arguments presented by each that may form the basis for a successful defense, the Examiner concluded that these possible defenses do not change the now final conclusion that there is sufficient evidence to support a finding that claims of breach of fiduciary duty exist against Fuld, O'Meara, Callan, and

Lowitt and a colorable claim of professional malpractice exists against Ernst & Young.[3796]

(4) Fiduciary Duty Claims

(a) Breach of Fiduciary Duty Claims Against Board of Directors

With the exception of Richard Fuld, there is not sufficient evidence to support colorable claims of breach of fiduciary duty against Lehman directors arising from Lehman's use of Repo 105 transactions or the firm's failure to adequately disclose these transactions and the transactions' impact on Lehman's financial position in its publicly filed financial statements.

First, Lehman directors were protected by Lehman's certificate of incorporation from breach of duty of care claims:

> A director shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director; provided that this sentence shall not eliminate or limit the liability of a director (i) for any breach of his duty of loyalty to the Corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under Section 174 of the [Delaware General Corporation Law], or (iv)

[3796] Prior to this invitation and during Schlich's four-day interview as an Ernst & Young representative, the Examiner invited Ernst & Young to opine on why Repo 105 transactions were proper and did not result in Lehman filing materially misleading financial statements. Examiner's Interview of Ernst & Young, Repo 105 Session, Oct. 16, 2009, at p. 14. Schlich replied that the transactions were proper if they complied with Lehman's self-defined Accounting Policy. *Id.* Despite an additional invitation from the Examiner, Ernst & Young has not offered any further explanation.

> for any transaction from which the director derives an improper personal benefit.[3797]

Courts will uphold such a clause as protecting directors from liability so long as there is not a concurrent violation of the duty of loyalty, which was not implicated here.[3798]

Second, Lehman's directors were not informed about the existence of Lehman's Repo 105 program. No director had even heard of Repo 105 transactions, either by name or description.

(b) Breach of Fiduciary Duty Claims Against Specific Lehman Officers

There is sufficient evidence to support a colorable claim that certain Lehman officers – Richard Fuld, Chris O'Meara, Erin Callan, and Ian Lowitt – breached their fiduciary duties by engaging in one or more of the following: (1) allowing and certifying the filing of financial statements that omitted or misrepresented material information regarding Lehman's use of Repo 105 transactions and their accounting treatment, thus exposing the firm to potential liability; and/or (2) failing to disclose to Lehman Directors information about the firm's Repo 105 program.

As a threshold matter, the business judgment rule is a standard of judicial review requiring a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the

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[3797] Lehman Brothers Holdings, Inc., Certificate of Incorporation, at § 10.1, Limitation of Liability of Directors.

[3798] *Stone v. Ritter*, 911 A.2d 362, 367 (Del. 2006) ("Such a provision can exculpate directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith or a breach of the duty of loyalty.").

action taken was in the best interests of the company."[3799] Thus, "a court will not substitute its judgment for that of the board if the latter's decision can be attributed to any rational business purpose."[3800] The business judgment rule presumption may be surmounted when the "decision was the product of an irrational process or . . . directors failed to establish an information and reporting system reasonably designed to provide the senior management and the board with information regarding the corporation's legal compliance and business performance, resulting in liability."[3801] Moreover, the business judgment rule does not protect a director or officer from personal liability for inaction unless the failure to act resulted from a conscious decision to take no action.[3802]

The business judgment rule does not protect director's or officer's decisions made in bad faith.[3803] "A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than advancing the best interests of

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[3799] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (internal quotation omitted)..

[3800] *Id.* (internal quotation omitted).

[3801] *In re Tower Air, Inc.*, 416 F.3d 229, 238 (3d Cir. 2005).

[3802] *In re Dwight's Piano, Co.*, No. 1:04-CV-066, 2009 WL 2913942, at *18 (Bankr. S.D. Ohio Sept. 9, 2009) (applying Delaware law) ("The 'business judgment rule' does not apply to director inaction. The appropriate standard for determining liability for director inaction is generally gross negligence.") (internal citations omitted); *see also See McMullin v. Beran*, 765 A.2d 910, 922 (Del. 2000) ("The business judgment rule is rebutted if the plaintiff shows that the directors failed to exercise due care in informing themselves before making their decision."); *see also Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985), *overruled on other grounds by Gantler v. Stephens*, 965 A.2d 695, 713 (Del. 2009); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000).

[3803] *See Unocal*, 493 A.2d at 954.

the corporation . . . or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[3804]

Sufficient evidence exists to support a finding by the trier of fact that Fuld, O'Meara, Callan, and Lowitt are not entitled to the business judgment rule presumption with respect to Lehman's use of Repo 105 transactions because they: (1) were at least grossly negligent in causing Lehman to file deficient and misleading periodic reports that failed to disclose the firm's use of Repo 105 transactions, thus exposing Lehman to potential liability; or (2) withheld from the Board, which relies upon the accurate transmission of information, material information regarding Lehman's Repo 105 program, thereby depriving the Board of the opportunity to make well-informed decisions about Lehman's leverage and deceiving the Board of Directors regarding Lehman's financial statements. Either one of these factors alone is sufficient to overcome the business judgment rule presumption.[3805]

In re American Int'l Group, Inc. ("*In re AIG*") is instructive. There, the court held that shareholders stated a claim for breach of duty of loyalty and failure to monitor by AIG's top managers, including its Chairman/CEO and his "inner circle," for allowing AIG to file materially misleading financial statements that overstated the value of the

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[3804] *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 67 (Del. 2006).

[3805] *See Brehm*, 746 A.2d at 264 n.66 ("[D]ecisions will be respected by courts unless the directors have a conflicting interests or lack independence with respect to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose, or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.").

corporation by billions of dollars and made AIG appear more secure than it really was.[3806] The single largest deception involved an elaborate $500 million sham transaction "staged to make AIG's balance sheet look better."[3807] Though the plaintiffs could not allege with great specificity the precise involvement of each of the defendants for each of the schemes and deceptions, the complaint detailed the sham transaction and other schemes with such specificity that the court was unwilling to infer that AIG engaged in risky and innovative transactions of such magnitude without the involvement or knowledge of the Chairman/CEO and his inner circle.[3808] Specifically, the court rejected the notion that the disputed products "came to market through the spontaneous, unsupervised actions of lower-level AIG actors."[3809]

One defendant in particular, who possessed knowledge that the sole purpose of the $500 million sham transaction was to dress up the company's balance sheet, tried to escape liability for fraud by imputing his knowledge onto the corporation. The court rejected this argument, stating:

> [U]nder Delaware law, where officers and directors have disabling conflicts that give them an interest in hiding information from a corporation's independent directors and stockholders, the conflicted fiduciaries' knowledge is not imputed to the corporation for purposes of holding those fiduciaries liable for the harm they caused to the corporation. In colloquial terms, ***a fraud on the board has long been a fiduciary violation under our law*** and typically involves the failure of

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[3806] *In re American Int'l Group, Inc.* ("*In re AIG*"), 965 A.2d 763, 774-75 (Del. Ch. 2009).
[3807] *Id.* at 775.
[3808] *See id.* at 795-99.
[3809] *Id.* at 797.

> insiders to come clean to the independent directors about their own wrongdoing, the wrongdoing of other insiders, or information that the insiders fear will be used by the independent directors to take actions contrary to the insiders' wishes. ***Delaware law provides no safe harbor to high-level fiduciaries who group together to defraud the board.*** The Stockholder Plaintiffs have alleged that Tizzio and the other AIG insiders who participated in the Gen Re Transaction [the "sham" transaction] ***violated their fiduciary duties by causing AIG to engage in illegal conduct***. If true, that was bad faith conduct that gave Tizzio and the other guilty insiders an interest in hiding what they had done.[3810]

In re AIG illustrates how fiduciaries that cause their company to engage in illegal conduct breach their duty of loyalty and good faith to the company, and as a result acquire a motive to breach their duty of candor to the board by intentionally failing to disclose information relating to their wrongdoing.[3811]

The Examiner finds that sufficient evidence exists to support a colorable claim that each of the following officers breached his or her fiduciary duties to Lehman and/or its Board of Directors:

(i) Richard Fuld

Having been advised by Bart McDade in June 2008 that the firm relied on Repo 105 transactions to manage the balance sheet, and that McDade believed Lehman should curtail and eventually cease its use of Repo 105 transactions, Fuld took no action to determine whether Lehman's use of Repo 105 transactions materially impacted its publicly filed financial statements and related disclosures. There is sufficient credible

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[3810] *Id.* at 806-7 (emphasis added).

[3811] *Cf. In re AIG*, 965 A.2d at 795 ("[T]hose who engage in sophisticated forms of financial fraud do their best not to leave an obvious paper trail. Rather, consistent with their improper objectives, those at the top of such schemes try to conceal their roles and not leave marked paths leading to their doorsteps.").

evidence to support a determination that Fuld's failure to make a deliberate decision about Lehman's disclosure obligations was grossly negligent or demonstrated a conscious disregard of his duties.[3812]

a. There Is Sufficient Evidence to Support a Finding By the Trier of Fact That Fuld Was at Least Grossly Negligent in Causing Lehman to File Misleading Periodic Reports

The duty of care requires that (1) directors and officers inform themselves, prior to making a business decision, of "all material information reasonably available to them" and (2) directors and officers "act with requisite care in the discharge of their duties."[3813] A claim that an officer acted with gross negligence is the same as a claim that he breached his duty of care.[3814]

[3812] Pursuant to Section 302 of the Sarbanes-Oxley Act, the SEC adopted Rules 13a-14 and 15d-14, promulgated under the Securities Exchange Act of 1934, requiring the principal executive and financial officers to certify, among other things, that "[b]ased on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading" and that "[b]ased on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report." *See* Pub. L. No. 107-204 § 302, 116 Stat. 777 (codified at 15 U.S.C. § 7241 (2006)); Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 33-8124, 67 Fed. Reg. 57,276, 57,277 (Aug. 28, 2002). A "fair presentation of an issuer's financial condition, results of operations and cash flows" requires the "disclosure of financial information that is informative and reasonably reflects the underlying transactions and events *and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition*, results of operations and cash flows." *Id.* at 57,279 (emphasis added).

[3813] *Aronson*, 473 A.2d at 812, *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000).

[3814] *Albert v. Alex Brown Mgmt. Servs. Inc.*, C.A. Nos. 04C-05-250 PLA, 04C-05-251 PLA, 2004 WL 2050527, at *6 (Del. Super. Sept. 15, 2004); *see also Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985), *overruled on other grounds by Gantler v. Stephens*, 965 A.2d 695, 713 (Del. 2009).

Lehman's exculpatory charter shielded directors, but not officers, from liability for good faith breaches of the duty of care.[3815] Although Fuld served Lehman as both an officer and a director, Lehman's exculpatory charter for directors does not shield him from liability for breach of the duty of care with respect to his duties as an officer.[3816]

There is sufficient evidence to support a determination that by no later than March 28, 2008 – twelve days before signing Lehman's first quarter Form 10-Q – Fuld knew or should have known that Lehman's quarter-end Repo 105 transactions for first quarter 2008 reduced Lehman's net balance sheet by $49.1 billion.[3817] Fuld met regularly, at least twice a week, with Gregory and members of the Executive Committee to discuss the state of the firm. On March 28, 2008, McDade requested a special meeting of the Executive Committee to discuss Lehman's Repo 105 program and other balance

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[3815] *See* Lehman Brothers Holdings, Inc., Certificate of Incorporation, at § 10.1, Limitation of Liability of Directors; see also DEL. CODE ANN. tit. 8, § 102(b)(7) (2009); *Stone v. Ritter*, 911 A.2d 362, 367 (Del. 2006) ("Such a provision can exculpate directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith or a breach of the duty of loyalty.").

[3816] *See Arnold v. Society for Savings Bancorp. Inc.*, 650 A.2d 1270, 1288 (Del. 1994) (stating that officers who are also directors are protected by the exculpatory charter for their actions as directors only and that where a defendant is a director and officer, only those actions taken solely in the defendant's capacity as an officer are outside the purview of Section 102(b)(7)) (citing R. Franklin Balotti & Jesse A. Finkelstein, *Delaware Law of Corp. & Business Org.* § 4.19, at 4-335 (Supp.1992)).

[3817] Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008), at p. 1 [LBEX-DOCID 506399] (attached to e-mail from Angela Judd, Assistant to Richard S. Fuld, Jr., Lehman, to Scott Friedheim, *et al.* Lehman (Mar. 28, 2008) [LBEX-DOCID 561761] and containing Firm Balance Sheet Details with Repo 105 column showing total quarter-end usage of $49.102 billion); *see also* Lehman Brothers, Executive Committee Meeting Material, Agenda (Mar. 28, 2008) [LBEX-DOCID 545869] (attached to e-mail from Angela Judd, Assistant to Richard S. Fuld, Jr., Lehman, to Scott J. Freidheim, *et al.* Lehman (Mar. 28, 2008) [LBEX-DOCID 561761] and containing topics for discussion line-item "Repo 105/108"); e-mail from Jennifer Fitzgibbon, Lehman, to Leonard Scicutella, *et al.* Lehman (Mar. 28, 2008) [LBEX-DOCID 1854825] (transmitting copy of Balance Sheet and Cash Capital Update (Mar. 27, 2008) [LBEX-DOCID 1698670] and stating "please [see] attached balance sheet presentation discussed in today's executive committee meeting").

sheet reduction issues, and to request Gregory's blessing in freezing Lehman's Repo 105 usage.[3818] Although Fuld may not have attended the meeting because he was on one or more telephone calls, both Fuld and his assistants received the meeting materials.[3819] The materials also were forwarded by Fuld's assistant to other Lehman executives.[3820] The meeting materials included a presentation that referenced Lehman's $49.1 billion quarter-end Repo 105 usage for first quarter 2008.[3821]

In light of Fuld's receipt of the presentation, the fact that Fuld regularly communicated with other Executive Committee members including Gregory, Fuld's admitted focus on balance sheet and net leverage reduction in 2008, and the significance that McDade placed on the need to impose discipline on Lehman's Repo 105 program, there is sufficient evidence to support a colorable claim that Fuld knew or should have known before signing Lehman's first quarter Form 10-Q that Lehman had reduced its

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[3818] *See* Section III.A.4.e.2.a of this Report.

[3819] Herbert H. (Bart) McDade III, Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008) [LBEX-DOCID 095961] (attached to e-mail from Patricia Lombardi, Assistant to Herbert H. (Bart) McDade III, Lehman, to Lehman Brothers Executive Committee Members, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 120929]); Lehman, Executive Committee Meeting Material, Agenda (Mar. 28, 2008) [LBEX-DOCID 115827] (attached to e-mail from Patricia Lombardi, Assistant to Herbert H. (Bart) McDade III, Lehman, to Lehman Brothers Executive Committee Members, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 120929]).

[3820] E-mail from Angela Judd, Assistant to Richard S. Fuld, Jr., Lehman, to Scott J. Freidheim, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 561761].

[3821] Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008), at p. 1 [LBEX-DOCID 506399] (attached to e-mail from Angela Judd, Assistant to Richard S. Fuld, Jr., Lehman, to Scott J. Freidheim, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 561761], containing Firm Balance Sheet Details with Repo 105 column showing total usage of $49.102 billion and break-out for Repo 105 usage by business group); Lehman, Executive Committee Meeting Material, Agenda (Mar. 28, 2008) [LBEX-DOCID 545869] (attached to e-mail from Angela Judd, Assistant to Richard S. Fuld, Jr., Lehman, to Scott J. Freidheim, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 561761], listing topics for discussion at Executive Committee meeting, including "Repo 105/108" and "Delever v Derisk").

net balance sheet by $49.1 billion using Repo 105 transactions. Such a finding could support a claim of gross negligence against Fuld for failing to ensure that Lehman's first quarter 2008 Form 10-Q fairly presented its financial condition, thereby exposing Lehman to potential liability.

In addition, sufficient evidence exists to support a finding that in June 2008, only weeks before he signed Lehman's second quarter Form 10-Q, Fuld had actual knowledge of Lehman's quarter-end Repo 105 usage for that quarter. McDade recalled having specific discussions with Fuld in June 2008 about Lehman's Repo 105 usage and McDade's plan to reduce the firm's use of Repo 105 transactions by half in the third quarter 2008.[3822] McDade walked Fuld through a report of Lehman's quarter-end Repo 105 usage – $38.6 billion at year-end 2007; $49.1 billion at first quarter 2008; and $50.38 billion at second quarter 2008.[3823] The Examiner reproduces below one page from the document McDade walked Fuld through in mid-June 2008.[3824]

[3822] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 4 ("[I]n quarter three, I certainly talked to Fuld about Repo 105.").

[3823] *Id*. at p. 5; *see also* Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets (Draft) (June 16, 2008), at p. 3 [LBHI_SEC07940_641516].

[3824] Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets (Jun. 19, 2008), at p. 3 [LBEX-DOCID 2932594].

Other Targets

in $ Billions

Repo 105

	Q4'07	Q1'08	Q2'08	Q3'08 Target
FID Core	$29.7	$42.0	$44.4	$21.0
Equities Core	$1.5	$1.1	$1.4	$1.0
Prime Services	$7.4	$6.0	$4.5	$3.0
Total	**$38.6**	**$49.1**	**$50.3**	**$25.0**

Level III

	Q4'07	Q1'08	Q2'08	Q3'08 Target
Level III Net	$38.9	$40.2	$37.8	$36.0

Other Targets

	Q3'08 Target
Month End Intra Quarter Balance Sheet	
Gross Balance Sheet	$815
Net Balance Sheet	$420
Muni TOB Inventory	$3

LEHMAN BROTHERS
FOIA CONFIDENTIAL TREATMENT
REQUESTED BY LEHMAN BROTHERS HOLDINGS INC.

3

LBEX-DOCID 2932594

McDade recalled that when he advised Fuld that Lehman should reduce its Repo 105 usage to $25 billion, "Fuld understood that this would put pressure on traders."[3825] McDade also recalled that "Fuld knew about the accounting of Repo 105."[3826] Fuld's Repo 105 discussions with McDade took place only weeks before Lehman filed its second quarter 2008 Form 10-Q on July 10, 2008. Fuld denied any recollection of conversations with McDade or other members of Lehman's Executive Committee

[3825] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. at 6
[3826] *Id.*

regarding Repo 105.[3827] A finder of fact will have to further evaluate Fuld's statements in light of other evidence of his knowledge of Repo 105 and his interest in reducing Lehman's net leverage.

Accordingly, there is sufficient evidence to support a colorable claim that Fuld was at least grossly negligent for failing to ensure Lehman's second quarter 2008 Form 10-Q fairly presented Lehman's financial condition and for allowing Lehman to file financial statements that misrepresented Lehman's accounting treatment for repo transactions.

(ii) Chris O'Meara

There is credible evidence that, as CFO from December 2004 until December 1, 2007, O'Meara actively managed Lehman's Repo 105 program. Although O'Meara professed limited knowledge of and involvement with Lehman's Repo 105 program, contemporaneous documents show that:

- O'Meara was involved in establishing firm-wide limits on Repo 105 activity no later than mid-2006 and through December 1, 2007.[3828]
- An increase in the Repo 105 cap required O'Meara's authorization.[3829] O'Meara was involved with and the evidence shows he approved an increase of the cap, from $22 billion to $25 billion in February 2007.[3830]

[3827] Examiner's Interview of Richard S. Fuld, Jr., Nov. 19, 2009, at p. 8.

[3828] Lehman, Global Balance Sheet, Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 2 [LBEX-WGM 754587] (stating that Grieb and O'Meara set cap on total Repo 105 and Repo 108 usage); Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 8 (stating that Grieb, Reilly and O'Meara shared responsibilities in setting limits through December 2007).

- O'Meara regularly discussed Repo 105 limits and Lehman's reliance on Repo 105 with Grieb and Reilly, including in mid-to-late 2007 at approximately the same time that Lehman began to ramp-up its use of Repo 105 transactions.[3831]

- O'Meara was instrumental in creating the "80/20" or "continual use" and "120%" rules that, according to Grieb, were intended to ensure Repo 105 transactions were not undertaken solely at quarter-end.[3832] Based upon documents and witness statements, sufficient credible evidence exists from which a reasonable inference could be drawn that there was no legitimate business purpose for the "80% rule" other than to mask Lehman's Repo 105 practice.

- As CFO until December 2007, O'Meara worked with other members of Lehman's Finance Committee to set balance sheet targets and net leverage ratio targets.[3833] During several Board meeting in 2007, O'Meara discussed Lehman's net leverage ratio.[3834] O'Meara also was involved in balance sheet tightening efforts in FID.[3835]

[3829] Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 8 (stating that Grieb was not empowered to authorize FID to exceed its Repo 105 limit and that an excession or change in limit required consensus among O'Meara and Reilly). Grieb reported directly to O'Meara.

[3830] *See* e-mail from Joseph Gentile, Lehman, to Michael Gelband, Lehman, *et al.* (Feb. 21, 2007) [LBEX-DOCID 4553218] ("I have been able to get a temp limit of 3 bn for repo 105 activity, which covers known real estate issues. . . ."); e-mail from Joseph Gentile, Lehman, to Gerard Reilly, Lehman (Feb. 21, 2007) [LBEX-DOCID 4553220] (responding to question "Where did the 3bn come from?" by writing: "We spoke with grieb…and he was ok with a temporary excession of $3. . . ."); e-mail from Michael McGarvey, Lehman, to Anuraj Bismal, Lehman, *et al.* (May 9, 2007) [LBEX-DOCID 3223356] ("17 bn was the year end limit for FID. In Q1 Joe Gentile spoke to Ed Grieb about raising it to 20bn (based on the attached doc) and according to Joe Ed agreed."). Grieb recalled generally that in 2007 "as a result of discussions with O'Meara and Reilly, we raised the limit." Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 12. Grieb further stated that he did not have the authority to change the limit alone and that an increase or change to the limit required consensus among O'Meara and Reilly. *Id.*

[3831] *Id.* at pp. 10, 12.

[3832] Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 2 [LBEX-WGM 748489]; Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 13; Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 13.

[3833] Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 7; Examiner's Interview of Michael McGarvey, Sept. 11, 2009, at p. 5; Examiner's Interview of Tejal Joshi, Sept. 15, 2009, at p. 5; Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 5; Examiner's Interview of Kaushik Amin, Sept. 17, 2009, at p. 5; Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 11; Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 9; Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 5.

[3834] *See, e.g.*, Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 11, 2007), at p. 3 [LBHI_SEC07940_026364]; Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors

- O'Meara's involvement with Lehman's balance sheet targets continued in 2008, while he was CRO.[3836]

- O'Meara understood that the motivation for, and a consequence of, undertaking Repo 105 transactions was balance sheet reduction, particularly at quarter-end.[3837] For example, on a regular basis between April 2008 and September 2008 while he was CRO, O'Meara received the daily balance sheet scorecard, wherein the consolidated balance sheet routinely tracked the reduction to Lehman's balance sheet caused by Repo 105.[3838]

(Oct. 15, 2007), at p. 3 [LBHI_SEC07940_026407]; Lehman Brothers Holdings Inc., Minutes of Meeting of the Board of Directors (Nov. 8, 2007), at p. 4 [LBHI_SEC07940_026650].

[3835] *See* e-mail from Kentaro Umezaki, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 18, 2007) [LBEX-DOCID 187618]; e-mail from Kentaro Umezaki, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 19, 2007) [LBEX-DOCID 318475]; e-mail from Ian T. Lowitt, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Sept. 7, 2007) [LBEX-DOCID 1357178]; Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 6 (discussing O'Meara's criticism of Gentile if FID breached its balance sheet limit); e-mail from Christopher M. O'Meara, Lehman, to Gerard Reilly, Lehman (Nov. 20, 2007) [LBEX-DOCID 578184] (stating "we should be pressuring everywhere to try to end year in good way on balance sheet . . . especially since the rev's are not materializing").

[3836] *See* e-mail from Jackson Tam, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (May 29, 2008) [LBEX-DOCID 079846] (transmitting Lehman, May 2008 Balance Sheet Projection (May 28, 2008) [LBEX-DOCID 019912]).

[3837] *See* e-mail from Ryan Traversari, Lehman, to Christopher M. O'Meara, Lehman (May 16, 2008) [LBEX-DOCID 3233899] (stating that Lehman's balance sheet is larger intra-month than at month-end because of Repo 105 transactions). Moreover, Grieb, who reported directly to O'Meara and said that he was not authorized to make decisions about Repo 105 limits without O'Meara's approval, informed Joseph Gentile of Lehman's FID that Repo 105 was "a tool that could be used to reduce Lehman's net balance sheet" when FID was in breach of its balance sheet limit. *See* Examiner's Interview of Joseph Gentile, Oct. 21, 2009, at p. 6. Given that O'Meara established the Repo 105 cap, authorized increases in Repo 105 volumes, established the continual use rule, and communicated regularly with Grieb and Reilly who were deeply involved in Lehman's Repo 105 program and acknowledged its primary purpose was balance sheet reduction, sufficient evidence exists from which a trier of fact could make a finding that O'Meara also was aware of the motive for undertaking Repo 105 transactions.

[3838] *See, e.g.*, Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 7, 2008 (Apr. 9, 2008), at p. 9 [LBEX-DOCID 520619] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 9, 2008) [LBEX-DOCID 523578] and showing consolidated FID and Equities balance sheet reduced by $18.527 billion and Prime Services balance sheet reduced by $4.458 billion through Repo 105 transactions as of April 7, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 8, 2008 (Apr. 10, 2008), at p. 9 [LBEX-DOCID 520620] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 10, 2008) [LBEX-DOCID 523579] and showing consolidated FID and Equities balance sheet reduced by $18.853 billion and Prime Services balance sheet reduced by $4.562 billion through Repo 105 transactions as of April 8, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 9, 2008 (Apr. 10, 2008), at p. 9 [LBEX-DOCID 251339] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 10, 2008) [LBEX-

- O'Meara understood that Reilly and others within Lehman viewed Repo 105 as a temporary means of dealing with "sticky" inventory.[3839] When Reilly

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DOCID 258560] and showing consolidated FID and Equities balance sheet reduced by $19.688 billion and Prime Services balance sheet reduced by $4.548 through Repo 105 transactions as of April 9, 2008); Balance Sheet and Disclosure Scorecard for Trade Date April 10, 2008 (Apr. 14, 2008), at p. 9 [LBEX-DOCID 251342] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 14, 2008) [LBEX-DOCID 275231] and showing consolidated FID and Equities balance sheet reduced by $19.967 billion and Prime Services balance sheet reduced by $4.491 billion through Repo 105 transactions as of April 10, 2008); Balance Sheet and Disclosure Scorecard for Trade Date April 11, 2008 (Apr. 14, 2008), at p. 9 [LBEX-DOCID 251344] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Apr. 14, 2008) [LBEX-DOCID 258562] and showing consolidated FID and Equities balance sheet reduced by $20.260 billion and Prime Services balance sheet reduced by $4.517 billion through Repo 105 transactions as of April 11, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 12, 2008 (May 13, 2008), at p. 1 [LBEX-LL 1950262] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (May 13, 2008) [LBEX-DOCID 3187357] and stating "Rates decreased by $(5.0B) from prior day due to . . . increased Repo 105 usage . . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 22, 2008 (May 27, 2008), at p. 1 [LBEX-LL 1950706] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (May 27, 2008) [LBEX-DOCID 275984] and stating "Global rates net balance sheet decreased ($2.0B), predominantly due to an increase in Repo 105 benefit . . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 28, 2008 (May 30, 2008), at p. 1 [LBEX-LL 1950670] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (May 30, 2008) [LBEX-DOCID 275995] and stating "Global rates net balance sheet decreased by ($3.1B) primarily due to a decrease in Americas driven by an increased utilization of Repo 105 within the Agency business"); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 29, 2008 (May 30, 2008), at p. 1 [LBEX-LL 1950658] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (June 2, 2008) [LBEX-DOCID 011127] and stating "Global Rates net balance sheet decreased ($6.5B) . . . [t]he decrease in Europe is coming from increased utilization of Repo 105"); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date June 18, 2008 (June 20, 2008) [LBEX-LL 1950514] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (June 20, 2008) [LBEX-DOCID 275942] and stating that "Global rates net balance sheet decreased…driven by a[n]…increase in Repo 105 utilization . . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date August 13, 2008 (Aug. 14, 2008) [LBEX-LL 782812] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Aug. 14, 2008) [LBEX-DOCID 4214810] and stating that "Global rates net balance sheet decreased . . . driven by an increase in Repo 105 benefit . . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date August 25, 2008 (Aug. 26, 2008) [LBEX-LL 782924] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Aug. 26, 2008) [LBEX-DOCID 079536] and stating that "Global Rates net balance sheet decreased . . . driven by an increase in repo 105 usage . . . . "); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date August 28, 2008 (Aug. 29, 2008) [LBEX-LL 782966] (attached to e-mail from Tal Litvin, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Aug. 29, 2008) [LBEX-DOCID 275880] and stating that "Global rates [net balance sheet] was down . . . driven by increased Repo 105 benefit . . . .").

[3839] *See* e-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman (Aug. 19, 2007) [LBEX-DOCID 4553354] (forwarding to Christopher M. O'Meara e-mail chain discussions between John Feraca, Reilly, and David Sherr regarding possibility of placing mortgage-backed securities into the Repo 105 program); e-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Aug. 20, 2007)

and others attempted to move "sticky" inventory into the Repo 105 program, they informed O'Meara and requested his opinion.[3840]

- By no later than June 17, 2008, O'Meara knew that the actual volumes of firm-wide Repo 105 for the fourth quarter 2007, first quarter 2008, and second quarter 2008 were $38.6 billion, $49.1 billion and $50.38 billion, respectively.[3841] Lehman filed its second quarter 2008 Form 10-Q, signed by Fuld and Lowitt, on July 10, 2008, less than four weeks later.

- O'Meara had knowledge of the proposed firm-wide $25 billion Repo 105 cap for third quarter 2008.[3842]

- O'Meara was involved in re-establishing and/or extending credit lines with Repo 105 counterparties.[3843]

(same); *see also* e-mail from John Feraca, Lehman, to Gerard Reilly, Lehman (Aug. 18, 2007) [LBEX-DOCID 4553350] (discussing possibility of moving either CMBS or RMBS into Repo 105); e-mail from Gerard Reilly, Lehman, to John Feraca, Lehman (Aug. 18, 2007) [LBEX-DOCID 4553351] ("Many benefits to us getting these assets [CMBS and RMBS] into the [Repo 105] program."); e-mail from John Feraca, Lehman, to David Sherr, Lehman, *et al.* (Aug. 19, 2007) [LBEX-DOCID 4553352] ("[W]e are looking at the possibility of Repo 105 for AAA RMBS and CMBS positions . . . only want to focus on non-agency products for this exercise as both agency pass-thrus and agency CMOs roll up as government or agency products in the balance sheet, not mortgages."); e-mail from David Sherr, Lehman, to John Feraca, Lehman, *et al.* (Aug. 19, 2007) [LBEX-DOCID 4553353] (same); e-mail from Gerard Reilly, Lehman, to John Feraca, Lehman, *et al.* (Aug. 19, 2007) [LBEX-DOCID 4553356] (same); e-mail from John Feraca, Lehman, to David Sherr, Lehman, *et al.* (Aug. 20, 2007) [LBEX-DOCID 4553357] ("We spoke to the 3 of the 4 counterparties we currently use for Repo 105 on UST and Agencies via LBIE (the MTS equivalent) and all 3 declined our proposal to use AAA private label RMBS and CMBS . . . our only other choice will be to look if any of our existing counterparties in LBI would be willing to transact through LBIE.").

[3840] *See* note 993, *supra*; *see also* e-mail from Kentaro Umezaki, Lehman, to John Feraca, Lehman, *et al.* (Aug. 20, 2007) [LBEX-DOCID 4553359] (Umezaki replies to Feraca, "not sure that is worth the effort . . . we need Chris [O'Meara] to opine.").

[3841] Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets [Draft] (June 16, 2008), at p. 3 [LBEX-DOCID 012458] (attached to e-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (June 17, 2008) [LBEX-DOCID 011380]); e-mail from Christopher M. O'Meara, Lehman, to Gerard Reilly, Lehman, *et al.* (June 17, 2008) [LBEX-DOCID 033813].

[3842] Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets [Draft] (June 16, 2008), at p. 3 [LBEX-DOCID 012458] (attached to e-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (June 17, 2008) [LBEX-DOCID 011380]).

[3843] *See* e-mail from Matthew Pinnock, Lehman, to Paolo R. Tonucci, Lehman (May 21, 2008) [LBEX-DOCID 1548431] (asking for authorization from O'Meara for Repo 105 increase with Mizuho); e-mail from Paolo R. Tonucci, Lehman, to Matthew Pinnock, Lehman (May 21, 2008) [LBEX-DOCID 1548433] (same); e-mail from Paolo R. Tonucci, Lehman, to Christopher M. O'Meara, Lehman (May 21, 2008) [LBEX-DOCID 1533687] (same); e-mail from Christopher M. O'Meara, Lehman, to Paolo R. Tonucci,

Moreover, net leverage reduction was an issue of importance during O'Meara's tenure as CFO. O'Meara reported to the Finance and Risk Committee on Lehman's net leverage ratio.[3844] In a November 2007 e-mail, O'Meara wrote: "I realize we're in a tough spot given mkt, but we should be pressuring everywhere to try to end year in good way on balance sheet . . . especially since the rev's are not materializing."[3845]

a. There Is Sufficient Evidence To Support a Colorable Claim That O'Meara Was at Least Grossly Negligent in Allowing Lehman to File Misleading Financial Statements and Engage in Material Volumes of Repo 105 Transactions

The Examiner finds there is sufficient evidence to support a colorable claim that O'Meara breached his fiduciary duties by permitting the expansion of Lehman's Repo 105 practice while the program and its impact on Lehman's reported net leverage ratio remained undisclosed in the firm's publicly reported financial statements. Although O'Meara was no longer Lehman's CFO when the firm filed its 2007 Form 10-K on January 29, 2008, the Examiner concludes that there is sufficient evidence to support a finding that O'Meara continued to have culpable knowledge and involvement in

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Lehman (May 21, 2008) [LBEX-DOCID 1533688] (same); *see also* e-mail from Christopher M. O'Meara, Lehman, to Gerard Reilly, Lehman (Apr. 11, 2008) [LBEX-DOCID 4553298] (setting up meeting to discuss Lehman's Repo 105 program); e-mail from Christopher M. O'Meara, Lehman, to Gerard Reilly, Lehman , *et al.* (June 17, 2008) [LBEX-DOCID 033813].

[3844] Lehman, Risk, Liquidity, Capital and Balance Sheet Update Presentation to Finance and Risk Committee of Lehman Board of Directors (Sept. 11, 2007), at pp. 2, 30 [WGM_LBEX_02247] (with Welikson's Handwritten Notes); Lehman Brothers Holdings Inc., Finance and Risk Committee Minutes (Sept. 11, 2007), at pp. 2-3 [LBEX-AM 067018]; *see also* Lehman, Presentation on Risk, Liquidity, Capital and Balance Sheet Update to Finance and Risk Committee of Lehman Board of Directors (Sept. 11, 2007), at p. 50 [LBEX-AM 067167].

[3845] E-mail from Christopher M. O'Meara, Lehman, to Gerard, Reilly, Lehman (Nov. 20, 2007) [LBEX-DOCID 578184].

Lehman's Repo 105 practice in late 2007 and early 2008 as well as involvement in the preparation of Lehman's 2007 Form 10-K.[3846]

As CFO through December 1, 2007 and the highest ranking officer overseeing Lehman's Repo 105 program, O'Meara had a duty to: (1) monitor Lehman's use of Repo 105 transactions and (2) ensure Lehman filed accurate and complete Forms 10-K and 10-Q.

O'Meara and Grieb established an internal limit of $22 billion for firm-wide Repo 105 transactions, which they increased to $25 billion in February 2007. The limit was not required under accounting rules, and appears to have been a decision on their part to keep Lehman's Repo 105 activity within a range they deemed immaterial.

In late 2007 and early 2008, the volume of Lehman's undisclosed Repo 105 transactions was material. Under O'Meara's watch, the volume of Repo 105

[3846] Though Erin M. Callan took over the role of CFO in December 2007, O'Meara continued to be involved in the drafting sessions for Lehman's 2007 Form 10-K. E-mail from Joy Fernandez, Lehman, to Erin M. Callan, Lehman (Nov. 5, 2007) [LBEX-DOCID 2974570] (stating that Chris O'Meara was scheduled to attend January 14, 2008 meeting to review LBHI 2007 10-K along with Erin M. Callan, Edward Grieb, Steve Rossi, and Ryan Traversari). Moreover, the Examiner has located evidence suggesting that O'Meara sub-certified the 2007 10-K for Callan and was responsible for certain financial reporting in Lehman's Form 10-Q for first quarter 2008.. *See* Lehman Brothers Holdings Inc., Reporting Instructions, Quarter Ended February 29, 2008 (Feb. 22, 2008), at p. 5 [LBEX-DOCID 3756724] (stating that O'Meara was the certifier for the Review of Risk Management narrative for accuracy of MD&A discussions of credit risk, market risk, operational risk, reputational risk, value at risk, other measures of risk and distribution of trading revenues); e-mail from Martin Kelly, Lehman, to Ian T. Lowitt, Lehman (July 8, 2009) [LBEX-DOCID 2329856] ("[W]ould you like to have Erin sign a sub-certification letter (not necessary strictly speaking but we did have Chris sub-certify to Erin at year end."); e-mail from Martin Kelly, Lehman, to Erin M. Callan, Lehman (July 9, 2008) [LBEX-DOCID 1536331] (asking Callan "if I could have you sub-certify on the quarter[ly report since] (Chris [O'Meara] sub-certified to you at year end)"); e-mail from Ian T. Lowitt, Lehman, to Martin Kelly, Lehman (July 9, 2008) [LBEX-DOCID 2329856] ("I spoke to Tom [Russo about sub-certification] and he thinks better if didn't come from him and better to present as consistent with what Chris did when Erin overlapped.").

transactions rose to $38 billion at the close of Lehman's fourth quarter 2007 – $13 billion (and more than 50%) over the last known "limit" of $25 billion. The expansion of Lehman's Repo 105 activity was due primarily to "a lack of policing" and it was "not an issue for management."[3847] The volume of Lehman's Repo 105 usage was known to senior management, but because FID needed more Repo 105 to make balance sheet targets, "there was no stoppage."[3848]

In light of O'Meara's knowledge of the volume of Lehman's Repo 105 transactions, his involvement in setting internal management rules for Repo 105 usage, and his awareness of the purpose of Repo 105 transactions, sufficient evidence exists to support a colorable claim that O'Meara was at least grossly negligent in permitting Lehman to file a materially misleading 2007 Form 10-K.

b. There Is Sufficient Evidence To Support a Colorable Claim That O'Meara Breached His Fiduciary Duties by Failing to Inform the Board and His Superiors of Lehman's Repo 105 Practice

The Examiner also finds that sufficient evidence exists to support a colorable claim that, as CRO from December 1, 2007 through September 2008, O'Meara breached his fiduciary duties to the Board of Directors and his superiors, including the CEO and CFO who were responsible for certifying Lehman's financial statements, by failing to report material information within the scope of his agency.

[3847] Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 11.

[3848] *Id.* Ed Grieb also recalled reading reports on the firm-wide volume of Repo 105 transactions on at least a monthly basis. Examiner's Interview of Edward Grieb, Oct. 2, 2009, at p. 12.

O'Meara had a duty to inform his superiors of material information regarding Lehman's Repo 105 usage. Officers and key managerial personnel of Lehman are agents of the corporation that employs them.[3849] Principles of agency law squarely hold that an agent has a duty of candor or a duty to disclose relevant information to his principal.[3850]

Commentators agree that officers have an obligation to "inform the superior officer to whom, or the board of directors . . . to which, the officer reports of information about the affairs of the corporation known to the officer, within the scope of the officer's

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[3849] *See Science Accessories Corp. v. Summagraphics Corp.*, 425 A.2d 957, 962 (Del. 1980). In *Science Accessories Corp*, the Delaware Supreme Court held that the "principles and limitations of agency law carry over into the field of corporate employment so as to apply not only to officers and directors, but also key management personnel." *Id.* "[U]nder elemental principles of agency law, an agent owes his principal a duty of good faith, loyalty and fair dealing. Encompassed within such general duties of an agent is a duty to disclose information that is relevant to the affairs of the agency entrusted to him." *Id.* The imposition of these duties reflects the courts' "concern for the integrity of the employment relationship, which has led courts to establish a rule that demands of a corporate officer or employee undivided and unselfish loyalty to the corporation." *Id.* (quoting *Md. Metals, Inc. v. Metzner*, 382 A.2d 564, 568 (Md. 1978); *see also Cahall v. Lofland*, 114 A. 224, 228 (Del. Ch. 1921) (stating that under "well-established and familiar rules of equity," a director of a corporation "is not accountable to the stockholder for withholding information" about the value of the stock, but to the corporation) (quoting *Du Pont v. Du Pont*, 242 F. 98, 136 (D.C. Del. 1917)). The Delaware Supreme Court has characterized these employee-agent obligations as fiduciary duties. *Science Accessories Corp*, 425 A.2d at 965 (former employees' failure to disclose off-duty development of competing business "was not, without more, a violation of their fiduciary duty of loyalty"); *see also Lewis v. Vogelstein*, 699 A.2d 327, 334 (Del. Ch. 1997) (describing agent's duties to principal as "fiduciary in character").

[3850] *See* RESTATEMENT (THIRD) AGENCY § 8.11 ("An agent has a duty to use reasonable effort to provide the principal with facts that the agent knows…or should know…the principal would wish to have…or…are material to the agent's duties to the principal."); RESTATEMENT (SECOND) AGENCY § 381 ("[A]n agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agency has notice, the principal would desire to have and which can be communicated without violating a superior duty to a third person.").

functions, and known to the officer to be material to such superior officer, board or committee."[3851]

There is sufficient evidence to support a finding that in 2008, as he assisted other Lehman officers with the firm's balance sheet reduction efforts, O'Meara had knowledge of the mechanics and magnitude of Lehman's Repo 105 practice. O'Meara received a copy of McDade's March 28, 2008 balance sheet reduction presentation to the Executive Committee, which included a reference to Lehman's quarter-end Repo 105 usage for first quarter 2008.[3852] After he became President in June 2008, McDade brought O'Meara "back in the [balance sheet] process" to help in light of O'Meara's past experience as Lehman CFO.[3853] In June 2008, O'Meara met with McDade and others to discuss the Balance Sheet and Key Disclosures document, which reported the firm-wide quarter-end Repo 105 usage.[3854]

[3851] ABA Comm'n on Corporate Laws, Changes in the Model Business Corporations Act, 60 BUS. LAW. 943, 951 (2005); *see also* Shannon German, What They Don't Know Can't Hurt Them: Corporate Officers' Duty of Candor to Directors, 34 DEL. J. CORP. L. 221, 223 (2009) ("Extending the duty of candor to impose on corporate officers a duty to provide information to the board of directors would give the corporation a way to seek redress for harm caused by misconduct within the corporation of which the board was not aware."); Z. Jill Barclift, Senior Corporate Officers and the Duty of Candor: Do the CEO and CFO Have a Duty to Inform?, 41 VAL. U. L. REV. 269, 270 (2006) ("The broadening of the definition of the duty to inform that senior officers owe directors to include an underlying affirmative duty to provide information, even when director or shareholder action is not requested, offers an opportunity for greater monitoring of corporate governance by focusing on those often most culpable.").

[3852] Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008) [LBEX-DOCID 197391] (attached to e-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman (Mar. 28, 2008) [LBEX-DOCID 214211]).

[3853] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 8.

[3854] Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets [Draft] (June 16, 2008), at p. 3 [LBEX-DOCID 3363493] (attached to e-mail from Gerard Reilly, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (June 17, 2008) [LBEX-DOCID 3383643]); e-mail from Christopher M. O'Meara, Lehman, to Herbert H.

To form a basis for a fiduciary's personal liability for breaching the duty of candor to his principal, the undisclosed or misrepresented facts must be material to the principal's decisions or responsibilities.[3855] While materiality for purposes of information to shareholders is determined under the "total mix of information" standard, the Delaware Supreme Court has adopted a *lower* standard of materiality with respect to management's disclosure of information to the board.[3856] Information must be disclosed if it is "relevant" to the board and of sufficient "magnitude" to be important.[3857] Similarly, under agency law principles, an agent breaches his duty of care to the principal when he fails to provide information to the principal that may be material to the principal's decision-making, such as by enabling the principal to: (1) reconsider a course of action or make alternate arrangements; (2) take action to avoid harm to third parties; or (3) take action to protect the principal's interests.[3858]

When an agent has an ongoing relationship with his principal and the relationship involves more than the execution of specific orders, the duty to inform the

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(Bart) McDade III, Lehman, *et al.* (June 17, 2008) [LBEX-DOCID 033813] (replying to receipt of Balance Sheet and Key Disclosures 2008 3Q Targets [Draft] (June 16, 2008) and stating that "meeting is being set up to discuss" the document); e-mail from Gerard Reilly, Lehman, to Ian T. Lowitt, Lehman, *et al.* (June 19, 2008) [LBEX-DOCID 2962369] (transmitting updated version of Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets (June 19, 2008) [LBEX-DOCID 2932594] and indicating that a meeting among Reilly, Lowitt, O'Meara, McDade and Patrick Whalen took place).

[3855] *See* RESTATEMENT (THIRD) OF AGENCY § 8.11, cmt. d.

[3856] *See Brehm v. Eisner*, 746 A.2d 244, 260 n. 49 (Del. 2000).

[3857] *Id.* at n.49 ("The term 'material' is used in this context to mean relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decision-making.").

[3858] *See* RESTATEMENT (THIRD) OF AGENCY § 8.11 cmts. b-d.

principal is wide in scope.[3859] Thus, although O'Meara was primarily responsible for risk management in 2008, he also had involvement in Lehman's balance sheet reduction efforts and continued to have a duty to report to his principal(s) material information of which he was aware. "If an agent fails to provide information to the principal that is material to decisions that the principal will make, the agent may not have acted with the due diligence and care reasonably to be expected of an agent in a particular position."[3860]

Given O'Meara's extensive prior involvement in the Repo 105 program and his continued access to information regarding Lehman's use of Repo 105 transactions, O'Meara understood the impact of the transactions on Lehman's balance sheet and the purpose for engaging in these transactions, was aware of FID's difficulties in making balance sheet targets, and knew of the volumes at which FID engaged in Repo 105 transactions. Under agency law principles, O'Meara had a duty to report this information to any of his superiors responsible for Lehman's publicly filed financial statements, including the Board of Directors, CEO and CFO.

(iii) Erin Callan

Callan became Lehman's CFO on December 1, 2007. As early as January 2008, Callan received e-mails from Reilly, Lehman's Global Product Controller, and others

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[3859] *See* RESTATEMENT (THIRD) OF AGENCY § 8.11 cmt. c.

[3860] RESTATEMENT (THIRD) OF AGENCY § 8.11 cmt. d.

regarding Lehman's Repo 105 program and its relation to balance sheet management.[3861] One e-mail that was forwarded to Callan indicated that Lehman's Fixed Income Division had recommended that the Repo 105 program be expanded.[3862]

During meetings in early 2008, Callan was warned by Lehman's Global Financial Controller, Martin Kelly, that:

- The large size of the Repo 105 program presented "headline risk;"
- Because Lehman did not disclose Repo 105 transactions in its publicly filed statements, Lehman exposed itself to "reputational risk" if its use of Repo 105 were to become public;
- Repo 105 transactions lacked economic substance, and were used to reduce net balance sheet primarily at quarter-end; and
- Kelly and other Lehman employees believed that none of Lehman's peer investment banks used Repo 105-type transactions.[3863]

In addition to the red flags raised by Kelly, Callan was put on further notice of potential risks or problems with Lehman's Repo 105 program during the March 28, 2008 Executive Committee meeting in which McDade recommended to the Executive Committee that Lehman cap its Repo 105 usage.[3864] Callan received the materials the night before the meeting, which listed the $49.1 billion in Repo 105 transactions that

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[3861] E-mail from Gerard Reilly, Lehman, to Erin M. Callan, Lehman (Jan. 3, 2008) [LBEX-DOCID 3383445].
[3862] E-mail from Gerard Reilly, Lehman, to Erin M. Callan, Lehman (Feb. 1, 2008) [LBEX-DOCID 3383459] (transmitting Lehman, FID – Balance Sheet (Jan. 17, 2008) [LBEX-DOCID 3363222]).
[3863] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 8.
[3864] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 4.

Lehman had undertaken at the end of the first quarter 2008.[3865] McDade discussed with Executive Committee members on March 28, 2008, Lehman's use of Repo 105 transactions and recommended to the Executive Committee during the meeting that Lehman limit its firm-wide Repo 105 usage to a certain dollar amount.[3866] On April 9, 2008, twelve days after McDade's presentation to the Executive Committee, Callan signed Lehman's quarterly report.[3867]

Starting in April 2008, Callan received the Daily Balance Sheet and Disclosure Scorecard, through which she was informed on a regular basis of the impact of Repo 105 transactions on Lehman's firm-wide balance sheet.[3868]

[3865] Herbert H. (Bart) McDade III, Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008), at p. 1 [LBEX-DOCID 095966] (attached to e-mail from Gerard Reilly, Lehman, to Erin M. Callan, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 124422] and indicating that the attachment is for the Executive Committee meeting); *see also* Herbert H. (Bart) McDade III, Lehman Brothers, Executive Committee Meeting Material, Agenda (Mar. 28, 2008) [LBEX-DOCID 115827] (attached to e-mail from Patricia Lombardi, Assistant to Herbert H. (Bart) McDade III, to Lehman Executive Committee Members (Mar. 28, 2008) [LBEX-DOCID 120929] and listing among seven topics of discussion for March 28, 2008 Executive Committee meeting "Repo 105/108" and "Delever v Derisk"). Callan was a member of the Executive Committee.

[3866] *Id.* at pp. 3-4.

[3867] LBHI, 10-Q (filed Apr. 9, 2008), at p. 92.

[3868] *See, e.g.*, Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 7, 2008 (Apr. 9, 2008), at p. 9 [LBEX-DOCID 520619] (attached to e-mail from Tal Litvin, Lehman, to Erin M. Callan, Lehman, *et al.* (Apr. 9, 2008) [LBEX-DOCID 523578] and showing consolidated FID and Equities balance sheet reduced by $18.527 billion and Prime Services balance sheet reduced by $4.458 billion through Repo 105 transactions); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 10, 2008 (Apr. 14, 2008), at p. 9 [LBEX-DOCID 251342] (attached to e-mail from Tal Litvin, Lehman, to Erin M. Callan, Lehman, *et al.* (Apr. 14, 2008) [LBEX-DOCID 275231] and showing consolidated FID and Equities balance sheet reduced by $19.967 billion and Prime Services balance sheet reduced by $4.491 billion through Repo 105 transactions); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 11, 2008 (Apr. 14, 2008), at p. 9 [LBEX-DOCID 251344] (attached to e-mail from Tal Litvin, Lehman, to Erin M. Callan, Lehman, *et al.* (Apr. 14, 2008) [LBEX-DOCID 258562] and showing consolidated FID and Equities balance sheet reduced by $20.260 billion and Prime Services balance sheet reduced by $4.517 billion through Repo 105 transactions); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 12, 2008 (May 13, 2008), at p. 1 [LBEX-LL 1950262] (attached to e-mail from Tal Litvin, Lehman, to Erin M. Callan, Lehman,

Callan thus had ample red flags to alert her to potential problems arising from Lehman's Repo 105 program before she signed Lehman's first quarter Form 10-Q. Callan ignored these red flags even though she trusted the judgment of Kelly and hand-picked him to serve as Lehman's Global Financial Controller. Callan did not report to her superiors or the Board of Directors Kelly's discomfort with Lehman's Repo 105 program or the risks that non-disclosure in Lehman's publicly filed statements entailed.[3869]

Callan told the Examiner that following her meetings with Kelly in early 2008, Kelly's concerns likely fell by the wayside because of other more pressing issues following Bear Stearns' near collapse.[3870] Lehman's Repo 105 program was "not high" on Callan's "list" so she did not spend "any meaningful amount of time" on it.[3871] While

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et al. (May 13, 2008) [LBEX-DOCID 3187357] and stating "Rates decreased by $(5.0B) from prior day due to . . . increased Repo 105 usage. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 22, 2008 (May 27, 2008), at p. 1 [LBEX-LL 1950706] (attached to e-mail from Tal Litvin, Lehman, to Erin M. Callan, Lehman, *et al.* (May 27, 2008) [LBEX-DOCID 275984] and stating "Global rates net balance sheet decreased ($2.0B), predominantly due to an increase in Repo 105 benefit. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 28, 2008 (May 30, 2008), at p. 1 [LBEX-LL 1950670] (attached to e-mail from Tal Litvin, Lehman, to Erin M. Callan, Lehman, *et al.* (May 30, 2008) [LBEX-DOCID 275995] and stating "Global rates net balance sheet decreased by ($3.1B) primarily due to a decrease in Americas driven by an increased utilization of Repo 105 within the Agency business"); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 29, 2008 (May 30, 2008), at p. 1 [LBEX-LL 1950658] (attached to e-mail from Tal Litvin, Lehman, to Erin M. Callan, Lehman, *et al.* (June 2, 2008) [LBEX-DOCID 011127] and stating "Global Rates net balance sheet decreased ($6.5B)…[t]he decrease in Europe is coming from increased utilization of Repo 105").

[3869] Callan told the Examiner that she did not discuss Repo 105 with Fuld, McDade, Gregory, Tonucci, the Executive Committee, or Ernst & Young. Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at pp. 18-19.

[3870] *Id.* at p. 17.

[3871] *Id*.

a trier of fact could accept that explanation, Callan's failure to act, which did not result from a reasoned decision, is not protected by the business judgment rule.[3872]

a. There Is Sufficient Evidence To Support a Finding By the Trier of Fact That Callan Breached Her Fiduciary Duties by Causing Lehman to Make Materially Misleading Statements

To establish "director liability based on a disclosure violation, plaintiffs must plead facts that show that the violation was made knowingly or in bad faith, a showing that requires allegations regarding what the directors knew and when."[3873] A Delaware court would apply the same standard to officer liability.[3874] The evidence of Callan's knowledge of Lehman's Repo 105 program and the warnings she received from Kelly, coupled with Callan's responsibilities as the firm's CFO, is sufficient to support a colorable claim that she breached her fiduciary duties when she knowingly or in bad faith caused Lehman to publicly file periodic reports that contained material omissions and/or misrepresentations.

Corporate fiduciaries breach their duty of loyalty under Delaware law by intentionally failing to act in the face of a known duty to act, demonstrating a conscious

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[3872] The business judgment rule does not protect an officer from personal liability for inaction unless the failure to act was the result of a conscious and reasoned decision to take no action. *McMullin v. Beran*, 765 A.2d 910, 922 (Del. 2000) ("The business judgment rule is rebutted if the plaintiff shows that the directors failed to exercise due care in informing themselves before making their decision."). Alternatively, Callan's failure to act in the face of a known duty to act also rebuts the business judgment rule presumption.

[3873] *In re Citigroup*, 964 A.2d at 133-34.

[3874] *See Gantler v. Stephens*, 965 A.2d 695, 709 (Del. 2009) (stating that fiduciary duties of officers and directors are identical).

disregard for their duties and a lack of true devotion to the interests of the corporation and its shareholders.[3875]

Through her discussions with Kelly regarding the potential reputational harm Lehman would suffer if the public were to learn about the firm's use of Repo 105 transactions to manage its balance sheet and net leverage ratio, Callan was warned not only of the potential harm to Lehman, but also of the likely materiality of information regarding Lehman's Repo 105 program. With knowledge of these aspects of Lehman's Repo 105 program, Callan nonetheless caused Lehman to file its first quarter Form 10-Q in April 2008 without disclosing the firm's reliance upon Repo 105 transactions, thereby exposing Lehman to potential liability.[3876]

Sufficient evidence also exists to support a colorable claim that Callan breached her fiduciary duties to Lehman by exposing the firm to potential liability for making misleading statements during Lehman's earnings calls for the first quarter and second quarter of 2008. The March 18, 2008 earnings call demonstrates that "transparency on the balance sheet" and Lehman's efforts at deleveraging were of interest to analysts and the market. During the call, Callan reported to analysts the drop in Lehman's net leverage ratio from the fourth quarter 2007 to the first quarter 2008, but did not disclose that the reduction in leverage was partially attributable to an approximately $11 billion

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[3875] *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 243-44 (Del. 2009) (stating that directors breach their duty of loyalty "if they knowingly and completely fail[] to undertake their responsibilities").
[3876] *See* Sections III.A.4.j.1–2 of this Report (discussing materiality and disclosure obligations).

increase in quarter-end Repo 105 usage between fourth quarter 2007 and first quarter 2008 (from approximately $38 billion at the end of fiscal year 2007 to approximately $49 billion at the end of first quarter 2008). When asked repeatedly about the means by which Lehman deleveraged, Callan only mentioned the sale of assets, at no time mentioning Lehman's use of off-balance sheet repo transactions to manage the balance sheet and improve net leverage. Similarly, during the preliminary second quarter 2008 earnings call, Callan focused on Lehman's reduced leverage but failed to mention that Lehman had temporarily removed $50 billion in assets from its balance sheet using Repo 105 transactions.

b. There Is Sufficient Evidence to Support a Colorable Claim That Callan Breached Her Fiduciary Duty of Care by Failing to Inform the Board of Directors of Lehman's Repo 105 Program

On March 25, 2008, Callan spoke to the Board's Finance and Risk Committee about the "industry-wide pressure to delever" and the firm's plan for reducing total assets, focusing primarily on the Fixed Income Division, but she failed to disclose in that presentation that the Fixed Income Division relied heavily on Repo 105 transactions for managing its balance sheet at quarter-end.[3877] During an April 15, 2008 meeting of the Board of Directors, Callan reported Lehman's net leverage ratio and the firm's plan

[3877] Lehman Brothers Holdings Inc., Minutes of Meeting of the Finance and Risk Committee (Mar. 25, 2008), at p. 2 [LBEX-AM 003592].

at further reducing leverage through targeted reductions in net assets, but again said nothing about the firm's use of Repo 105 transactions.[3878]

In light of the market demand that Lehman deleverage and Kelly's concerns about the risks of Lehman's Repo 105 practice, Callan knew or should have known that information regarding Lehman's Repo 105 practice (*e.g.*, accounting treatment, lack of disclosure, volumes of quarter-end transactions, and impact on Lehman's publicly reported net leverage ratio) would have been material to Lehman's directors.[3879] Information must be disclosed if it is "relevant" to the board and of sufficient "magnitude" to be important.[3880]

Given Callan's actual knowledge about Lehman's Repo 105 program when speaking to the Board of Directors and the likely potential materiality of information relating to Repo 105 transactions' impact on the firm-wide balance sheet and net leverage ratio, the Examiner concludes that sufficient evidence exists to support a colorable claim that Callan violated her duties of loyalty, good faith, and due care by failing to disclose material information to the Board.

[3878] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Apr. 15, 2008), at p. 4 [LBEX-AM 003654].

[3879] To form a basis for an officer's personal liability for breaching the duty of candor, the undisclosed or misrepresented facts must be material to the principal's decisions or responsibilities. While materiality for purposes of information to shareholders is determined under the "total mix of information" standard, the Delaware Supreme Court has adopted a *lower* standard of materiality with respect to management's disclosure of information to the board. *See Brehm*, 746 A.2d at 259-60 n.49.

[3880] *Id.* at 260 n.49 ("The term 'material' is used in this context to mean relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decisionmaking."); *see also* RESTATEMENT (THIRD) OF AGENCY § 8.11 cmts. b-d.

(iv) Ian Lowitt

There is sufficient evidence to support a finding by the trier of fact that Lowitt was at least grossly negligent in causing Lehman to file materially misleading financial statements. According to Kelly, by the time Lowitt became Lehman's CFO in June 2008, Lowitt was "quite familiar" with Lehman's use of Repo 105 transactions to reduce its balance sheet at quarter-end and "understood [the] details" of the program.[3881] In addition:

- While serving as co-CAO, Lowitt was informed of John Feraca's ultimately unsuccessful attempts to place real estate securities into the Repo 105 program.[3882] Lowitt recalled that Feraca would report on Lehman's Repo 105 use to him because Lowitt was a member of Lehman's Asset Liability Committee ("ALCO").[3883] Feraca also informed Lowitt of the volume of Repo 105 transactions with specific counterparties at the close of the first quarter 2008.[3884] Lowitt recalled that at the close of the first quarter 2008, he attempted to gauge the materiality of Lehman's Repo 105 usage and asked Feraca for information to determine whether Lehman was increasing its Repo 105 activity.[3885]

[3881] Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 10 (stating that when he raised his concerns about Repo 105 to Lowitt, Lowitt was already "quite familiar with the program and understood its details); Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 10 (recalling that Lehman had initiated its Repo 105 program in the early 2000s and that FID and Equities division would use Repo 105 transactions to reach balance sheet targets).

[3882] E-mail from Kentaro Umezaki, Lehman, to Christopher M. O'Meara, Lehman, *et al.* (Aug. 17, 2007) [LBEX-DOCID 1533678].

[3883] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 12.

[3884] E-mail from John Feraca, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Feb. 28, 2008) [LBEX-DOCID 3207903]; e-mail from John Feraca, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Feb. 28, 2008) [LBEX-DOCID 3207907]; e-mail from John Feraca, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Feb. 28, 2008) [LBEX-DOCID 3207908]; e-mail from John Feraca, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Feb. 29, 2008) [LBEX-DOCID 3207910].

[3885] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 12.

- During the second quarter 2008, Lowitt was told that the intra-quarter balance sheet increase of $95 billion in FID's rates business was due, in part, to a $22.4 billion reduction in Repo 105 since quarter-end.[3886]

- Lowitt received the Daily Balance Sheet and Disclosure Scorecard from April to September 2008, which made frequent mention of the impact of Repo 105 transactions on Lehman's balance sheet.[3887]

[3886] *See* e-mail from Gerard Reilly, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Mar. 20, 2008) [LBEX-DOCID 4220790]; Lehman, March Net Balance Sheet Daily Trend (Mar. 20, 2008) [LBEX-DOCID 4070215]; e-mail from Gerard Reilly, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Mar. 20, 2008) [LBEX-DOCID 2973597].

[3887] *See, e.g.*, Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 7, 2008 (Apr. 9, 2008), at p. 9 [LBEX-DOCID 520619] (attached to e-mail from Tal Litvin, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Apr. 9, 2008) [LBEX-DOCID 523578] and showing consolidated FID and Equities balance sheet reduced by $18.527 billion and Prime Services balance sheet reduced by $4.458 billion through Repo 105 transactions as of April 7, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 8, 2008 (Apr. 10, 2008), at p. 9 [LBEX-DOCID 520620] (attached to e-mail from Tal Litvin, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Apr. 10, 2008) [LBEX-DOCID 523579] and showing consolidated FID and Equities balance sheet reduced by $18.853 billion and Prime Services balance sheet reduced by $4.562 billion through Repo 105 transactions as of April 8, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 9, 2008 (Apr. 10, 2008), at p. 9 [LBEX-DOCID 251339] (attached to e-mail from Tal Litvin, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Apr. 10, 2008) [LBEX-DOCID 258560] and showing consolidated FID and Equities balance sheet reduced by $19.688 billion and Prime Services balance sheet reduced by $4.548 billion through Repo 105 transactions as of April 9, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 10, 2008 (Apr. 14, 2008), at p. 9 [LBEX-DOCID 251342] (attached to e-mail from Tal Litvin, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Apr. 14, 2008) [LBEX-DOCID 275231] and showing consolidated FID and Equities balance sheet reduced by $19.967 billion and Prime Services balance sheet reduced by $4.491 billion through Repo 105 transactions as of April 10, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date April 11, 2008 (Apr. 14, 2008) [LBEX-DOCID 251344], at p. 9 (attached to e-mail from Tal Litvin, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Apr. 14, 2008) [LBEX-DOCID 258562] and showing consolidated FID and Equities balance sheet reduced by $20.260 billion and Prime Services balance sheet reduced by $4.517 billion through Repo 105 transactions as of April 11, 2008); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 12, 2008 (May 13, 2008), at p. 1 [LBEX-LL 1950262] (attached to e-mail from Tal Litvin, Lehman, to Ian T. Lowitt, Lehman, *et al.* (May 13, 2008) [LBEX-DOCID 3187357] and stating "Rates decreased by $(5.0B) from prior day due to . . . increased Repo 105 usage. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 22, 2008 (May 27, 2008), at p. 1 [LBEX-LL 1950706] (attached to e-mail from Tal Litvin, Lehman, to Ian T. Lowitt, Lehman, *et al.* (May 27, 2008) [LBEX-DOCID 275984] and stating "Global rates net balance sheet decreased ($2.0B), predominantly due to an increase in Repo 105 benefit. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 28, 2008 (May 30, 2008), at p. 1 [LBEX-LL 1950670] (attached to e-mail from Tal Litvin, Lehman, to Ian T. Lowitt, Lehman, *et al.* (May 30, 2008) [LBEX-DOCID 275995] and stating "Global rates net balance sheet decreased by ($3.1B) primarily due to a decrease in Americas driven by an increased utilization of Repo 105 within the Agency business"); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date May 29, 2008 (May 30, 2008), at p. 1 [LBEX-LL 1950658] (attached to e-mail from Tal Litvin, Lehman, to Ian T. Lowitt, Lehman, *et al.* (June 2, 2008) [LBEX-DOCID

- Four days before the close of second quarter 2008, Lowitt was informed of funding problems with certain Repo 105 counterparties.[3888]

Furthermore, Lowitt attended the March 28, 2008 special meeting of the Executive Committee requested by McDade.[3889] Lowitt received the same documents that listed the $49.1 billion in Repo 105 transactions Lehman had undertaken at the end of the first quarter 2008, and was present when McDade discussed Lehman's use of Repo 105 transactions.[3890]

011127] and stating "Global Rates net balance sheet decreased ($6.5B) . . . [t]he decrease in Europe is coming from increased utilization of Repo 105"); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date June 18, 2008 (June 20, 2008) [LBEX-LL 1950514] (attached to e-mail from Tal Litvin, Lehman, to Ian T. Lowitt, Lehman, *et al.* (June 20, 2008) [LBEX-DOCID 275942] and stating that "Global rates net balance sheet decreased . . . driven by a[n] . . . increase in Repo 105 utilization. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date August 13, 2008 (Aug. 14, 2008) [LBEX-LL 782812] (attached to e-mail from Tal Litvin, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Aug. 14, 2008) [LBEX-DOCID 4214810] and stating that "Global rates net balance sheet decreased . . . driven by an increase in Repo 105 benefit. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date August 25, 2008 (Aug. 26, 2008) [LBEX-LL 782924] (attached to e-mail from Tal Litvin, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Aug. 26, 2008) [LBEX-DOCID 079536] and stating that "Global Rates net balance sheet decreased . . . driven by an increase in repo 105 usage. . . ."); Lehman, Balance Sheet and Disclosure Scorecard for Trade Date August 28, 2008 (Aug. 29, 2008) [LBEX-LL 782966] (attached to e-mail from Tal Litvin, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Aug. 29, 2008) [LBEX-DOCID 275880] and stating that "Global rates [net balance sheet] was down . . . driven by increased Repo 105 benefit. . . .").

[3888] E-mail from John Feraca, Lehman, to Ian T. Lowitt, Lehman, *et al.* (May 27, 2008) [LBEX-DOCID 070831]

[3889] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at p. 4 (stating that the entire Executive Committee, except for Fuld, and *ex officio* members Lowitt and Friedheim attended the March 28, 2008 meeting).

[3890] Examiner's Interview of Herbert H. "Bart" McDade III, Jan. 28, 2010, at pp. 3-4; Herbert H. (Bart) McDade III, Lehman, Balance Sheet and Cash Capital Update (Mar. 27, 2008), at p. 1 [LBEX-DOCID 095961] (attached to e-mail from Gerard Reilly, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 120929] and indicating that the attachment is for the Executive Committee meeting)); *see also* Herbert H. (Bart) McDade III, Lehman, Executive Committee Meeting Material, Agenda (Mar. 28, 2008) [LBEX-DOCID 115827] (attached to e-mail from Patricia Lombardi, Assistant to Herbert H. (Bart) McDade III, to Ian T. Lowitt, Lehman, *et al.* (Mar. 28, 2008) [LBEX-DOCID 120929] and listing among seven topics of discussion for March 28, 2008 Executive Committee meeting "Repo 105/108" and "Delever v Derisk").

Lowitt also received the June 2008 Balance Sheet and Key Disclosures document that incorporated McDade's planned directive to reduce Lehman's firm-wide Repo 105 usage by half – from $50 billion to $25 billion in third quarter 2008 – and met with McDade, Reilly, O'Meara, and Morton to discuss the issues.[3891] Thus, at the time Lowitt signed the second quarter 2008 Form 10-Q, sufficient evidence exists to support a colorable claim that he was aware of the material impact that Lehman's Repo 105 practice had on the firm-wide balance sheet and publicly reported leverage ratios.

Lowitt took no action to ensure Lehman filed accurate and complete financial statements and MD&A. Lowitt certified Lehman's second quarter 2008 Form 10-Q, exposing Lehman to potential liability for making material misstatements and omissions in publicly filed financial statements and MD&A; there is sufficient evidence to support a colorable claim that Lowitt breached his fiduciary duty of care.

(c) Remedies

The primary remedy for a breach of fiduciary duty is forcing the fiduciary to "disgorge" his or her profits. A fiduciary is liable to disgorge profits regardless of

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[3891] E-mail from Christopher M. O'Meara, Lehman, to Herbert H. (Bart) McDade III, Lehman, *et al.* (June 17, 2008) [LBEX-DOCID 033813] (replying to receipt of Balance Sheet and Key Disclosures 2008 3Q Targets [Draft] (June 16, 2008) and stating that "meeting is being set up to discuss" the Balance Sheet and Key Disclosure 2008 3Q Targets document); e-mail from Gerard Reilly, Lehman, to Ian T. Lowitt, Lehman, *et al.* (June 19, 2008) [LBEX-DOCID 2962369] (transmitting updated version of Lehman, Balance Sheet and Key Disclosures 2008 3Q Targets (June 19, 2008) [LBEX-DOCID 2932594] and indicating that a meeting with Reilly, Lowitt, O'Meara, and McDade took place).

whether it can be proven that the breach injured the fiduciary's principal.[3892] If a plaintiff is seeking disgorgement of salary, however, then the plaintiff must also demonstrate a quantifiable harm to the principal.[3893] Outside Delaware, there is considerable authority for the proposition that a corporate officer must disgorge all of the compensation paid for services during the period of the breach.[3894] Courts applying Delaware law, however, appear to be split between applying this rule of full disgorgement and requiring disgorgement of only the compensation attributable to the breaching conduct.[3895]

[3892] *Thorpe ex rel. Castleman v. CERBCO, Inc.*, 676 A.2d 436, 445 (Del. 1996) (finding defendant liable for disgorgement plus reimbursement of "any expenses, including legal and due diligence costs, that the corporation incurred").

[3893] *See Cintron v. Merritt-Chapman & Scott Corp.*, 407 A.2d 1040, 1045 (Del. 1979).

[3894] *See, e.g.*, *Wilshire Oil Co. of Texas v. Riffe*, 406 F.2d 1061, 1062 (10th Cir. 1969) (holding that, under Oklahoma law, a corporation was entitled to judgment against former officer in an amount equal to seven-twelfths of the salary and bonus paid him for services during a calendar year, where he was in breach for period of seven months in that year); *see also Carco Group, Inc. v. Maconachy*, 644 F. Supp. 2d 218, 244 (E.D.N.Y. 2009) ("Under New York law, an employee is required to forfeit all compensation, including 'commissions or salary,' paid beginning with his first disloyal act."); *Aramony v. United Way Replacement Benefit Plan*, 191 F.3d 140, 153 (S.D.N.Y. 1999) (holding that, under New York law, an unfaithful fiduciary was obligated to return all salary paid to him during the time in which he was in violation of his fiduciary duties); *In re Omni Mech. Contractors, Inc.*, 114 B.R. 518, 541 (Bankr. E.D. Tenn. 1990) ("The general rule . . . is that corporate officers who breach their duty of loyalty or who willfully breach their contract of employment are not entitled to any compensation for services performed during that time period even though some services were performed properly.").

[3895] *Compare Borden v. Sinskey*, 530 F.2d 478, 497-98 (3d Cir. 1976) (disgorging unfaithful fiduciary defendant of all salaries earned from companies that he wrongfully acquired for himself instead of presenting his employer with the opportunity to acquire them), and *Guth v. Loft*, 5 A.2d 503, 508 (Del. 1939) (upholding a decision requiring an officer to turn over to his former employer "all salary or compensation" paid to him by a competing interest from the time he began self dealing as well as any compensation paid above what was reasonable after his fiduciary relationship with the plaintiff ended) *with Technicorp Intern. II, Inc. v. Johnston*, No. Civ. A. 15084, 2000 WL 713750, at *53 (Del. Ch. May 31, 2000) (permitting agents to retain an amount representing reasonable compensation for the services they had "legitimately and beneficially performed for the corporations."), and *Julian v. E. States Const. Serv., Inc.*, Civ. A. No. 1892-VCP, 2008 WL 2673300 at * 1 (Del.Ch. July 8, 2008) (disgorging only the bonuses

While the most common remedies for breach of fiduciary duty are in equity, a plaintiff's recovery is not limited to disgorgement or other remedies that may be traced directly to the breach.[3896] Indeed, Delaware courts have wide latitude to craft damage remedies to compensate a party with respect to whom a defendant breached a fiduciary duty.[3897] Another remedy that may be available to a party asserting a breach of fiduciary duty would be compensatory damages, which would attempt to rectify any financial harm caused to the beneficiary by a fiduciary's breach of his duties.[3898] The Restatement of Torts supports the contention that, in the case of a breach of fiduciary

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directors awarded themselves in violation of their fiduciary duties instead of all compensation paid to them while they were in violation of their duties).

[3896] *See, e.g.*, *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1166 (Del. 1995) (citations omitted) ("[T]he measure of damages for *any* breach of fiduciary duty, under an entire fairness standard of review, is 'not necessarily limited to the difference between the price offered and the 'true' value as determined under the appraisal proceedings.' . . . [T]he [Court of Chancery] 'may fashion any form of equitable and monetary relief as *may* be appropriate, including rescissory damages.'"); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983) ("Under such circumstances [involving a breach of fiduciary duty], the [court's] powers are complete to fashion any form of equitable and monetary relief as may be appropriate, including rescissory damages."); *Harman v. Masoneilan Int'l, Inc.*, 442 A.2d 487, 500 (Del. 1982) ("[T]he relief available in equity for tortious conduct by one standing in a fiduciary relation with another is necessarily broad and flexible.").

[3897] *See Weinberger v UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983) ("[T]he Chancellor's powers are complete to fashion any form of equitable and monetary relief as may be appropriate, including rescissory damages.").

[3898] *See, e.g.*, *Noerr v. Greenwood*, No. 14320-NC, 2002 WL 31720734, at *5 (Del. Ch. Nov. 22, 2002) (granting class certification to a claim requesting primarily compensatory damages based on a breach of fiduciary duty); *Painewebber R & D Partners II, L.P. v. Centocor, Inc.*, No. 14405, 1999 WL 160123, at *15 (Del. Ch. Mar. 15, 1999) (approving settlement agreement including compensatory damages for alleged breaches of fiduciary duty); *see also Thorpe*, 676 A.2d at 445 (holding that Delaware case law did not only require that the defendant not profit from disloyal conduct but that the beneficiary of the duty also suffer harm as a result of the breach and, therefore, damages could be appropriate if proven); *cf. In re JP Morgan Chase & Co. S'Holder Litig.*, 906 A.2d 766, 772 (Del. 2006) (denying plaintiff's claim for compensatory damages not because compensatory damages were inapplicable to a claim for breach of fiduciary duty but because the requested damages could not be connected to the alleged breach).

duty, compensatory damages may be awarded.[3899] A party seeking compensatory damages would have to prove damages and causation in order to be successful.[3900]

In the event that Lehman is eventually subject to liability as a consequence of the actions of one or more of its officers, those officers may be liable to Lehman accordingly.

(5) Malpractice Claims Against Ernst & Young

The Examiner concludes that sufficient evidence exists to support colorable claims against Ernst & Young LLP ("Ernst & Young") for professional malpractice arising from Ernst & Young's failure to follow professional standards of care with respect to communications with Lehman's Audit Committee, investigation of a whistleblower claim, and audits and reviews of Lehman's public filings.[3901]

[3899] RESTATEMENT (SECOND) OF TORTS § 874 cmt. b (1979) ("The remedy of a beneficiary against a defaulting or negligent trustee is ordinarily in equity; the remedy of a principal against an agent is ordinarily at law. However, irrespective of this, the beneficiary is entitled to tort damages for harm caused by the breach of duty arising from the relation. . . .").

[3900] *See LNC Invs., Inc. v. First Fidelity Bank, N.A., N.J.*, 173 F.3d 454, 465 (2d Cir. 1999) ("[W]here damages are sought for breach of fiduciary duty under New York law, the plaintiff must demonstrate that the defendant's conduct proximately caused injury in order to establish liability."); *Am. Fed. Group, Ltd v. Rothenberg*, 136 F.3d 897, 908 n.7 (2d Cir. 1998) (stating that in breach of fiduciary duty cases where the remedy sought is damages to compensate for loss, the usual damages-causation rule for tort cases applies).

[3901] The Examiner consulted with an industry expert, Gary L. Holstrum, PhD, CPA, to assist in the analysis of professional auditing standards. Dr. Holstrum earned a PhD in accounting from the University of Iowa's School of Business. He recently served as an Associate Chief Auditor and Director of Research, and has been a consultant to the Office of Chief Auditor, at the Public Company Accounting Oversight Board. He has been a professor of accountancy at several universities, including the University of Southern California, the University of Texas at Austin, the University of Florida, and the University of South Florida. In 2009, Dr. Holstrum received the Distinguished Service in Auditing Award from the Auditing Section of the American Accounting Association. Dr. Holstrum's experience, including publications and service on the Auditing Standards Board, is more fully described in his resume, Appendix 17, Repo 105 Appendix. Dr. Holstrum concurs with the findings in this Section of the Report,

(a) Background and Legal Standards

(i) Professional Standards

One of the primary responsibilities of an external auditor is to express an opinion whether the company's financial statements are presented fairly, in all material respects, in accordance with Generally Accepted Accounting Principles ("GAAP"). Professional standards have been established to ensure that external auditors fulfill their obligations when auditing and reviewing financial statements and other information contained in SEC filings. Those standards are known as generally accepted auditing standards, or "GAAS." GAAS consists of authoritative standards, originally established by the American Institute of Certified Public Accountants ("AICPA"), which auditors must comply with when they conduct audits and reviews.

The Sarbanes-Oxley Act of 2002 authorized the Public Accounting Oversight Board ("PCAOB") to establish auditing and related professional practice standards to be used by registered public accounting firms.[3902] PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards*, issued by the PCAOB and approved by the SEC, requires registered public accounting firms to comply with all applicable auditing and related professional practice standards of the PCAOB in their

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and in his opinion, a valid claim for professional malpractice can be raised on these facts. The Examiner met with counsel for Ernst & Young to discuss the colorable claims identified in this Section, and counsel presented several arguments as to why Ernst & Young did not commit malpractice. Following that presentation, the Examiner discussed Ernst & Young's presentations with Dr. Holstrum, and Dr. Holstrum's opinion as to the existence of colorable claims did not change.

[3902] *See* Pub. L. No. 107-204, § 103(a)-(d), 2002 U.S.C.C.A.N. (116 Stat), 745, 755-57 (codified at 15 U.S.C. § 73213 (2006)).

engagements relating to documents filed with the SEC, including audits of annual financial statements and reviews of interim financial information of public companies.[3903] The PCAOB adopted as interim auditing standards the generally accepted auditing standards described in the AICPA's Auditing Standards Board ("ASB") Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, in existence on April 16, 2003.[3904]

GAAS consists of ten standards (three general standards, three fieldwork standards, and four reporting standards) that are further interpreted and defined in "Statements on Auditing Standards" or "SASs" which are referred to by reference to "AU" sections.[3905] Among the ten auditing standards are the following:

- Due professional care is to be exercised in the performance of the audit and the preparation of the report.

[3903] *See* Order Approving Proposed Rule Relating to Compliance with Auditing and Related Professional Practice Standards, Exchange Act Release No. 48,730, 81 SEC Docket 1509 (Oct. 31, 2003).

[3904] *See* Order Regarding Section 103(A)(3)(B) of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8222, Exchange Act Release No. 47,745, 80 SEC Docket 142 (Apr. 25, 2003). Ernst & Young is registered with and regulated by the PCAOB, and Ernst & Young's audits and reviews for public companies such as Lehman are subject to the PCAOB's auditing standards. The PCAOB Auditing Standards, which are applicable to the Ernst & Young annual audit and interim review engagements of Lehman during the periods addressed in this Report, are shown in the "Standards" section of the PCAOB web site (www.pcaob.org). The PCAOB adopted as its "Interim Auditing Standards" only those SASs issued by the ASB that were issued before April 16, 2003. After that date, the PCAOB issued its own additional Auditing Standards and revisions of the Interim Auditing Standards as it deemed appropriate, subject to its due process requirements, including approval by the SEC. Any SAS issued by the ASB after April 16, 2003 (essentially after SAS No. 101) did not and does not become a PCAOB Auditing Standard, applicable to audits of public companies (and, consequently, is not shown on the PCAOB web site).

[3905] CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 95, AU § 150.02 (Am. Inst. of Certified Pub. Accountants 2002). The AU standards adopted by the PCAOB are available at http://www.pcaobus.org/Standards/Interim_Standards/Auditing_Standards/index.aspx. They are referenced by the applicable section and paragraph number for the remainder of this Section of the Report.

- A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
- Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.
- The auditor's report must state whether the financial statements are presented in accordance with GAAP.
- Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
- The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated.

See AU § 150.02.

The objective of an auditor's "review" of quarterly financial information is to provide a basis for reporting whether the reviewer is aware of material modifications that should be made to the information to conform with GAAP. *See* AU § 722.07. A review includes obtaining sufficient knowledge of the entity's business and its internal control as it relates to the preparation of both annual and interim financial information to: (1) identify the types of potential material misstatements in the interim financial information and consider the likelihood of their occurrence; and (2) select the inquiries and analytical procedures that will provide the accountant with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with GAAP. *See* AU

§ 722.09. In the course of reviewing interim financial information, auditors are required to make inquiries of members of management who have responsibility for financial and accounting matters concerning, among other things, significant transactions occurring or recognized in the last several days of the interim period. *See* AU § 722.18(c).

(ii) Common Law Standards

To state a claim of auditor malpractice under New York law,[3906] a client must allege the existence of a duty, a breach of that duty, proximate causation, and damages.[3907] Generally, breaches of duty are demonstrated by a showing that the auditor departed from accepted standards of practice and that this departure was the proximate cause of plaintiff's injury.[3908] In determining whether an auditor has deviated from accepted standards, courts and tribunals routinely look to the recognized and

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[3906] Lehman's engagement letter with Ernst & Young does not contain a choice-of-law provision, but New York law would likely apply to a malpractice action given that Lehman was headquartered in New York and most of Ernst & Young's audit work was centered in New York. *See AIG v. Greenberg*, 965 A.2d 763, 817-22 (Del. Ch. 2009) (New York law governed malpractice and breach of contract claims against auditor where auditing work was performed primarily in New York and audited client was headquartered in New York). The engagement letter for the 2007 audit contains a mandatory arbitration clause, *see* Letter from Ernst & Young to Christopher M. O'Meara, Lehman, re: 2007 audit services (May 15, 2007), at ¶ 33 [EY-LE-KEYPERS 2641786] ("Engagement Letter (May 15, 2007)"), and such clauses are generally adhered to in bankruptcy proceedings in this jurisdiction. *See In re Refco, Inc. Sec. Litig.*, Nos. 07 MDL 1992(GEL), 07 Civ. 11604(GEL), 2008 WL 2185676, at *5 (S.D.N.Y. May 21, 2008) (holding that the trustee was bound by arbitration clause in engagement letters between debtor and auditing firm); *In re Hagerstown Fiber Ltd. P'Ship*, 277 B.R. 181, 206 (Bankr. S.D.N.Y. 2002) ("If the debtor agreed in a pre-petition contract to arbitrate a dispute, the trustee, suing as successor to the debtor, is likewise bound by the arbitration clause."). Lehman and Ernst & Young had not yet signed the 2008 engagement letter, but the 2007 engagement letter states that Ernst & Young will continue to provide audit services in later years pursuant to the terms of the 2007 agreement unless terminated by Lehman or Ernst & Young. Engagement Letter (May 15, 2007) at ¶ 9 [EY-LE-KEYPERS 2641786].

[3907] *See VTech Holdings, Ltd. v. Pricewaterhouse Coopers*, LLP, 348 F. Supp 2d 255, 262 (S.D.N.Y. 2004).

[3908] *Id.*; *Hous. Works, Inc. v. Turner*, 179 F. Supp 2d 177, 215 (S.D.N.Y. 2001).

accepted professional standards for accountants and auditors, generally measured by GAAP and GAAS.[3909]

(b) There Is Sufficient Evidence to Support a Colorable Claim That Ernst & Young Was Negligent

The Examiner finds that sufficient evidence exists to support at least three colorable claims that could be asserted against Ernst & Young relating to Lehman's Repo 105 activities and reporting: (1) negligence in connection with the investigation into whistleblower Matthew Lee's claims concerning $50 billion in Repo 105 activities at the end of the second quarter 2008, including failing to conduct an adequate inquiry into the allegations prior to the filing of Lehman's Form 10-Q, and failing to properly inform management and the Audit Committee of Lee's allegations; (2) at least with respect to Lehman's first quarter and second quarter 2008 Forms 10-Q, if not with respect to earlier filings, negligence by failing to take proper action when Ernst & Young was made aware that the financial information may be materially misleading because of the failure to disclose the effect of the timing and volume of Lehman's Repo 105 activities (which had a material effect on interim financial statement items), and failing to take proper action with respect to materially misleading statements contained in the MD&A sections of the Forms 10-Q for these quarters; and (3) at least with respect

[3909] *See, e.g.*, *Cumis Ins. Soc'y Inc. v. Tooke*, 739 N.Y.S.2d 489, 493 (App. Div. 2002). As discussed in Section III.A.4.j.5.a.i of the Examiner's Report, the PCAOB standards incorporate GAAS and must be followed for all audits and reviews of public companies by public accounting firms, which in turn must be registered with the PCAOB.

to Lehman's 2007 Form 10-K, if not with respect to earlier Forms 10-K, negligence by failing to take proper action when Ernst & Young was made aware that the financial statements may be materially misleading because of the failure to disclose the effect of the timing and volume of Lehman's Repo 105 activities (which had a material effect on financial statement items), and failing to take proper action with respect to materially misleading statements contained in the MD&A sections of the Form 10-K.[3910]

(i) Malpractice in Failure to Advise Audit Committee of Repo 105 Activity and Lee's Allegations

The Examiner concludes that sufficient evidence exists to support a colorable claim for malpractice[3911] against Ernst & Young arising from Ernst & Young's failure to apprise the Audit Committee of Matthew Lee's allegations relating to Lehman's extensive quarter-end Repo 105 activity:

[3910] Professional negligence claims may also be presented as breach-of-contract claims, although a similar liability standard would be applied under either cause of action. In addition, if Lehman were subject to a securities fraud claim and sought to allocate fault to Ernst & Young, Lehman would likely need to demonstrate scienter on the part of Ernst & Young, rather than mere negligence. *Rothman v. Gregor*, 220 F.3d 81, 98 (2d Cir. 2000) (securities fraud complaint alleged accounting firm had violated various GAAP provisions; those allegations, without corresponding fraudulent intent, were insufficient to state claim); *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111, 120-21 (2d Cir. 1982) (assuming accountant's recklessness could satisfy *scienter* requirement of securities fraud action, such recklessness must be conduct that is "highly unreasonable" and represents "an extreme departure from the standards of ordinary care"). The Examiner has not analyzed whether any of the actions or inaction of Ernst & Young could amount to recklessness sufficient to satisfy the more demanding standard of *scienter*.

[3911] Based on these facts, the Examiner also considered whether there also is a colorable claim against Ernst & Young for aiding and abetting breaches of fiduciary duty. The Examiner concluded that there is not sufficient, credible evidence identified at this time to support a claim. That said, however, with further discovery, such a claim may be uncovered.

- In May/June 2008, the Chairman of the Audit Committee and internal audit requested that Ernst & Young assist with the investigation into allegations made by Lee in a May 16, 2008 letter.[3912]

- Lee's letter alleged a number of possible accounting irregularities, including balance sheet substantiation discrepancies, valuation issues, and the lack of competence and independence of Lehman's internal audit department.[3913] Lee's letter did not mention Repo 105 transactions.

- As part of the investigation, William Schlich (Ernst & Young Audit Partner) and Hillary Hansen (another Ernst & Young partner) met with Lee on June 12, 2008, and during that meeting, Lee raised an additional allegation not contained in his letter; specifically, he advised Schlich and Hansen that at the end of the second quarter 2008, Lehman moved $50 billion in assets off its balance sheet using Repo 105 transactions, only to move those assets back onto the balance sheet a few days later.[3914] Although Schlich stated that he had no recollection of Lee's Repo 105 assertions, those assertions were prominent in Hansen's contemporaneous notes of the meeting with Lee and

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[3912] Examiner's Interview of Thomas Cruikshank, Oct. 8, 2009, at p. 7; Examiner's Interview of Thomas Cruikshank, Jan. 20, 2010, at p. 3; Examiner's Interview of Roger Berlind, Dec. 18, 2009, at p. 3; Examiner's Interview of Michael L. Ainslie, Dec. 22, 2009, at p. 2; Examiner's Interview of Sir Christopher Gent, Jan. 20, 2010, at p. 2; Examiner's Interview of Beth Rudofker, Dec. 15, 2009, at p. 5.

[3913] Letter from Matthew Lee, Lehman, to Martin Kelly, Lehman, *et al.* (May 16, 2008) [EY-LE-LBHI-KEYPERS 5826885]. Lee's letter contained the following six allegations: (1) on the last day of each month, Lehman's books and records contained approximately $5 billion of net assets in excess of what was managed on the last day of the month, thereby suggesting that the firm's senior management was not in control of its assets to be able to present full, fair, and accurate financial statements to the public; (2) Lehman had "tens of billions of dollars of unsubstantiated balances, which may or may not be 'bad' or non-performing assets or real liabilities"; (3) Lehman had tens of billions of dollars of illiquid inventory and did not value its inventory in a "fully realistic or reasonable" way; (4) given Lehman's rapid growth and increased number of accounts and entities, it had not invested sufficiently in financial systems and personnel to cope with the balance sheet; (5) the India Finance office lacked sufficient knowledgeable management, resulting in the real possibility of potential misstatements of material facts being distributed by that office; and (6) certain senior level internal audit personnel were not qualified to "properly exercise the audit functions they are entrusted to manage."

[3914] Examiner's Interview of Ernst & Young, Nov. 3, 2009, at p. 14 (statement of Hillary Hansen); Examiner's Interview of Matthew Lee, July 1 and July 10, 2009, at p. 17; *see also* Hillary Hansen, Ernst & Young, Notes from meeting with Matthew Lee, June 12, 2009, at p. 1 [EY-LE-LBHI-KEYPERS 5826869].

Schlich, and Hansen specifically recalled conferring with Schlich about Lee's Repo 105 allegations.[3915]

- The next day – on June 13, 2008 – Schlich met with the Audit Committee and participated in an update to the committee on the Lee investigation.[3916] Schlich did not inform the Audit Committee about the Repo 105 claims made by Lee, even though the Audit Committee asked to be told about each allegation.[3917]

- On July 8, 2008, the Audit Committee met with Schlich, Kelly, Lowitt, and Beth Rudofker to review the second quarter MD&A and financial statements.[3918] At that meeting, Schlich did not raise any issues concerning the adequacy of the disclosures or financial statements, and stated that Ernst & Young would issue an unqualified review report.[3919]

- On July 10, 2008, Ernst & Young issued an unqualified review report in connection with the issuance of Lehman's Form 10-Q.[3920]

- On July 22, 2008, Schlich again remained silent as to Lee's Repo 105 allegation at an Audit Committee meeting, where internal audit presented the results of the investigation into each of the claims made by Lee in his May 16, 2008 letter to management.[3921] At that meeting, the Audit Committee

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[3915] Examiner's Interview of Ernst & Young, Nov. 3, 2009 at p. 14 (statement of Hillary Hansen); *Id.* at p. 16 (statement of William Schlich); Examiner's Interview of Ernst & Young, Oct. 9, 2009, at p. 5 (statement of William Schlich).

[3916] Examiner's Interview of Roger Berlind, Dec. 18, 2009, at p. 4; Examiner's Interview of Michael L. Ainslie, Dec. 22, 2009, at p. 2; Examiner's Interview of Sir Christopher Gent, Jan. 20, 2010, at p. 2.; *see also* Lehman Brothers Holdings Inc., Minutes of Meeting of Audit Committee (June 13, 2008) [LBEX-AM 003759].

[3917] Examiner's Interview of Roger Berlind, Dec. 18, 2009, at pp. 2, 4; Examiner's Interview of Michael L. Ainslie, Dec. 22, 2009, at pp. 2, 3; Examiner's Interview of Sir Christopher Gent, Jan. 20, 2010, at p. 2; Examiner's Interview of Thomas Cruikshank, Jan. 20, 2010, at p. 3; Examiner's Interview of Beth Rudofker, Dec. 15, 2009, at p. 7; *see also* Lehman Brothers Holdings Inc., Minutes of Meeting of Audit Committee (June 13, 2008) [LBEX-AM 003759].

[3918] Lehman Brothers Holdings Inc., Minutes of Meeting of Audit Committee (July 8, 2008) at p. 2 [LBEX-AM 003831].

[3919] *Id.*

[3920] LBHI 10-Q (filed July 10, 2008), at p. 53.

[3921] Employee Letter Review, Presentation to the Audit Committee (July 22, 2008) [LBEX-AM 067664]; Examiner's Interview of Thomas Cruikshank, Jan. 20, 2010, at pp. 2, 3; Examiner's Interview of Michael L. Ainslie, Dec. 22, 2009, at p. 3; Examiner's Interview of Roger Berlind, Dec. 18, 2009, at pp. 3-4; Examiner's

> was told that "[c]orporate audit has largely completed an evaluation of [Lee's] observations in partnership with Financial Control and Ernst and Young."[3922]

There is sufficient evidence to support a colorable claim that Ernst & Young failed to exercise due professional care by failing to notify the Audit Committee of Lee's allegations about end-of-quarter Repo 105 transactions as a means to manipulate publicly reported balance sheet reductions.[3923] *See, e.g.*, AU § 316.79 ("Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is appropriate even if the matter might be considered inconsequential, . . . Fraud involving senior management and fraud . . . that causes a material misstatement of the financial statements should be reported directly to the audit committee"); AU § 317 (if auditor becomes aware of possible violations of laws or regulations which may have a direct or indirect effect on the financial statements, he or she must make inquiries, perform additional tests, and inform management and the audit committee of the issue).[3924]

Interview of Sir Christopher Gent, Jan. 20, 2010, at pp. 2-3; Examiner's Interview of Beth Rudofker, Dec. 15, 2009, at p. 7.

[3922] Employee Letter Review, Presentation to the Audit Committee (July 22, 2008), at p. 2 [LBEX-AM 067664]; *see also* Lehman Brothers Holdings Inc., Minutes of Meeting of Audit Committee (July 22, 2008), at pp. 4-5 [LBEX-AM 003861].

[3923] On two occasions during the course of the examination, the Examiner offered Ernst & Young the opportunity to provide the Examiner with a presentation, narrative, or explanation regarding the business purpose of Lehman's Repo 105 transactions. Ernst & Young declined that invitation.

[3924] *See also In re Allou Distribs., Inc.*, 395 B.R. 246, 272-73 (Bankr. E.D.N.Y. 2008) (finding that plaintiff sufficiently pled that auditing firm committed malpractice by failing to report suspicious circumstances and material discrepancies to the audit committee); Springer, Exchange Act Release No. 44858, 75 S.E.C. Docket 2095 (Sept. 27, 2001) (finding, in addition to other auditing violations, that an accountant had violated Section 10A of the Securities Exchange Act and engaged in professional misconduct by failing to

Moreover, in addition to its duty to report a determination that there is evidence that fraud "may" have occurred, Ernst & Young was required to discuss with the Audit Committee the quality of Lehman's accounting principles as applied to financial reporting, *see* AU § 380.11, which would include moving $30-$50 billion temporarily off the balance sheet at quarter-end through overseas "true sale" legal opinions that could not be obtained in the United States. Indeed, AU Section 380.11 states that auditors should discuss accounting policies, unusual transactions, the clarity and completeness of the financial statements, and unusual transactions with the audit committee. Specifically, that standard states that an auditor:

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notify the client's audit committee that he had detected information indicating that the client had reported $1.3 million in false revenues in its quarterly report). Section 10A(b) of the Securities Exchange Act of 1934, 15 US.C. § 78j-1(b), provides that:

> If, in the course of conducting an audit pursuant to this title to which subsection (a) applies, the registered public accounting firm detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred, the firm shall, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission—
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> (A) (i) determine whether it is likely that an illegal act has occurred; and
>
> (ii) if so, determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages; and
>
> (B) as soon as practicable, inform the appropriate level of the management of the issuer and assure that the audit committee of the issuer, or the board of directors of the issuer in the absence of such a committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of such firm in the course of the audit, unless the illegal act is clearly inconsequential.

> should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting. . . The discussion . . . should include such matters as the consistency of the entity's accounting policies and their application, and the clarity and completeness of the entity's financial statements, which include related disclosures. The discussion should also include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements. Examples of items that may have such an impact are the following:
>
> - Selection of new or changes to accounting policies
>
> - Estimates, judgments, and uncertainties
>
> - Unusual transactions
>
> - Accounting policies relating to significant financial statement items, including the timing of transactions and the period in which they are recorded.

See AU § 380.11. Contrary to that standard, Ernst & Young never communicated anything about the Repo 105 transactions to Lehman's Audit Committee members – let alone discuss the substantial and increasing volumes at quarter end.[3925]

[3925] Examiner's Interview of Thomas Cruikshank, Jan. 20, 2010, at pp. 1-2.; Examiner's Interview of Michael L. Ainslie, Dec. 22, 2009, at p. 3; Examiner's Interview of Roger Berlind, Dec. 18, 2009, at pp. 3, 4; Examiner's Interview of Sir Christopher Gent, Jan. 20, 2010, at pp. 3, 4; *see also* Lehman Brothers Holdings Inc., Minutes of Meeting of Audit Committee (June 13, 2008) [LBEX-AM 003759]; Lehman Brothers Holdings Inc., Minutes of Meeting of Audit Committee (July 8, 2008) [LBEX-AM 003831]; Lehman Brothers Holdings Inc., Minutes of Meeting of Audit Committee (July 22, 2008) [LBEX-AM 003861]. The Examiner reviewed Ernst & Young's work papers for the 2007 year-end audit and 2008 quarterly reviews and found no reference to any communication with the Audit Committee about Repo 105. The Examiner also reviewed relevant documents, dated from January 1, 2007 through September 15, 2008, from the e-mail accounts and desk files of 43 mid-to-senior-level auditors at Ernst & Young, and uncovered no communications with or references to communications with Lehman's Audit Committee regarding Repo 105. Ernst & Young does not dispute the fact that it did not discuss Lee's Repo 105 allegations with the Audit Committee.

The Examiner therefore concludes that Ernst & Young's failure to discuss these matters with the Audit Committee gives rise to a colorable claim of malpractice, particularly in light of: (1) the failure to disclose in public filings the use of Repo 105 transactions to reduce the balance sheet items that were used to calculate Lehman's net leverage ratio; (2) the impact of the Repo 105 transactions on Lehman's net leverage ratio;[3926] (3) Lehman's emphasis to the public of the importance of its net leverage ratio; (4) the sheer size and timing of the end-of-quarter activity that Lee highlighted to Ernst & Young ($50 billion); and (5) the Audit Committee's explicit request to be apprised of all of Lee's allegations.

[3926] GAAS requires an auditor to understand its client's business, and therefore, Ernst & Young had a duty to understand the importance of net leverage ratios to Lehman and the investing public. *See* AU § 722.10 (auditor/reviewer has responsibility of becoming sufficiently knowledgeable about client's business to allow auditor to identify the types of potential material misstatements and to select inquiries and analytical procedures that will provide the auditor with a basis for communicating whether he or she is aware of any material modifications that should be made for such financial information to conform with GAAP). Here there is no question that Ernst & Young had a full understanding of the net leverage ratio. Ernst & Young's documents contain calculations of materiality with respect to net leverage ratios, and Ernst & Young reviewed financial statements and other public disclosures emphasizing the importance of the ratio. *See*, *e.g.*, Ernst & Young, LBHI/LBI Walkthrough Template for Balance Sheet Close Process (Nov. 30, 2007) at p. 14 [EY-LE-LBHI-CORP-GAMX-07-033384] (stating that, with respect to reopening a closed balance sheet, "[m]ateriality is usually defined as any item individually, or in the aggregate, that moves net leverage by 0.1 or more (typically $1.8 billion)" and that "[n]et leverage is an important ratio analyzed by the rating agencies and included in Lehman's earnings release"); e-mail from William Schlich, Ernst & Young, to Carmine DiSibio, Ernst & Young, *et al*. (June 5, 2008) [EY-LE-LBHI-KEYPERS 0853883] (noting that Lehman's game plan for combating the release of its second quarter loss is to emphasize its capital raise and "significant de-levering of the balance sheet"); e-mail from William Schlich, Ernst & Young, to Ryan Traversari, Lehman, *et al*. (June 14, 2008) [LBEX-DOCID 2374461] (providing Schlich's comments on the attached draft version of the second quarter 2008 preliminary earnings call speech); Transcript of Lehman Brothers Holdings Inc. Second Quarter 2008 Preliminary Earnings Call [Draft] (June 16, 2008), at p. 15 [LBEX-DOCID 2046258] (noting that "deleveraging and de-risking the balance sheet was an important goal this quarter" and that net leverage as of May 31 had been reduced from 15.4x to 12.0x).

(ii) Lehman's 2008 Forms 10-Q

The Examiner also finds that sufficient evidence exists to support colorable claims for malpractice against Ernst & Young arising from Ernst & Young's review of Lehman's first and second quarter Form 10-Q financial statements and MD&A sections.[3927]

Sufficient evidence exists to support a finding that the financial statements in both quarters of 2008 were misleading because: (1) the notes stated that Lehman treated repos as collateralized agreements and financings, as opposed to disclosing that a significant volume of repo transactions were treated as sales (and thus were "off balance sheet"); and (2) the notes referred to the transfer of certain financial assets as sales pursuant to SFAS 140, but *only* with respect to securitization activities, without anywhere disclosing Lehman's Repo 105 activity.[3928]

Although a review of interim financial statements is "substantially less in scope than an audit," *see* AU § 722.09, the SEC requires a registrant such as Lehman to engage an independent accountant to review its interim financial information before the registrant files its Form 10-Q.[3929] The SEC further requires that an accountant's review report be filed with the interim financial information if the entity states that the interim

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[3927] For purposes of this analysis, the Examiner does not reach the issue of whether the treatment of the Repo 105 transactions as sales under SFAS 140 is proper. However, as discussed in Section III.A.4.j.2, there is sufficient evidence to support a determination by the trier of fact that the notes to the financial statements and other written disclosures presented a misleading picture of Lehman's financial condition by failing to disclose the effect of the volume and timing of Lehman's Repo 105 activity.

[3928] *See* Section III.A.4.j.2.c.ii of the Examiner's Report.

[3929] *See* Rule 10-01(d) of Regulation S-X, 17 C.F.R. § 210.10-01(d) (2009).

financial information has been reviewed by an independent public accountant.[3930] Ernst & Young filed such review reports in connection with both of Lehman's Forms 10-Q in 2008.[3931]

An auditor can, of course, be liable for violating professional standards in connection with the preparation of interim financial reports.[3932] Auditing and related professional practice standards applicable to the Examiner's finding of a colorable claim against Ernst & Young in the context of Ernst & Young's 2008 quarterly reviews of the notes to Lehman's quarterly financial statements include:

- AU Section 722.41-43 applies in situations where the auditor is aware that the interim financials contain inadequate disclosures or do not conform to GAAP in other ways. In those instances, the auditor should issue a modified review report that describes the inadequacies or non-GAAP compliant matters. The auditing standards define conformance with GAAP to mean not only that the accounting principles applied have general acceptance, but also to mean that the "financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation." *See* AU § 411.04 (addressing the meaning of "present fairly in conformity with [GAAP]").[3933]

[3930] *Id*.

[3931] *See* LBHI 10-Q (filed April 9, 2008), at 42; LBHI 10-Q (filed July 10, 2008), at 53.

[3932] *See, e.g., William Iselin & Co., Inc. v. Landau*, 522 N.E.2d 21, 23 (N.Y. 1988) (regardless of whether the activity is characterized as an "audit" or a "review," the accountant owes the party contracting for the services a duty to exercise due care in the performance of professional accounting services); *Collins v. Esserman & Pelter*, 681 N.Y.S.2d 399, 401 (App. Div. 1998) ("Even with respect to a review . . . the accountant is obligated to exercise due care in the performance of the engagement."); Kantor, Geisler & Oppenheimer, P.A., PCAOB Release No. 105-2007-009 (Dec. 14, 2007) (finding that accounting firm violated Section 10A(b) of the Exchange Act and PCAOB standards in quarterly review when, upon learning information indicating that an illegal act may have occurred, the firm failed to address appropriately the threshold question of whether it was likely that an illegal act had occurred).

[3933] *See also* AU § 431.02 (under GAAP, financial statements should contain "adequate disclosure of material matters. . . [regarding] form, arrangement, and content of the financial statements and their appended notes, including, for example, the terminology used, the amount of detail given, the

- AU Section 722.07 relating to "Interim Financial Information" states that the objective of a review of interim financials is to provide the accountant with a basis for communicating whether the accountant is aware of any material modifications that should be made to the interim financial information for it to conform with GAAP.

- AU Section 722.07 states that an interim review typically does not require the auditor to perform tests of or obtain evidence that corroborates the financial information, but that the review instead principally consists of performing analytical procedures and making inquiries of persons responsible for accounting and financial matters.[3934]

- AU Section 722.10 charges the auditor with the responsibility of becoming sufficiently knowledgeable about the entity's business to allow the auditor to identify the types of potential material misstatements and to select the inquiries and analytical procedures that will provide the accountant with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with GAAP.

- AU Section 722.18(c) provides that an auditor engaged in an interim review should inquire of management about significant transactions occurring or recognized in the last several days of the interim period.

- AU Section 722.18(c) states that an auditor engaged in an interim review should inquire of management about allegations of fraud or suspected fraud affecting the entity, for example, received in communications from employees, former employees, analysts, regulators, short sellers, or others.

- AU Section 722.18(c) provides that an auditor engaged in an interim review should inquire of management about unusual or complex situations that may have an effect on the interim financial information.

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classification of items in the statements, and the bases of amounts set forth. An independent auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which he is aware at the time").

[3934] Note that the standard goes on to require that when the reviewer becomes aware that the interim financial information may not be in conformity with GAAP in all material respects (which includes adequacy of disclosure), the reviewer is required to make additional inquiries and perform other procedures to corroborate the financial information. *See* AU § 722.22, *infra*.

- AU Section 722.22 specifies that if a reviewer of interim financial information becomes aware of information leading the reviewer to believe that the interim financial information may not be in conformity with GAAP in all material respects, the reviewer should make additional inquiries and perform other procedures that the reviewer considers appropriate to provide a basis for communicating whether the reviewer is aware of any material modifications that should be made to the interim financial information. The standards set forth the following example: "[I]f the accountant's interim review procedures lead him or her to question whether a significant sales transaction is recorded in conformity with [GAAP], the accountant should perform additional procedures, such as discussing the terms of the transaction with senior marketing and accounting personnel, reading the sales contract, or both, to resolve his or her questions."

- AU Section 722.26 states that if an "inadequate disclosure" is brought to the auditor's attention during an interim review, the auditor should evaluate matters such as the nature, cause, amount, and materiality of the "likely misstatement." Footnote 18 of AU Section 722.26 reminds the reviewer of the requirements concerning adequacy of disclosure that are contained in Rule 10-01 of Regulation S-X, including that "[t]he interim financial information shall include disclosures either on the face of the financial statements or in accompanying footnotes sufficient so as to make the interim information presented not misleading. . . ."

- AU Section 722.28 provides that a reviewer should not issue a review report if the reviewer has not completed the necessary review procedures or if the client does not provide the reviewer with the written representations the reviewer believes are necessary to achieve the objective of an interim review.

- AU Section 722.28-31 states that if the auditor performing the review becomes aware of matters that cause him or her to believe that material modifications should be made to make the interim information conform with GAAP (which includes adequacy of disclosure) such matters should be communicated to management, and if management does not respond appropriately, then the auditor should inform the audit committee. If the audit committee does not respond appropriately, then the auditor should consider whether to resign from the review engagement and as the entity's auditor.

- AU Section 722.32 states that if the auditor becomes aware of information indicating that fraud or an illegal act has or may have occurred, the auditor

must also determine his or her responsibilities under AU Section 316, *Consideration of Fraud in a Financial Statement Audit*, AU Section 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.

- AU Section 722.34 incorporates AU Section 380, which concerns communications with those charged with governance.[3935]

- AU Section 722.36 provides that if the accountant has identified matters to be communicated to "those charged with governance," the accountant should attempt to make such communications to the audit committee, or at least to the chair of the audit committee, and a representative of management *before* the entity files its interim financial information with a regulatory agency.

These and other professional standards are also incorporated into Ernst & Young's engagement letter with Lehman:

> "If we determine that there is evidence that fraud or possible illegal acts *may have occurred,* we will bring such matters to the attention of an appropriate level of management. If we become aware of fraud involving senior management or fraud (whether by senior management or other employees) that causes a material misstatement of the consolidated financial statements, we will report this matter directly to the Audit Committee. We will *ensure that the Audit Committee is adequately informed* of illegal acts that come to our attention unless they are clearly inconsequential. . . ."[3936]

The Examiner concludes that sufficient evidence exists to support a colorable claim that Ernst & Young should have made appropriate inquiries of management and performed analytical procedures concerning significant transactions that occurred at the ends of the quarters in 2008 and analyzed their impact upon the financial statements, including the footnotes. Particularly after Lee alerted Ernst & Young to $50 billion in

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[3935] *See* Section III.A.4.j.5.b.i. of this Report, which discusses the requirements of AU Section 380.

[3936] Letter from Ernst & Young to Christopher M. O'Meara, Lehman, re: 2007 audit services (May 15, 2007), at ¶ 9 [EY-LE-KEYPERS 2641786] (emphasis added).

Repo 105 transactions prior to the filing of the second quarter Form 10-Q, Ernst & Young should have reported to senior management and the Audit Committee that Lehman was using Repo 105 transactions to temporarily and artificially reduce balance sheet and its net leverage ratio for reporting purposes, without disclosing the practice to the public.[3937]

Sufficient evidence exists to support a colorable claim that Ernst & Young knew or should have known that the notes to the financial statements were false and misleading because, among other things, those notes describe all repos as "financings," which Ernst & Young knew was not the case, and those notes did not disclose the Repo 105 transactions. Ernst & Young had a professional obligation to communicate the issue to both senior management and the Audit Committee and to recommend corrections of the Forms 10-Q, and also to either issue modified review reports noting the materially inadequate disclosures, or to withhold its review reports altogether.

There is also sufficient evidence to support the existence of a colorable claim against Ernst & Young for malpractice in connection with the misleading statements concerning Lehman's net leverage ratio contained in the MD&A sections of Lehman's

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[3937] Before issuing its first and second quarter 2008 review reports, Ernst & Young obtained standard written representations from Lehman management stating that management was not aware of fraud or alleged fraud, and also disclosing transfers involving qualifying special purpose entities that were treated as sales under SFAS 140. *See* Letter from Richard S. Fuld, Jr., Lehman, *et al*. to Ernst & Young, re: Lehman Management Representations (Apr. 9, 2008), at pp. 2, 6-7 [EY-SEC-LBHI-GAMX-1Q08 002679]; Letter from Richard S. Fuld, Jr., Lehman, *et al*. to Ernst & Young, re: Lehman Management Representations (July 9, 2008), at pp. 2, 6-7 [EY-SEC-LBHI-WP-2Q 000277]. Ernst & Young cannot, however, rely on these letters as a defense to its failure to act on Lee's allegations, given that, among other things, Lee presented his allegations directly to Ernst & Young (and outside the presence of management).

two 2008 Forms 10-Q. Sufficient evidence exists to find that those disclosures were materially inadequate and misleading because Lehman did not disclose the fact that the reported assets, net assets, leverage ratio and the reduction in the net leverage ratio were materially affected by temporary Repo 105 transactions.

Auditors have a far more limited responsibility for disclosures and "other information" in filings accompanying financial statements, as opposed to the financial statements and accompanying footnotes, but the standards require the auditor to "read the other information [*e.g.*, the MD&A] and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements." *See* AU § 550.04. In addition, AU Section 550.05 states that if the auditor "becomes aware of information that he believes is a material misstatement of fact that is not a material inconsistency, . . . he should discuss the matter with the client. . . . If the auditor concludes he has a valid basis for concern, he should propose that the client consult with some other party whose advice might be useful to the client, such as the client's legal counsel".[3938] If the misstatement is not resolved, then the auditor should consider actions such as notifying

[3938] *See generally* AU § 312.10 (assessment of materiality involves both quantitative and qualitative considerations, including whether the omission of information would make it probable that the judgment of a reasonable person relying on the information would have been changed or influenced).

the client in writing of his or her views. *See* AU § 550.06.[3939] Here, Ernst & Young did none of those things.

There is sufficient evidence for a trier of fact to conclude that Ernst & Young should have insisted on proper disclosures of Repo 105 transactions in the interim information that it reviewed or withheld an unmodified review report because the interim information disclosures were materially inadequate and misleading. Furthermore, the MD&A information implied that Lehman had achieved desirable net leverage numbers by balance sheet reductions, without disclosing that those net numbers would have been significantly higher but for the Repo 105 transactions. There is credible evidence that Ernst & Young was aware of Lehman's Repo 105 policy as early as 2001,[3940] that Ernst & Young was aware of over $29 billion in Repo 105 transactions in 2007 when it received the Netting Grid,[3941] and that Ernst & Young was on notice as to the $50 billion in such transactions by no later than June 2008.[3942] Ernst & Young was aware of the importance in Lehman's industry of the net leverage number,

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[3939] Further, the standards state that "if the accountant concludes that there is a material inconsistency, *or becomes aware of information that he or she believes is a material misstatement of fact,* the action taken will depend on his or her judgment under the circumstances." *See* AU § 722.18(f) (cross-referencing to AU § 550.04-06) (emphasis added). In addition, as discussed in Section III.A.4.j.2.a of this Report, there is an SEC requirement that companies disclose "known trends" in MD&A sections.

[3940] Examiner's Interview of Ernst & Young, Repo 105, Oct. 16, 2009, at pp. 4-5 (statement of William Schlich); Examiner's Interview of John Feraca, Oct. 9, 2009, at p. 7.

[3941] Lehman, Accounting Policy Review Balance Sheet Netting and Other Adjustments [Draft] (Nov. 2007), at p. 26 [LBEX-DOCID 3213271] (stating total amount of Repo 105 for Feb. 28, 2007 was $29.258 billion), attached to e-mail from Margaret Sear, Lehman, to Jerry Gruner, Ernst & Young, *et al*. (Nov. 6, 2007) [LBEX-DOCID 3235499].

[3942] *See* Sections III.A.4.i.4 and III.A.4.j.5.b.i of this Report, which discuss Lee's statements to Ernst & Young.

as those numbers were being touted by Lehman in the press and investor calls.[3943] Given those facts, the Examiner finds that sufficient evidence exists to support a colorable claim against Ernst & Young in connection with its reviews of Lehman's interim financial information and its responsibilities regarding Lehman's MD&A information in both quarters of 2008.

(iii) Lehman's 2007 Form 10-K

Lehman's 2007 Form 10-K contained essentially the same statements as those in its later 2008 Forms 10-Q. In its 2007 Form 10-K, Lehman represented that it treated repurchase agreements as financings (*i.e.*, not as sales) even though Repo 105 transactions were treated as sales. In Note 1 to Lehman's Consolidated Financial Statements, Lehman stated that Lehman treated "[r]epurchase and resale agreements" as "collateralized agreements and financings for financial reporting purpose" which Lehman described were "collateralized primarily by government and government agency securities."[3944] In addition, Lehman stated that "[o]ther secured borrowings principally reflect transfers accounted for as financings rather than sales under SFAS 140."[3945] Lehman disclosed that it recognized the transfer of financial assets as sales pursuant to SFAS 140 – but it said so only with respect to "securitization activities."[3946]

[3943] *See* Section III.A.4.e.6 of this Report.

[3944] LBHI 2007 10-K, at p. 97. This disclosure is under the heading "Collateralized Lending Agreements and Financings."

[3945] *Id.*

[3946] *Id.* at p. 96. "Securitization activities" is a separate heading in the Note.

There is also sufficient evidence for a trier of fact to conclude that Ernst & Young knew or should have known that that those statements were materially misleading and failed to provide necessary disclosures concerning Lehman's use of Repo 105 transactions. Therefore, the Examiner finds sufficient evidence to support a colorable claim of malpractice against Ernst & Young in connection with its 2007 audit of Lehman.[3947]

The financial statements accompanying the 2007 Form 10-K were audited – as opposed to "reviewed" – by Ernst & Young and thus higher standards and requirements of professional care applied. For example, while quarterly reviews require the auditor to perform analytical procedures and make inquiries of management, among many other things, year-end audits mandate that the auditor perform tests, gather corroborating evidence that supports the financial statements, obtain reasonable assurance about whether the financial statements are free of material misstatements, and provide a positive opinion regarding whether the financial statements are fairly presented in conformity with GAAP. *See, e.g.*, AU §§ 310, 311, 326.

Accordingly, in performing its 2007 year-end audit, Ernst & Young was required to look at the data underlying the financial statements. Such an audit should have

[3947] While the issue concerning the lack of disclosure with respect to Lehman's Repo 105 activity goes back to earlier periods, the Examiner's investigation of potential claims against Ernst & Young has focused on the late 2007 and early 2008 critical period because of the increasing volume of Repo 105 transactions, the emphasis on reducing net leverage, and Lehman's public touting of its deleveraging during that time.

revealed that a significant volume of Lehman's repo activity was not treated as financings, but instead was reported as sales. In addition, the MD&A section to Lehman's 2007 Form 10-K discussed the net leverage ratio without disclosing the role that Repo 105 transactions played in that calculation. Ernst & Young's failure to require proper disclosures in the MD&A section and in footnotes to the financial statements constitutes sufficient evidence to find a colorable claim of malpractice.

(iv) Effect on Prior Filings

Finally, while Ernst & Young should have required proper disclosures in the 2007 Form 10-K and 2008 first quarter Form 10-Q prior to those filings, Ernst & Young also had a duty, upon learning in June 2008 of Lee's allegations concerning Repo 105 transactions, to revisit the earlier filings. The auditor's responsibilities in such situations is addressed in AU Section 561.04-06, which states that when an auditor becomes aware that facts may have existed at the date of a previously issued audit report which might have affected the report had the auditor then been aware of such facts, the auditor should investigate whether the new information is reliable and existed at the time of the original report and whether the new information indicates that the previously issued opinion is incorrect and should not be relied on. If the previously issued audit report is incorrect, the auditor should consider action to prevent future reliance on the prior reports.

(v) Causation and Damages

One measure of damages in an audit malpractice action against Ernst & Young would be the recovery of fees Lehman paid to Ernst & Young in connection with the 2007 audit and/or the 2008 reviews.[3948] It also is possible that the estate could recover additional damages beyond fees paid to Ernst & Young if it is shown that Lehman suffered damages that could have been avoided had Ernst & Young adhered to professional accounting standards. For example, had Ernst & Young fulfilled its obligation to advise the Audit Committee of the extent and significance of Repo 105 activities, the Audit Committee may have insisted on measures to actually and substantially reduce leverage or to take other remedial or strategic steps that might

[3948] *See, e.g., Stanley L. Bloch, Inc. v. Klein*, 258 N.Y.S.2d 501, 508 (Sup. Ct. 1965) (holding that measure of damages for professional negligence of accountant in issuing balance sheet containing substantial errors was accounting and auditing fees paid to accountant for year of service immediately prior to issuance of balance sheet and accounting and auditing fees necessitated by review thereof).

have led to a different outcome.[3949] Ernst & Young, in turn, may have a compelling argument that such a measure of damages is too speculative.[3950]

In addition, the estate may be able to seek compensation from Ernst & Young for fees and expenses that the estate incurred or will incur as a result of Ernst & Young's malpractice. For example, if an accountant's negligence in the preparation or certification of financial statements results in litigation against the accountant's client brought by purchasers of the client's securities, the client may be able to recover the expenses of the litigation and the amount of any judgment or reasonable settlement.[3951]

[3949] *See, e.g., Bd. of Trs. of Cmty. Coll. Dist. No. 508, County of Cook v. Coopers & Lybrand LLP*, 775 N.E.2d 55, 63 (Ill. App. 2002) (applying Illinois law, holding that auditor's failure to detect treasurer's violation of investment policy during audits could be the proximate cause of damages caused by investments made after the audit, where members of the board testified that they would have ended those investment practices had auditor detected them), *rev'd on other grounds*, 803 N.E.2d 460 (Ill. 2003); *Plan Comm. v. PricewaterhouseCoopers,* 335 B.R. 234, 249-51 (D.D.C. 2005) (creditors committee adequately alleged damages against debtor's auditing firm under District of Columbia law, where committee asserted that malpractice proximately caused debtor's insolvency and bankruptcy and specifically alleged that the board would have taken actions to avoid insolvency if it had been "timely alerted by appropriately audited financial statements to the fact that [company] was performing significantly worse than was presented in the negligently audited financial statements"), *dismissed on other grounds*, No. 02-01487 (TFH), 2007 WL 119917 (D.D.C. Apr. 20, 2007).

[3950] *See VTech Holdings Ltd. v. Pricewaterhouse Coopers* 348 F. Supp 2d 255, 267 (S.D.N.Y. 2004) (buyer of wired business could recover lost profits and consequential damages under New York law on accountant malpractice claim only if they were capable of being measured based on reliable factors).

[3951] A plaintiff generally is entitled to "actual out-of-pocket costs" that "flow as a natural and continuous consequence" from or are otherwise "proximately caused" by the defendant's breach of its legal duties. *Crowley v. Chait*, Civ. No. 85-2441 (HAA), 2004 U.S. Dist. LEXIS 27238, at *39 (D.N.J. Aug. 25, 2005); *Baker Hughes Oilfield Operation, Inc. v. Seabulk Tankers, Inc.*, No. Civ.A. 03-1230, 2004 WL 1290576, at *1 (E.D. La. June 8, 2004) (Baker I); *Keywell Corp. v. Piper & Marbury LLP*, No. 96-CV-0660E (SC), 1999 WL 66700, at *5 (W.D.N.Y. Feb. 11, 1999). Among the expenses that could be considered to flow from the breach of a legal duty are those incurred to repair harm to the plaintiff caused by the defendant's breach. *See, e.g. World Radio Labs., Inc. v. Coopers & Lybrand*, 557 N.W.2d 1, 15 (Neb. 1996) (holding that client was entitled to recover damages for accounting fees paid to second auditing firm as a result of defendant auditing firm's negligence).

(c) Possible Defenses

The Examiner recognizes that Ernst & Young may have valid defenses to these claims. As a general matter, the question of whether an auditor committed malpractice is a fact-intensive inquiry and requires the testimony and opinion of experts in the field. Indeed, many of the auditing standards set forth above do not impose bright line rules, but instead provide general guidance and principles. Ernst & Young likely would submit expert testimony in support of its view that it adhered fully to its professional responsibilities in its reviews and audits of Lehman's financial statements, and may take the position that some of the professional standards cited above apply only where an auditor has a subjective belief that a disclosure or other information is materially inaccurate. Ernst & Young also may take the position that preparation of financial statements is the responsibility of management – and not of the outside auditor.

The Examiner concludes that there is sufficient basis for claims to be submitted to a trier of fact, who will have to evaluate those claims in light of any defenses raised by Ernst & Young.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	Chapter 11 Case No.
LEHMAN BROTHERS HOLDINGS INC., *et al.*,	:	08-13555 (JMP)
	:	(Jointly Administered)
Debtors.	:	

REPORT OF ANTON R. VALUKAS, EXAMINER

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March 11, 2010

VOLUME 4 OF 9

Section III.A.5: Secured Lenders

Section III.A.6: Government

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REPORT OF EXAMINER ANTON R. VALUKAS

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5. Potential Claims Against Lehman's Secured Lenders

a) Introduction and Executive Summary

Pursuant to the eighth bullet of paragraph 2 of the Examiner Order, this Section of the Report examines transactions and transfers among the debtors and pre-Chapter 11 third-party lenders. The Examiner has consulted with the parties in interest, reviewed issues identified by those parties, conducted his own independent review and examination and exercised his discretion as to which issues to include in the Report. This Section of the Report covers potential common law claims against Lehman's lenders. Section III.B covers potential avoidance and preference actions.

Throughout 2008, and up to the date that Lehman filed for bankruptcy, Lehman's clearing banks demanded collateral to secure risks they assumed in connection with clearing and settling Lehman's triparty and currency trades, and other extensions of credit. This Section of the Report examines the circumstances surrounding Lehman's provision of approximately $15 to $21 billion in collateral (both in cash and securities) to its clearing banks, and Lehman's simultaneous inclusion of those funds in its reported liquidity pool.

As set forth in more detail below, the importance of liquidity to investment bank holding companies cannot be overstated. Broker-dealers are dependent on short-term financing to fund their daily operations, and a robust liquidity pool is critical to a broker-dealer's access to such financing. The Examiner has found that the size of

Lehman's liquidity pool provided comfort to market participants and observers, including rating agencies. The size of Lehman's liquidity pool encouraged counterparties to continue providing essential short-term financing and intraday credit to Lehman. In addition, the size of Lehman's liquidity pool provided assurance to investors that if certain sources of short-term financing were to disappear, Lehman could still survive.

Critically, the collateral posted by Lehman with its various clearing banks was initially structured in a manner that enabled Lehman to claim the collateral as nominally lien-free (at least overnight), and continue to count it in its reported liquidity pool. However, by September 2008, much of Lehman's reported liquidity was locked up with its clearing banks, and yet this fact remained undisclosed to the market prior to Lehman's bankruptcy.

What follows is a review of the demands for added credit protection by JPMorgan, Citi, HSBC, Bank of America, Bank of New York Mellon and Standard Bank, followed by a brief synopsis of the Examiner's legal conclusions. The Examiner concludes that there may be a colorable claim against one clearing bank – JPMorgan – arising from these collateral demands in 2008. Then, this Section discusses Lehman's public statements about its liquidity pool.

(1) JPMorgan

JPMorgan acted as LBI's principal clearing bank pursuant to a Clearance Agreement between JPMorgan and LBI. The most significant component of JPMorgan's clearing services was "triparty repo" clearing. Although triparty-repo investors typically required a broker-dealer such as LBI to post "margin" (that is, additional collateral) overnight to account for investor risk, before 2008, JPMorgan did not retain that margin intraday.

In February 2008, JPMorgan informed Lehman that JPMorgan would begin retaining the same margin intraday that triparty investors required overnight. This change – JPMorgan's retention of "triparty-investor margin" – was implemented gradually in 20 percent increments over the course of approximately five months.

JPMorgan also determined that its risk vis-à-vis broker-dealers such as LBI was greater than the risk faced by overnight investors. JPMorgan therefore instituted an additional margin requirement, which it called "risk-based margin," and incrementally imposed that margin on broker-dealers as well. Lehman initially responded to JPMorgan's risk-based margin requirement by posting approximately $5 billion in securities in June 2008. Lehman continued to post additional collateral at JPMorgan throughout the summer in response to JPMorgan's margin requirements.

In August 2008, JPMorgan raised concerns about collateral that Lehman had posted. In particular, Lehman had posted illiquid and difficult-to-price CDOs that

Lehman had self-priced. JPMorgan was also concerned because LCPI (not LBI or its holding company) had posted collateral to cover JPMorgan's risk-based margin. Lehman transferred much of this collateral from LCPI to LBHI in early August to alleviate JPMorgan's concern.

At the end of August, after significant negotiation, Lehman and JPMorgan entered into three agreements: an Amendment to the Clearance Agreement, a Guaranty and a Security Agreement. The Amendment to the Clearance Agreement added additional Lehman parties to the Clearance Agreement. Under the Guaranty, LBHI guaranteed the Lehman parties' obligations under the Clearance Agreement. The Security Agreement secured LBHI's Guaranty, granting JPMorgan a security interest in a Cash Account, Securities Account and certain related accounts. The Security Agreement also provided for an "Overnight Account" into which LBHI could transfer cash or securities overnight if no obligations remained outstanding under the Clearance Agreement at the end of the day. Those assets, however, generally had to be returned to Lehman's liened accounts by morning in order for JPMorgan to continue clearance operations. Lehman understood the August Agreements as documenting existing practice, not fundamentally altering its relationship with JPMorgan.

By late August and early September, Lehman's deteriorating financial condition became increasingly apparent. On September 4, 2008, Lehman and JPMorgan executives met to discuss Lehman's third quarter earnings and survival strategies.

JPMorgan emerged concerned with Lehman's plans. JPMorgan also reviewed a draft of Lehman's planned presentation to rating agencies, and JPMorgan expressed concerns about that presentation as well. The following day (September 5), JPMorgan's Investment Bank Risk Committee met to discuss the Investment Bank's exposures to various broker-dealers, and expressed particular concerns about Lehman. Then, on September 9, 2008, reports surfaced that acquisition talks between Lehman and KDB had fallen through, and Lehman's stock plummeted. In response, Lehman decided to preannounce its third quarter earnings the following morning, September 10. Also on September 9, JPMorgan requested $5 billion of additional collateral to cover all of JPMorgan's exposures to Lehman, not limited to triparty-repo clearing exposure. Lehman agreed to post $3 billion immediately, and posted the $3 billion in cash and money market funds by the next day.

JPMorgan further determined that it wanted a new "master-master" agreement with Lehman to cover its entire relationship across all Lehman liabilities and entities. For the collateral that JPMorgan requested on September 9 to cover all of JPMorgan's exposures to all Lehman entities, new documentation had to be executed. JPMorgan insisted that an Amendment to the Clearance Agreement, Security Agreement and Guaranty be in place before Lehman's earnings call the next morning. The evidence does not suggest, however, that JPMorgan threatened to cease clearing for Lehman if the agreements were not executed by then.

JPMorgan's and Lehman's legal teams negotiated the documents through the night. Lehman's attorneys received virtually no input from Lehman's senior financial officers or other business personnel, who were immersed in preparations for the upcoming earnings call. Indeed, neither Lehman's Treasurer nor its Chief Financial Officer reviewed the terms of the agreements or even a summary of the key terms before the agreements were signed.

These agreements significantly extended JPMorgan's rights to request and retain collateral by expanding the Lehman accounts over which JPMorgan had a lien and the obligations that its lien secured. The September Security Agreement and Guaranty also required three-days' written notice for LBHI to attempt to retrieve any of its collateral.

On September 11, JPMorgan executives met to discuss significant valuation problems with securities that Lehman had posted as collateral over the summer. JPMorgan concluded that the collateral was not worth nearly what Lehman had claimed it was worth, and decided to request an additional $5 billion in cash collateral from Lehman that day. The request was communicated in an executive-level phone call, and Lehman posted $5 billion in cash to JPMorgan by the afternoon of Friday, September 12. Around the same time, JPMorgan learned that a security known as Fenway, which Lehman had posted to JPMorgan at a stated value of $3 billion, was actually asset-backed commercial paper credit-enhanced by Lehman (that is, it was Lehman, rather than a third party, that effectively guaranteed principal and interest

payments). JPMorgan concluded that Fenway was worth practically nothing as collateral.

Notwithstanding JPMorgan's concerns with the quantity and quality of collateral posted by Lehman, Lehman believed that JPMorgan was overcollateralized. There is no evidence, however, that Lehman requested in writing the return of the billions of dollars of collateral it had posted in September. Lehman did informally request the return of at least some of its collateral, and JPMorgan returned some securities to Lehman on September 12. JPMorgan did not, however, release any of the cash collateral that Lehman had posted in response to the September 9 and September 11 requests.

The Examiner has analyzed a number of potential common law claims against JPMorgan in connection with the September Agreements and collateral demands. The Examiner concludes:

- The evidence does not support the existence of a colorable claim against JPMorgan for economic duress principally because the Examiner has found no evidence of an express unlawful threat by JPMorgan.
- The evidence does not support the existence of a colorable claim that the September Agreements are invalid for lack of consideration because (i) the September Amendment to the Clearance Agreement was a modification of an existing contract and, therefore, required no additional consideration, and

(ii) the September Security Agreement and Guaranty were supported by JPMorgan's continued extension of credit to Lehman.[3952]

- There may be a technical claim that the September Agreements are invalid for lack of authority, but there are substantial defenses to such a claim, including that Lehman ratified the agreements when it posted collateral on September 12. Accordingly, the Examiner concludes that the evidence does not support the existence of a colorable claim.

- The evidence does not support the existence of a colorable claim that JPMorgan fraudulently induced the September Agreements even if JPMorgan counsel told Lehman counsel that an agreement in principle had already been reached by Lehman's and JPMorgan's senior management. There is conflicting evidence as to whether there was such an agreement in principle. Nonetheless, regardless of the outcome of that disputed issue of fact, it does not appear that Lehman counsel in fact relied on the representation or reasonably could have relied upon it.

- The Examiner also concludes that the evidence does not support the existence of a colorable claim that JPMorgan breached the September Agreements by refusing to return collateral to Lehman. JPMorgan was not legally required to do so principally because Lehman failed to provide JPMorgan with written notice for return of collateral as required under the September Agreements.

- Finally, the Examiner concludes that the evidence may support the existence of a colorable claim – but not a strong claim – that JPMorgan breached the implied covenant of good faith and fair dealing by making excessive collateral requests to Lehman in September 2008. A trier of fact would have to consider evidence that the collateral requests were reasonable and that Lehman waived any claims by complying with the requests.

(2) Citibank

Citibank was Lehman's designated settlement member on the Continuous Linked Settlement ("CLS") system, a trading platform operated by a consortium of

[3952] *See infra* Section III.B.3.g.5.a for a discussion of claims to avoid the September Guaranty under applicable fraudulent transfer law where a different standard applies for assessing "reasonably equivalent value."

banks for the clearance and settlement of foreign exchange ("FX") trades. In executing trades for Lehman on the CLS system, Citi accepted Lehman's CLS trades, submitted them to the CLS Bank, and extended intraday credit to Lehman, thereby assuming a certain amount of intraday credit risk. Citi provided the clearing and settlement services on CLS under the aegis of a CLS Settlement Services Agreement for CLS User Members, originally entered into by Lehman and Citi in December 2003, and later amended in October 2004. Notably, this Agreement provided that any extension of credit by Citi was within Citi's "sole discretion."

Citi provided Lehman with additional financial services, such as maintaining cash deposit and custodial accounts, providing credit facilities, and some custody and clearing services in emerging markets and in the United States.

After the market's negative reaction to Lehman's second quarter earnings announcement and Lehman's announced personnel changes on June 12, 2008, Citi sought to reduce its intraday risk exposure to Lehman. Consequently, on that same day, Citi obtained a $2 billion "comfort" deposit from Lehman, to be maintained at Citi in an overnight call account. Although the $2 billion deposit was not formally pledged, Citi believed that it had a general right of setoff. In addition, according to Citi personnel, had Lehman withdrawn the deposit, Lehman would have had to prefund its transactions in order for Citi to continue clearing and settling Lehman's trades. The $2 billion deposit was included in Lehman's reported liquidity pool.

Further, beginning in July, the parties negotiated – without success – the terms of a formal pledge agreement on the understanding that Lehman would pledge securities to collateralize Citi's clearing and settlement lines, in lieu of the cash deposit. Citi proposed several versions of a collateral pledge agreement, and Lehman proposed different portfolios of assets to post as collateral. Citi declined to accept any of the securities proposed by Lehman as collateral; Citi had difficulty pricing the assets and questioned whether there was a ready market for them.

The negotiations between Citi and Lehman over the pledge agreement ceased when, between September 9 and 12, Lehman and Citi amended two critical agreements instead of executing the pledge agreement. By early September, Citi had become acutely concerned about its claim on the $2 billion deposit. Then, on September 9, the reported failure of the KDB deal, coupled with Lehman's announcement that it would accelerate its third quarter earnings announcement to September 10, prompted Citi to request that Lehman immediately amend the parent Guaranty Amendment to expand the scope of the holding company Guaranty (to include obligations owed to Citi under any custodial agreement with Citi in addition to extensions of credit by Citi) and ultimately added 10 additional Lehman subsidiaries to the guaranty (Citi had originally requested that 17 be added). On September 12, the parties also amended the Direct Custodial Services Agreement ("DCSA"), which provided Citi with a broad and explicit security interest over cash, securities or other assets held by Citi on behalf of Lehman.

Citi continued thereafter to provide clearing and trade settlement services for Lehman, albeit under reduced clearing limits, until Lehman filed for bankruptcy on September 15. Ultimately, Citi cleared for Lehman through CLS until Friday, September 19.

The Examiner has identified potential common law claims against Citi arising out of these transactions, but has not found any of them to be colorable.

- The evidence does not support the existence of a colorable claim for economic duress surrounding Citi's demand that Lehman execute the September 9 amendment to the Guaranty because, *inter alia*, there is no evidence of an express unlawful threat by Citi to induce Lehman to agree to its terms. Indeed, Lehman successfully negotiated certain terms in its favor prior to signing the amendment.

- Likewise, the evidence does not support the existence of a colorable claim for failure of consideration: Citi extended credit to Lehman at its sole discretion, and the September 9 amendment induced Citi to continue providing intraday credit to Lehman subsidiaries. Given the rapidly deteriorating market conditions, it was not unreasonable for Citi to seek added security from Lehman.[3953]

- The evidence does not support the existence of a colorable claim against Citi for breach of the duty of good faith and fair dealing in connection with its CLS agreement with Lehman. The Examiner found no evidence to suggest any obligation by Citi to provide clearing and settlement services to Lehman, and given the increased risk Citi faced vis-à-vis Lehman on September 9, there is no colorable claim that Citi acted unreasonably, irrationally, arbitrarily, or in bad faith by exercising or threatening to exercise its contractual right to cease extending clearing advances and to cease serving as Lehman's CLS settlement member bank.

[3953] *See infra* Section III.B.3.g.5.b for a discussion of claims to avoid the Guaranty under applicable fraudulent transfer law where a different standard applies for assessing "reasonably equivalent value."

(3) HSBC

HSBC principally provided Lehman with clearing and settlement services for sterling-denominated trades in CREST, a clearing and settlement system for certain securities. Sterling-denominated trades in CREST are settled in real time; consequently, as Lehman's settlement bank, HSBC extended Lehman intraday credit to facilitate the settlement of its CREST trades. The governing agreement between Lehman and HSBC (the "CREST agreement") provided that HSBC had "absolute discretion" to terminate its responsibilities as Lehman's CREST settlement bank (which included extensions of intraday credit associated with settling Lehman's trades). The CREST agreement further provided that HSBC could terminate the contract without notice, only requiring 30 days' notice to the extent that HSBC "consider[ed] it practicable and appropriate."

HSBC provided myriad other banking services to Lehman, including acting as Lehman's trustee for special purpose vehicles in the Cayman Islands, as Lehman's counterparty in derivatives trades and other transactions, and providing various other credit products to Lehman. HSBC's most significant credit exposure, however, derived from HSBC's role as Lehman's CREST settlement bank.

Beginning in mid-2006, HSBC took steps to reduce its credit exposure to the financial sector generally, and, in 2007, it reduced its lines of uncommitted credit available to the investment banks. HSBC accelerated these measures after the near collapse of Bear Stearns in early 2008. Viewing Lehman as the next most vulnerable

investment bank, HSBC further reduced various lines of credit it had extended to Lehman. Initially, HSBC implemented these measures quietly, undetected by both Lehman and the marketplace. However, on August 18, 2008, HSBC advised Lehman of its intention to withdraw from its business relationship with Lehman entirely. In addition, over the next several days, HSBC demanded that Lehman deposit just under $1 billion into accounts in the U.K. and in Hong Kong, ultimately to be secured by three cash deeds. HSBC intended the U.K. deposit to cover its exposure arising from CREST clearing and settling. The smaller Hong Kong deposit was intended to collateralize various lines of credit HSBC provided to Lehman subsidiaries in the Asian market.

Lehman understood that HSBC would cease clearing and settling trades in CREST for Lehman if Lehman did not post this collateral. Lehman initially deposited the equivalent of approximately $800 million with HSBC on August 28. Later that same day, HSBC permitted Lehman to retrieve that deposit to assist Lehman in meeting its third quarter balance sheet targets. Lehman subsequently re-deposited the equivalent of approximately $800 million with HSBC on September 1. On September 2, Lehman deposited approximately $180 million in an HSBC Hong Kong account.

Negotiations over the terms of the cash deeds ensued, and Lehman secured favorable concessions during that process. Two cash deeds were executed to cover the U.K. deposit on September 9 (the "U.K. Cash Deeds"), and the parties executed a third cash deed on September 12 related to the Hong Kong deposit (the "Hong Kong Cash

Deed"). English law governed the terms of the U.K. Cash Deeds, while Hong Kong law governed the terms of the Hong Kong Cash Deed. Notably, the deeds limited Lehman's ability to access the collateral unless there were no debts in certain, specified accounts (and no contingent liabilities), and HSBC retained general rights of setoff in all events.

The Examiner has identified several potential claims under English law against HSBC arising out of these transactions involving the U.K. Cash Deeds, but has not found any of them to be colorable.

- The evidence does not support the existence of a colorable claim that the U.K. Cash Deeds are invalid for lack of consideration. English law does not require consideration to enforce an agreement contained in a deed. In any event, because the CREST agreement gave HSBC absolute discretion in providing Lehman with settlement and clearing services, Lehman received consideration in HSBC's agreement to continue providing those services. Lehman may have also received consideration in the form of the interest it received on the collateral it posted.

- Likewise, the evidence does not support the existence of a colorable claim for economic duress because the operative CREST agreement (and other credit agreements) permitted HSBC to terminate its services at its discretion. In any event, the Examiner found no evidence of duress, in particular given that Lehman negotiated more favorable terms for itself in the provisions of the deeds.

- The evidence does not support the existence of a colorable claim for breach of the duty of good faith and fair dealing. HSBC's absolute discretion over offering CREST services and extensions of credit to Lehman is not subject to such an obligation under English law, and even if it was, HSBC's demands were grounded in legitimate commercial concerns about Lehman's viability.

- HSBC did not breach the notice provision of the CREST agreement. HSBC's determination not to provide more advanced notice of its decision to terminate services was not arbitrary, capricious, unreasonable or in bad faith; instead, it was legitimately grounded in its commercial interest.

- The evidence does not support the existence of a colorable claim that the U.K Cash Deeds were contracts of adhesion or standard form contracts. HSBC and Lehman were sophisticated parties to agreements that were extensively negotiated (ultimately resulting in changes that favored Lehman).

- Likewise, the evidence does not support the existence of a colorable claim that HSBC was unjustly enriched through the U.K. Cash Deeds. The Examiner concludes that the U.K. Cash Deeds are valid contracts, under which Lehman had a duty to convey a benefit to HSBC, for which Lehman received a benefit.

- The evidence does not support the existence of a colorable claim that HSBC breached a fiduciary duty to Lehman. HSBC did not owe Lehman a duty independent of its narrowly defined role as Lehman's CREST settlement bank, and the CREST agreement imposed no obligation on HSBC to continue providing services to Lehman.

- Even if HSBC's collateral demands were to have factored materially in Lehman's decision to file for bankruptcy, the evidence does not support the existence of a colorable claim that HSBC's demand for collateral tortiously interfered with Lehman's contracts with other parties. HSBC was acting to protect its own commercial interests.

- Finally, the evidence does not support the existence of a colorable claim that HSBC fraudulently or negligently represented its plans to terminate its commercial relationship with Lehman. To the contrary, HSBC was forthright about its intentions to reduce its exposure to Lehman and ultimately to cease doing business with Lehman.

(4) Other Lenders

Several banks, in addition to JPMorgan, Citi and HSBC, demanded increased security from Lehman in the weeks preceding the petition date. While the Examiner did not investigate whether or not there were colorable claims arising from these transactions, the Examiner sets forth factual findings as they are relevant to the analysis of Lehman's reported liquidity pool.

- **Bank of America ("BofA")**. BofA provided clearing and other financial services to Lehman. In connection with its clearing services, BofA provided unsecured, intraday credit to cover overdrafts. On August 14, 2008, BofA demanded a deposit from Lehman in order for Lehman to retain its overdraft credit. In addition, BofA required Lehman to sign a Security Agreement (executed on August 25), in which Lehman agreed to maintain $500 million in collateral with BofA, and granted BofA a security interest in that collateral. The Security Agreement permitted Lehman to remove assets from the deposit account with advance notice of three days.

- **Bank of New York Mellon ("BNYM").** BNYM provided Lehman with credit related to commercial paper and medium term note programs. On August 20, BNYM requested that Lehman prefund its transactions with BNYM. After a series of discussions, Lehman and BNYM agreed on September 8, 2008, that Lehman would open a money market account with BNYM and maintain a sufficient deposit there to cover BNYM's forecasted intraday exposure to Lehman. Thereafter, on September 11, Lehman and BNYM executed a Collateral Deposit Agreement, requiring Lehman initially to deposit $125 million intraday and maintain a collateral account of at least $50 million.

- **Standard Bank**. Standard Bank provided Lehman with clearing and settlement services in South Africa. On August 18, Standard Bank requested that Lehman begin prefunding its trades. Discussions ensued, and on September 4, 2008, Standard Bank demanded $200 million in collateral by September 9, or it would cease settling Lehman's trades. Consequently, Lehman provided $200 million in collateral to Standard Bank on September 9, and executed a pledge agreement to cover the deposit on September 11. The Examiner's financial advisors have not been able to identify a U.S. debtor as the source of these funds.

(5) The Federal Reserve Bank of New York

The FRBNY was one of Lehman's major creditors, particularly in the wake of Bear Stearns' near collapse in March 2008, and in the weeks subsequent to Lehman's bankruptcy.

During the time period surrounding the near collapse of Bear Stearns in March 2008, the FRBNY established the Primary Dealer Credit Facility, or PDCF, through which the FRBNY offered short-term, collateralized loans to broker-dealers at its "discount window," in effect acting as a repo counterparty of last resort. Additionally, the FRBNY created the Term Securities Lending Facility, or TSLF, under which, every 28 days, broker-dealers could engage in a competitive auction and could swap mortgage-backed securities and other securities for Treasuries. The Examiner finds the evidence does not support the existence of colorable claims in connection with the lending transactions between the FRBNY and Lehman.

(6) Lehman's Liquidity Pool

Lehman represented in regulatory filings and in public disclosures that it maintained a liquidity pool that was intended to cover expected cash outflows for 12 months in a stressed liquidity environment and was available to mitigate the loss of secured funding capacity. After the Bear Stearns crisis in March 2008, it became acutely apparent to Lehman that any disruption in liquidity could be catastrophic; Lehman thus paid careful attention to its liquidity pool and how it was described to the market.

Lehman reported the size of its liquidity pool as $34 billion at the end of first quarter 2008, $45 billion at the end of second quarter, and $42 billion at the end of the third quarter. Lehman represented that its liquidity pool was unencumbered – that it

was composed of assets that could be "monetized at short notice in all market environments."

The Examiner's investigation of Lehman's transfer of collateral to its lenders in the summer of 2008 revealed a critical connection between the billions of dollars in cash and assets provided as collateral and Lehman's reported liquidity. At first, Lehman carefully structured certain of its collateral pledges so that the assets would continue to appear to be readily available (*i.e.*, the Overnight Account at JPMorgan, the $2 billion comfort deposit to Citi, and the three-day notice provision with BofA). Witness interviews and documents confirm that Lehman's clearing banks required this collateral and without it would have ceased providing clearing and settlement services to Lehman or, at the very least, would have required Lehman to prefund its trades. The market impact of either of those outcomes could have been catastrophic for Lehman. Lehman also included formally encumbered collateral in its liquidity pool. Lehman included the almost $1 billion posted to HSBC and secured by the U.K. Cash Deeds in its liquidity pool; Lehman included the $500 million in collateral formally pledged to BofA; Lehman included an additional $8 billion in collateral posted to JPMorgan and secured by the September Agreements; and Lehman continued to include the $2 billion at Citi, even after the Guaranty and DCSA amendments.

By the second week of September 2008, Lehman found itself in a liquidity crisis; it no longer had sufficient liquidity to fund its survival. Thus, an understanding of

Lehman's collateral transfers, and Lehman's attendant loss of readily available liquidity, is essential to a complete understanding of why Lehman ultimately failed.

b) Lehman's Dealings With JPMorgan

This Section of the Report discusses collateral posted by Lehman entities during 2008 in response to requests made by JPMorgan Chase ("JPMorgan") and agreements between Lehman and JPMorgan relating to clearing operations, credit, and collateral. In addition to the many witness interviews conducted and documents reviewed by the Examiner, the Examiner has informally sought and obtained information from Alvarez & Marsal, counsel for the Debtors, counsel for JPMorgan and counsel for the Creditors' Committee relating to the issues discussed in this Section of the Report.

(1) Facts

(a) Overview of JPMorgan-Lehman Relationship

JPMorgan acted as LBI's (LBHI's U.S. broker-dealer subsidiary) principal clearing bank for securities trading and triparty repurchase ("repo") agreements.[3954] In that role, JPMorgan assisted in the clearance and settlement of securities traded by LBI and LBI funding through triparty repos. Clearing banks facilitate security trades between buyers and sellers and secured loans between borrowers and lenders by

[3954] JPMorgan engaged in other roles with Lehman, including as a counterparty to derivative transactions, counterparty to purchases and sales of securities and other financial instruments, lender on both secured and unsecured terms, investment banker to assist with the issuance of loans, bonds and equity, and counterparty to securities lending transactions. Tonucci described Lehman's dealings with JPMorgan as Lehman's "most important relationship." Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 4.

providing services such as valuing the collateral posted by borrowers, applying and enforcing specific rules regarding collateralization and moving cash and collateral between accounts.[3955] JPMorgan was one of only two banks in the United States that provided the vast majority of clearing services to broker-dealer entities such as LBI; the other was The Bank of New York.[3956]

JPMorgan's clearing services for broker-dealers such as LBI consisted principally of triparty-repo clearing and clearing for other types of securities transactions. Triparty repos are a principal source of funding for broker-dealers[3957] and represented the largest intraday risk to JPMorgan of the clearing activities it carried out for Lehman.[3958] As implied by its name, triparty repo involves three parties: an investor (typically a pension fund, money market mutual fund or bank), a borrower (such as a broker-dealer) and a clearing bank.[3959] In a triparty repo, a triparty clearing bank such as

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[3955] *See, e.g.*, Tobias Adrian, *et al.*, *The Federal Reserve's Primary Dealer Credit Facility*, CURRENT ISSUES IN ECON. & FIN., Aug. 2009, at p. 6, *available at* http://www.newyorkfed.org/research/current_issues/ci15-4.pdf [hereinafter "Current Issues: PDCF"]; Lehman, Repo Manual (Nov. 8, 2005), at p. 11 [LBEX-LL 1175483] [hereinafter "Repo Manual"].

[3956] Current Issues: PDCF, at p. 6; Working Group on Government Securities Clearance and Settlement, *Report to the Federal Reserve Board* (Dec. 2003), at p. 10, *available at* http://www.federalreserve.gov/boarddocs/press/Other/2004/20040107/attachment.pdf [hereinafter "Working Group Report"].

[3957] Counterparty Risk Management Policy Group III, *Containing Systemic Risk: The Road to Reform* (Aug. 6, 2008), at p. 113, *available at* http://www.crmpolicygroup.org/docs/CRMPG-III.pdf [hereinafter "CRMPG III Report"]. A document drafted by JPMorgan, "Best Practices – Intraday and Overnight Tri-party Dealer Financing," formed a basis for what was ultimately published by the CRMPG. Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 7; JPMorgan, Best Practices – Intraday and Overnight Tri-Party Dealer Financing [JPM-EXAMINER00006026]; Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 4 (explaining that Lehman was "very reliant on triparty repo" and that triparty repo "is the lifeblood of an investment bank").

[3958] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 5.

[3959] Current Issues: PDCF, at pp. 2, 6.

JPMorgan acts as an agent, facilitating cash transactions from investors to broker-dealers, which, in turn, post securities as collateral.[3960] The broker-dealers and investors negotiate their own terms; JPMorgan acts only as an agent.[3961] Triparty repos typically mature overnight, although investors and broker-dealers can also enter into "term repos" (repos that mature at a later time) or "open repos" (repos without a set maturity date that permit the agreement to be terminated on any day).[3962]

Each night collateral is allocated to investors (into designations called "triparty shells"), either manually by the broker-dealer or, more typically, through an automated process in JPMorgan's Broker Dealer Automation System ("BDAS").[3963] The investors, in turn, provide overnight or longer-term funding to the broker-dealer. The following morning, JPMorgan "unwinds" the triparty repos, returning cash to the triparty investors and retrieving the securities posted the night before by the broker-dealer.

[3960] CRMPG III Report, at p. 114; Repo Manual, at p. 7 [LBEX-LL 1175483]. Triparty repos are similar to loans in which collateral is posted to secure the loan. *See* Current Issues: PDCF, at p. 2 ("In a repo transaction, the holder of a security obtains funds by selling that security to another financial market participant under an agreement to repurchase the security at a fixed price on a predetermined future date. In essence, the seller is borrowing funds against the security, typically as a means of financing the original purchase of the security.").

[3961] *E.g.*, Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at p. 3.

[3962] *See* CRMPG III Report, at pp. 114-15; Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries, *Cross-Border Securities Settlements* (Mar. 1995), at p. 42, *available at* http://www.bis.org/publ/cpss12.pdf.

[3963] JPMorgan's Responses to Examiner's First Set of Questions re Lehman/JPM Accounts & Collateral dated September 3, 2009 (Oct. 23, 2009), at pp. 1, 19 [hereinafter "JPMorgan First Written Responses"]; Examiner's Interview of John N. Palchynsky, May 11, 2009, at p. 4. BDAS is a mainframe system that JPMorgan uses to manage its clearance activities. Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 12; JPMorgan, U.S. Clearance, http://www.jpm.com/tss/General/U_S_Clearance/1114735376505 (last visited Dec. 17, 2009). BDAS handles tens of thousands of trade settlements daily. JPMorgan, U.S. Clearance, http://www.jpm.com/tss/General/U_S_Clearance/1114735376505 (last visited Dec. 17, 2009).

These securities then serve as collateral against the risk created by JPMorgan's cash advance to investors.[3964] During the business day, broker-dealers arrange the funding that they will need at the close of business through new triparty-repo agreements. This new funding must repay the cash that JPMorgan advanced during the business day, as well as any other non-JPMorgan cash needs. Thus, throughout the day, broker-dealers send instructions into JPMorgan's system to indicate the details of new triparty repos (*e.g.*, collateral amount and type) that will close at the end of the day.[3965] The process then repeats itself.

JPMorgan also facilitates the settlement of broker-dealer sales and purchases of securities.[3966] For example, a broker-dealer client may wish to purchase a bond for $10 million. At time of settlement, the "delivery-versus-payment" ("DVP") convention entails the simultaneous exchange of cash for the security. JPMorgan would advance the $10 million cash for the benefit of the broker-dealer. The cash would go out while the security came in to an account over which JPMorgan held a security interest. The broker-dealer would effectively receive a $10 million loan from JPMorgan collateralized by the security. The broker-dealer will in most cases repay this loan at end of day by borrowing the $10 million from a triparty-repo investor. The risks to JPMorgan after advancing the cash and prior to repayment are that the just-purchased security will fall

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[3964] *See* CRMPG III Report, at pp. 114-15.

[3965] Examiner's Interview of John N. Palchynsky, May 11, 2009, at pp. 3-4; JPMorgan First Written Responses, at p. 19.

[3966] *See* CRMPG III Report, at p. 113; Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 4.

in value below the $10 million cash advance or the broker-dealer will default on its repayment obligation.

The JPMorgan-LBI clearing relationship was governed by a Clearance Agreement between LBI and JPMorgan's predecessor, The Chase Manhattan Bank, executed in June 2000.[3967] JPMorgan agreed to act as LBI's "non-exclusive clearance agent for securities transactions" and "to open and maintain a clearance account."[3968]

The Clearance Agreement also provided for the extension of credit to LBI by JPMorgan, but at JPMorgan's sole discretion. JPMorgan could "solely at [its] discretion, permit [LBI] to use funds credited to the Account prior to final payment . . . or otherwise advance funds to [LBI] prior to final payment."[3969] Further, "[n]otwithstanding the fact that [JPMorgan] may from time to time make advances or loans . . . or otherwise extend credit to [LBI], whether or not as a regular pattern, [JPMorgan] may at any time decline to extend such credit at [JPMorgan's] discretion, with notice."[3970]

In consideration of any advances or loans JPMorgan extended to LBI pursuant to the Clearance Agreement, LBI granted JPMorgan "a continuing security interest in, lien upon and right of set-off as to" certain LBI assets (explicitly excluding certain

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[3967] Clearance Agreement (June 15, 2000), at p. 20 [JPM-2004 0031786]. For ease of reference, The Chase Manhattan Bank is referred to hereinafter as part of JPMorgan.

[3968] *Id*. at p. 1. The clearance account is actually a set of accounts: Clearing Accounts, Custody Accounts and Segregated Accounts. *Id.*

[3969] *Id*. at p. 4.

[3970] *Id*.

segregated customer accounts).[3971] In other words, daily credit extended by JPMorgan was secured by a lien on certain LBI accounts maintained at JPMorgan.

Initially, the Clearance Agreement was to expire on October 7, 2002, at which time if the parties had not entered into a written extension, the agreement would automatically renew for a one-year period.[3972] The Examiner is unaware of any written extension of the agreement during that time. The parties, however, continued to operate pursuant to the terms of the Clearance Agreement, as evidenced by their amending the agreement on May 30, 2008.[3973]

(b) Triparty Repo Prior to 2008

The September 11, 2001 terrorist attacks significantly disrupted the operations of the clearing banks (in particular the Bank of New York, due to its proximity to the World Trade Center), exacerbating policy concerns about the concentration of clearing banks and risk of disruptions to financial markets.[3974] In the attacks' aftermath, the Federal Reserve, the SEC and the Treasury Department initiated discussions with

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[3971] *Id*. at pp. 12-13. In the Clearance Agreement, this provision was in tension with the definition of "Clearing Accounts" and "Custody Accounts," which JPMorgan agreed to "hold as [LBI's] custodian, free of [JPMorgan's] lien, claim or interest." *Id*. at p. 1. In May 2008, the Clearance Agreement was amended to delete this lien-free language in the definition of "Clearing Accounts" and "Custody Accounts." Amendment to Clearance Agreement (May 30, 2008), at p. 1 [JPM-2004 0085662].

[3972] Clearance Agreement (June 15, 2000), at p. 17 [JPM-2004 0031786].

[3973] The May Amendment to the Clearance Agreement added Lehman Commercial Paper Inc. ("LCPI") as a party to the Clearance Agreement. Amendment to Clearance Agreement (May 30, 2008), at p. 1 [JPM-2004 0085662]. Furthermore, JPMorgan and Lehman entered into agreements after the Clearance Agreement that secured Lehman's obligations arising from JPMorgan's provision of specific clearing services to Lehman. *See, e.g.*, Cash Collateral Agreement (Oct. 3, 2005) [JPM-2004 0085509].

[3974] Working Group Report, at p. 11; Examiner's Interview of Christopher J. McCurdy, Aug. 26, 2009, at p. 2.

market participants to explore the risks of having only two clearing banks.[3975] The Federal Reserve considered the option of creating its own clearing bank of last resort called "NewBank." It looked at ways to transfer positions quickly from one clearing bank to "NewBank" in the event that customers lost confidence in a clearing bank or in the event that a clearing bank was incapacitated by some catastrophic event. Ultimately, there was "no easy solution" to these problems, and the "NewBank" project was held in abeyance.[3976] The Federal Reserve and the clearing banks continued, however, to discuss a broad range of risks to clearing banks, including risks posed by failure of a broker-dealer.[3977]

In evaluating triparty-repo clearing risks in 2008, JPMorgan recognized that the triparty-repo market had recently expanded, both in terms of volume and the types of

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[3975] Working Group Report, at p. 11.

[3976] Examiner's Interview of Christopher J. McCurdy, Aug. 26, 2009, at p. 2; *see also* Working Group Report, at pp. 28-37; Working Group on NewBank Implementation, *Report to the Federal Reserve Board* (Dec. 2005), *available at* http://www.federalreserve.gov/boarddocs/Press/Other/2005/20051215/attachment.pdf [hereinafter "NewBank Working Group Report"].

[3977] *See, e.g.*, e-mail from Janet Birney, Lehman, to Daniel J. Fleming, Lehman, *et al.* (Feb. 26, 2008) [LBEX-DOCID 280175] ("The recent market turmoil has prompted the Fed to question JPMC on the viability of Triparty financing in the event of broker dealer default."); e-mail from Janet Birney, Lehman, to Daniel J. Fleming, Lehman, *et al.* (May 5, 2008) [LBEX-DOCID 065656]; e-mail from Lucinda M. Brickler, FRBNY, to Timothy F. Geithner, FRBNY, *et al.* (July 16, 2008) [FRBNY to Exam. 034046] (attaching "talking points" the FRBNY developed for a July 17, 2008 meeting with "Dimon and Kelly regarding near-term measures to enhance the stability of the triparty repo market"); FRBNY, Talking Points, Near-term Measures to Enhance the Stability of the Triparty Repo Market [Draft] (July 16, 2008), at p. 1 [FRBNY to Exam. 034047] (talking points noting, "[i]n the event of the default of a large borrower, the potential for systemic risk to materialize co[u]ld be reduced").

securities funded.[3978] That is, more triparty-repo transactions were occurring and triparty-repo parties were using less-liquid and often harder-to-price securities.[3979] Liquidity and ease-of-pricing are both critical factors affecting risks to triparty investors and clearing banks. The premise of a triparty repo is that it constitutes secured funding in which the lender (investor) has the opportunity to sell the collateral immediately upon a broker-dealer's (borrower's) failure to pay maturing principal. U.S. Treasury securities are the optimal collateral for U.S. dollar transactions since large blocks can be sold readily within one trading day and the widely quoted prices of such securities are highly reliable. Stated differently, if a triparty investor has, for example, a value of par on its $100 million of Treasury security collateral and needs to sell it quickly because a borrower failed to repay its loan in the morning, the investor would almost certainly be able to sell the collateral during the same business day at a value very close to par.

To guard against the possibility of the investor realizing less than the loan amount in a liquidation scenario, the borrower must pledge additional "margin" (*i.e.*, additional collateral) to the lender[3980] – for example, $100 million of Treasury securities in exchange for $98 million in cash. This 2 percent "haircut" (*i.e.*, discount) is typical for

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[3978] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 4; *see also* Current Issues: PDCF, at p. 2.
[3979] CRMPG III Report, at pp. 113-14; Current Issues: PDCF, at p. 2.
[3980] Repo Manual, at p. 14 [LBEX-LL 1175483].

U.S. Treasury collateral.[3981] Even if the borrower defaults, the lender will suffer no loss if it can sell the $100 million of Treasury securities for $98 million or more.

As noted above, the risk of investor loss depends upon the investor's ability to sell collateral quickly and on the accuracy of the quoted price. Illiquid collateral requires longer time periods for sale at more uncertain prices, with time periods and prices dependent on the type of collateral, the amount of collateral to sell and prevailing market conditions.[3982]

Due to the salvage-value uncertainty associated with illiquid collateral, triparty investors demand higher haircuts as perceived collateral illiquidity increases. Equally important, haircuts generally increase as market volatility increases. For example, some lenders increased haircuts on asset-backed securities by 10 percent or more during times of market turmoil.[3983] Larger haircuts directly reduce the amount of funding

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[3981] *See, e.g.*, NewBank Working Group Report, at p. 10.

[3982] As one example, consider a broker-dealer that owns $10 million of a triple-B rated residential mortgage-backed security (RMBS). Assume the entire issuance of this particular bond is $20 million, so the broker-dealer owns half of the bond issue. Typically there would be zero or very few observable trades of this specific bond during the preceding month. Hence, there is no way to know beforehand how the market will react – in terms of liquidation time and price – to a triparty-repo investor (as lender to the broker-dealer secured by the RMBS collateral) who seeks to sell $10 million of the RMBS bond quickly (upon a default of the broker-dealer). The market may treat this triple-B bond as it has other similarly rated RMBS bonds in the prior month, but assumptions of this type add uncertainty. Even the quoted price in advance of any attempt to sell the bond is an estimate based on models and the recent performance of the prevailing residential housing market rather than a representation of recent trade activity. In short, the more illiquid the collateral, the greater the uncertainty of the salvageable value of such collateral to the triparty lender.

[3983] *See, e.g.*, e-mail from Laura M. Vecchio, Lehman, to Lori Bettinger, SEC, *et al.* (May 7, 2008) [LBEX-WGM 012803] (showing Dresdner increasing haircut on ABS from 110 to 120 during stress period); *see also* e-mail from Amberish Ratanghayra, Lehman, to John Feraca, Lehman, *et al.* (Mar. 24, 2008) [LBEX-DOCID 046250] ("Danske has requested an increase in haircut to 15%."). Craig Delany, a managing

available to a broker-dealer, which may force the broker-dealer to sell collateral, find other funding arrangements (such as issuance of unsecured debt), or accept a reduction in excess liquidity.

As triparty-repo agent to broker-dealers, JPMorgan was effectively their intraday triparty lender. When JPMorgan paid cash to the triparty investors in the morning and received collateral into broker-dealer accounts (which secured its cash advance), it bore a similar risk for the duration of the business day that triparty lenders bore overnight. If a broker-dealer such as LBI defaulted during the day, JPMorgan would have to sell the securities it was holding as collateral to recoup its morning cash advance.

JPMorgan used a measurement for triparty and all other clearing exposure known as Net Free Equity ("NFE"). In its simplest form, NFE was the market value of Lehman securities pledged to JPMorgan plus any unsecured credit line JPMorgan extended to Lehman minus cash advanced by JPMorgan to Lehman.[3984] An NFE value greater than zero indicated that Lehman had not depleted its available credit with JPMorgan. The NFE methodology also enabled JPMorgan to monitor its exposure position at all times during the trading day and thereby evaluate collateral substitutions

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director at JPMorgan's Investment Bank, however, stated that, in triparty repos, typically investors look to the counterparty (*i.e.*, broker-dealer) first and the collateral second when setting haircuts. In other words, a haircut may not be sufficient for an investor if it has serious concerns about the viability of its counterparty. Examiner's Interview of Craig M. Delany, Sept. 9, 2009, at p. 13.

[3984] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 5.

by Lehman that might produce undesired credit exposures.[3985] If a trade would put Lehman's NFE below zero, the trade would not be permitted.[3986] Through February 2008, JPMorgan gave full value to the securities pledged by Lehman in the NFE calculation and did not require a haircut for its effective intraday triparty lending. Consequently, through February 2008, JPMorgan did not require that Lehman post the margin required by investors overnight to JPMorgan during the day.[3987]

Dan Fleming, Lehman Global Head for Cash and Collateral Management, stated that Lehman objected to the opaque nature of JPMorgan's NFE formula and that there often was disagreement between Lehman and JPMorgan regarding NFE figures, with Lehman struggling to find causal connections between drops in NFE and Lehman's actions.[3988] In February 2008, Lehman requested that JPMorgan provide a daily NFE snapshot in order to allow Lehman to obtain better estimates of its position.[3989]

(c) JPMorgan Restructures Its Approach to Triparty Risk

In early 2008, the Federal Reserve Bank of New York ("FRBNY") urged JPMorgan to focus on the risks associated with its intraday exposure to broker-dealer

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[3985] *Id*. at p. 6.

[3986] *Id*. at p. 5; Examiner's Interview of Daniel J. Fleming, Apr. 22, 2009, at p. 3.

[3987] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 4.

[3988] Examiner's Interview of Daniel J. Fleming, Apr. 22, 2009, at p. 4; Examiner's Interview of Craig L. Jones, Sept. 28, 2009, at p. 5. Tonucci described NFE as "not a transparent thing." Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 6.

[3989] E-mail from Craig L. Jones, Lehman, to Daniel J. Fleming, Lehman (Feb. 26, 2008) [LBEX-DOCID 280175].

clients.[3990] In February 2008, JPMorgan's Ricardo Chiavenato, a risk manager at JPMorgan, was tasked with reviewing JPMorgan's triparty business.[3991] After analyzing the market and increasing risks faced by clearing banks handling triparty repo transactions, Chiavenato recommended that JPMorgan retain triparty-investor margin – the same margin triparty investors required.[3992] JPMorgan decided to implement the margin requirements gradually.[3993]

JPMorgan incorporated its new margin requirements into the NFE calculation. Under its new approach, JPMorgan reduced the value it assigned to securities it held commensurate with the margin requirements of the triparty investors.[3994] For example, if Lehman had borrowed $19 million in an overnight triparty repo from an investor, it might have pledged $20 million (market value) of corporate bonds as collateral (at a haircut of 5 percent). Before February 2008, JPMorgan required no triparty-investor margin, so JPMorgan's payment of $19 million cash in the morning to repay the lender (a cash advance for the benefit of Lehman) in concert with the receipt of the $20 million

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[3990] *See* e-mail from Janet Birney, Lehman, to Daniel J. Fleming, Lehman, *et al.* (Feb. 26, 2008) [LBEX-DOCID 280175].

[3991] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at pp. 3, 5.

[3992] *Id*. at p. 5. This recommendation that clearing banks retain margin against cash advances is consistent with a December 2005 report of a working group commissioned by the Federal Reserve Board to study "NewBank" feasibility. A portion of this report dealt with prudent risk management practices and included the requirement that clients post margin to collateralize the clearing bank's risk exposure. *See* NewBank Working Group Report, at p. 17.

[3993] E-mail from Janet Birney, Lehman, to Daniel J. Fleming, Lehman, *et al.* (Feb. 26, 2008) [LBEX-DOCID 280175].

[3994] *Id*.; Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 6.

of securities would give Lehman an immediate $1 million "surplus" of NFE.[3995] Lehman could then use this surplus by withdrawing cash or securities or by executing other trades that might draw down the surplus.

Upon full implementation of JPMorgan's plan to retain triparty-investor margin, the change to the NFE calculation would be to treat the $20 million market value of corporate bonds as if they were worth only $19 million. With this applied discount, there would then be no NFE surplus to Lehman generated by JPMorgan paying $19 million cash in the morning and receiving $20 million of bonds. Operationally, JPMorgan implemented this change by adjusting NFE each morning by the amount of margin required by triparty investors the night before.[3996] For example, if triparty investors required $4.5 billion margin from LBI on Tuesday night, JPMorgan would subtract $4.5 billion from LBI's NFE on Wednesday morning, effectively retaining the same amount of margin as triparty investors required.

Lehman and JPMorgan representatives discussed these new collateral requirements, as well as other changes, on a February 26, 2008 conference call. JPMorgan explained that because "recent market turmoil . . . prompted the Fed to question JPMC on the viability of [t]riparty financing in the event of broker dealer default," JPMorgan proposed that it "hold back the margin on the collateral as a counter

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[3995] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 4.

[3996] *See* JPMorgan's Responses to Examiner's Second Set of Questions re Lehman/JPM Accounts & Collateral dated October 13, 2009 (Nov. 2, 2009), at p. 6 [hereinafter "JPMorgan Second Written Responses"].

debit to the Net Free Equity (NFE) calculation, e.g. - for an asset at 102 they would keep the 2."[3997] JPMorgan offered to implement this plan "incrementally . . . over the next 5-6 weeks."[3998]

Despite Lehman's initial resistance to JPMorgan's proposal,[3999] effective March 17, 2008, JPMorgan began accounting for 20 percent of the triparty-investor margin in its NFE calculation for Lehman.[4000] Lehman reported internally that JPMorgan had begun implementing the intraday margin due to "market conditions."[4001] "[M]arket conditions" was an apparent reference to the near collapse of Bear Stearns and resultant market instability occurring at the time.

JPMorgan continued to meet with Lehman throughout the summer to discuss triparty risk and margin requirements. On May 2, 2008, Fleming and others from Lehman participated in a conference call with Ed Corral, then JPMorgan's Global Head of U.S. Fixed Income Clearing, Mark Doctoroff, JPMorgan's primary relationship

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[3997] E-mail from Janet Birney, Lehman, to Daniel J. Fleming, Lehman, *et al.* (Feb. 26, 2008) [LBEX-DOCID 280175].

[3998] *Id*.

[3999] *See* e-mail from Paolo R. Tonucci, Lehman, to Janet Birney, Lehman, *et al.* (Feb. 29, 2008) [LBEX-DOCID 098461] (describing JPMorgan's proposal as "a blunt tool being used to address a very complex issue"). Lehman was concerned that "debiting the NFE for the margin [would] be a problem," apparently because Lehman had "hit [its] NFE limit several times" over the prior few weeks. E-mail from Craig L. Jones, Lehman, to Daniel J. Fleming, Lehman (Feb. 26, 2008) [LBEX-DOCID 280175].

[4000] Lehman, JPM Chase Triparty Repo, at p. 4 [LBEX-AM 001399]; e-mail from Jack Fondacaro, Lehman, to Janet Birney, Lehman, *et al.* (Mar. 17, 2008) [LBEX-DOCID 280168] ("Chase just notified us that they will begin charging us intra day margin (20% of the 2%)."); JPMorgan Second Written Responses, at pp. 4-5.

[4001] E-mail from Jack Fondacaro, Lehman, to Janet Birney, Lehman, *et al.* (Mar. 17, 2008) [LBEX-DOCID 280168].

manager for Lehman, and others from JPMorgan.[4002] JPMorgan had "requested the meeting to discuss where they are headed and how their risk department is looking at the [triparty product] business (prompted by discussions with the FED)."[4003] According to Lehman, JPMorgan "was very clear that the meeting was a product specific issue and . . . assured [Lehman] that they had no intention of hindering [Lehman's] business."[4004] The parties discussed, among other things, "[c]hanges to the [i]ntra-[d]ay [m]argining process and the impact on Lehman's NFE."[4005] At the meeting JPMorgan stated that Lehman must post 100 percent triparty-investor margin by the end of June.[4006] In addition, "Chase agreed to provide a real time credit screen to monitor their NFE and analysis on the potential impact to [Lehman's] NFE."[4007]

[4002] E-mail from Janet Birney, Lehman, to Daniel J. Fleming, Lehman, *et al.* (May 5, 2008) [LBEX-DOCID 065656].

[4003] *Id*.

[4004] *Id*.

[4005] E-mail from Janet Birney, Lehman, to Jack Fondacaro, Lehman, *et al*. (May 2, 2008) [LBEX-DOCID 036292]; Discussion Points [LBEX-DOCID 077455]. The parties also discussed a schedule of "[c]ollateral and haircut changes for Lehman end-of-day 'box' clearance loans." E-mail from Janet Birney, Lehman, to Jack Fondacaro, Lehman, *et al*. (May 2, 2008) [LBEX-DOCID 036292]; Discussion Points [LBEX-DOCID 077455]; *see also* JPMorgan, Fail Financing Collateral Schedule [LBEX-DOCID 014193]; Lehman, JPM Chase Triparty Repo, at p. 1 [LBEX-AM 001399] ("JPM Chase wants to revise the collateral schedule for overnight box loans. This would include the exclusion of certain asset types and an overall increase in haircuts.").

[4006] E-mail from Janet Birney, Lehman, to Daniel J. Fleming, Lehman, *et al.* (May 5, 2008) [LBEX-DOCID 065656]. There apparently was some confusion as to whether JPMorgan would require the same margin amount as triparty investors held overnight or instead a static 2 percent margin. JPMorgan clarified that it intended the former. E-mail from Craig L. Jones, Lehman, to Janet Birney, Lehman, *et al*. (May 5, 2008) [LBEX-DOCID 065656]; e-mail from Craig L. Jones, Lehman, to Janet Birney, Lehman (May 5, 2008) [LBEX-DOCID 023260].

[4007] E-mail from Craig L. Jones, Lehman, to Rachel Zera, Lehman (May 2, 2008) [LBEX-DOCID 031544]. As here, some witnesses refer to JPMorgan as "Chase." It appears that Lehman also "[a]greed to pledge over to Chase excess non-investment grade and non-rated priced collateral to assist with NFE." *Id*.; Examiner's Interview of Craig L. Jones, Sept. 28, 2009, at p. 7 (pledging non-rated assets to JPMorgan was

Retention of 100 percent triparty-investor margin, phased in incrementally, was only one aspect of JPMorgan's risk-mitigation measures for its triparty-repo business.[4008] JPMorgan believed that its risk was actually *greater* than that of individual triparty investors because, as a clearing bank, JPMorgan would hold larger collateral positions than any individual investor, and thus would face greater risks in a liquidation scenario.[4009] In addition, JPMorgan concluded that triparty-repo investors had not adequately assessed risks in the margins they charged.[4010] Thus, in order to mitigate liquidation and price risk, JPMorgan advised Lehman, as well as other broker-dealer clients, that additional margin would be required, based on collateral type, above and beyond the margin required by the investors.[4011] JPMorgan's new "risk-based margin"

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beneficial to NFE). Despite having access to its own credit screen, Lehman often struggled to understand NFE and how different factors affected it. *E.g.*, Examiner's Interview of Craig L. Jones, Sept. 28, 2009, at pp. 2, 9-10; Examiner's Interview of Daniel J. Fleming, Apr. 22, 2009, at p. 4; e-mail from Craig L. Jones, Lehman, to Daniel J. Fleming, Lehman (July 7, 2008) [LBEX-DOCID 055604].

[4008] As of early summer, JPMorgan was assigning a 125 percent margin to equities without regard to triparty-investor margin. *See, e.g.*, JPMorgan, Tri-party Repo Discussion - Lehman (May 29, 2008), at p. 2 [JPM-EXAMINER00006028]; e-mail from Ricardo S. Chiavenato, JPMorgan, to David A. Weisbrod, JPMorgan (Aug. 20, 2008) [JPM-2004 0006544]; e-mail from Ricardo S. Chiavenato, JPMorgan, to David A. Weisbrod, JPMorgan, *et al.* (Sept. 8, 2008) [JPM-2004 0007292].

[4009] For example, a triparty-repo investor that had loaned $19 million against collateral with quoted market value of $20 million (5 percent haircut) would need to sell this collateral during the trading day if the borrower declared bankruptcy overnight. JPMorgan's "concentration risk" to the broker-dealer borrower was much higher than that of any triparty investor. The bank faced a higher relative risk than any one investor given the concentration of positions it held against a single broker-dealer. Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at pp. 9-10.

[4010] *E.g.*, *id*. at p. 10; Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at p. 4 (overnight investors were not concerned about liquidation pricing because they assumed clearing banks would unwind securities).

[4011] *See, e.g.*, e-mail from Ricardo S. Chiavenato, JPMorgan, to Thomas H. Mulligan, JPMorgan, *et al.* (Aug. 14, 2008) [JPM-2004 0061182] (discussing risk-based margin with respect to "all dealers"); e-mail from Jane Buyers-Russo, JPMorgan, to Stephen Eichenberger, JPMorgan, *et al*. (Sept. 11, 2008) [JPM-2004 0032729] ("We have taken steps this summer to improve the intraday exposures by increasing margins

would take into account "liquidation risk" to account for one-day price volatility for securities, and "price risk," an "estimate of potential vendor price overstatement for illiquid securities."[4012]

As with triparty-investor margin, JPMorgan planned to implement its new risk-based margin requirement incrementally. JPMorgan first calculated risk-based margin manually because BDAS did not yet have the capability.[4013] Initially JPMorgan was able to calculate only a static snapshot of risk-based margin based on a broker-dealer's collateral pool at the start of the day. Throughout the day, however, broker-dealers could substitute triparty collateral and buy and sell securities. Both activities changed the risk profile of the collateral pool. JPMorgan planned eventually to implement the risk-based-margin concept and "dynamic" margining into BDAS, which would track JPMorgan's risk in real-time as collateral was substituted.[4014]

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and excluding certain collateral classes . . . ."); Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 6.

[4012] JPMorgan, Tri-party Repo Discussion - Lehman (May 29, 2008), at p. 10 [JPM-EXAMINER00006028]. Chiavenato explained that vendor pricing may not be accurate for some types of securities; JPMorgan accounted for this "price risk" in its risk-based margin calculation. The "price risk" component did not mitigate the risk of dealer self-pricing. Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 11. JPMorgan's views of the liquidation risk and the price risk rolled up into one haircut (or margin amount) for each collateral type. *See* JPMorgan, Detailed Summary - Breakdown by Security and Rating (Sept. 5, 2008) [JPM-EXAMINER00006088].

[4013] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 6; e-mail from Thomas H. Mulligan, JPMorgan, to Jane Buyers-Russo, JPMorgan, *et al.* (Sept. 11, 2008) [JPM-2004 0032729] ("We are close to having a system to calculate the risk based margin required to address the 1 day price + liquidation risk (Zubrow agreed to this methodology).").

[4014] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 6. JPMorgan had not implemented dynamic margining as of September 15, 2008, when LBHI filed its bankruptcy petition. *E.g.*, *id*.

(d) Lehman Begins Posting Additional Collateral

On June 2, 2008, JPMorgan met with Lehman to discuss the move toward risk-based margin.[4015] At that time, JPMorgan was applying only 20 percent investor margin for intraday financing.[4016] JPMorgan presented Lehman with calculations showing that $2.8 billion of additional collateral would be required to reach 100 percent investor margin and an additional $3.2 billion would be necessary to satisfy JPMorgan's new risk-based margin requirement based on the prevailing (May 23, 2008) portfolio data.[4017] JPMorgan calculated that $6.1 billion of additional collateral (with apparent rounding) was necessary to cover both the liquidation and price risk.[4018] As a result of that meeting, Lehman agreed to post $5 billion of collateral to begin to cover this deficit.[4019] Although JPMorgan's calculations from late May suggest that JPMorgan required only an additional $3.2 billion to cover risk-based margin (and that the $6.1 billion figure included the adjustment to 100 percent triparty-investor margin as well), JPMorgan witnesses stated that the $5 billion that Lehman agreed to post covered risk-based

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[4015] Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at p. 5; JPMorgan Second Written Responses, at p. 5.

[4016] JPMorgan, Tri-party Repo Discussion - Lehman (May 29, 2008), at p. 2 [JPM-EXAMINER00006028].

[4017] *Id*. at pp. 3, 5, 7.

[4018] *Id.* at p. 5.

[4019] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at pp. 10-11; Examiner's Interview of Edward J. Corral, Sept. 30, 2009, at pp. 4-5; Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at p. 5; JPMorgan Second Written Responses, at p. 5. JPMorgan and Lehman initially attempted to document this collateral pledge through a letter agreement. *See* e-mail from Daniel J. Fleming, Lehman, to Mark G. Doctoroff, JPMorgan, *et al*. (July 16, 2008) [LBEX-AM 001354]; Letter from JPMorgan to Paolo R. Tonucci, Lehman, re: Delivery to JPMorgan Chase Bank, N.A. of $5 billion of Securities [Draft] (July 2008) [LBEX-AM 001356]. That letter agreement does not appear to have ever been executed. Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 7.

margin, not triparty-investor margin.[4020] Internally, Lehman stated in August that the amount required for JPMorgan's risk-based margin was "estimated at $6.2 billion" and "[i]n lieu of implementing the additional haircut systemically" JPMorgan reduced Lehman's "intraday credit position by $5 billion, requiring [Lehman] to pledge additional collateral for a like amount."[4021] Although the additional $5 billion was not the ultimate level of collateral JPMorgan wanted, JPMorgan viewed the $5 billion collateral as a "step in the right direction."[4022]

To fulfill its offer to pledge $5 billion of collateral, Lehman posted approximately $5.7 billion (face value) of securities at JPMorgan on June 19, 2008.[4023] The collateral consisted of large positions in four CDOs – called SASCO, Freedom, Spruce and Pine – and one asset-backed commercial paper position, known as Fenway.[4024] Lehman posted

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[4020] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 10; Examiner's Interview of Edward J. Corral, Sept. 30, 2009, at pp. 4-5; Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at pp. 4-5; *see also* e-mail from Ricardo S. Chiavenato, JPMorgan, to Mark G. Doctoroff, JPMorgan, *et al.* (Aug. 13, 2008) [JPM-2004 0061165] (referencing "the $5bi static margin to meet our risk-based margin"); e-mail from Ricardo S. Chiavenato, JPMorgan, to David A. Weisbrod, JPMorgan (Aug. 20, 2008) [JPM-2004 0006544] (listing "$5 bi extra collateral" separate from "100% of tri-party investor margin"); JPMorgan Second Written Responses, at p. 5.

[4021] E-mail from Janet Birney, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Aug. 5, 2008) [LBEX-DOCID 4165589]; *see also* e-mail from Daniel J. Fleming, Lehman, to Janet Birney, Lehman (Aug. 1, 2008) [LBEX-DOCID 63603]. While risk-based margin changed throughout the summer, it appears that Birney was likely referencing the $6.1 billion calculation from late May.

[4022] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 11.

[4023] JPMorgan Second Written Responses, at p. 5.

[4024] E-mail from Craig L. Jones, Lehman, to John Feraca, Lehman, *et al*. (June 19, 2008) [LBEX-DOCID 055575]; JPMorgan Second Written Responses, at p. 5. The SASCO 2008-C2 ("SASCO") bond was a commercial real estate ("CRE") CDO, although it was sometimes described less precisely as a collateralized mortgage obligation ("CMO"). Freedom, Spruce and Pine were collateralized loan obligations ("CLOs") – a special type of CDO that consists of primarily high-yield (or "leveraged") loans to corporate borrowers. The Fenway transaction was widely described as asset-backed commercial paper

these securities to a clearance account within JPMorgan called "LCD," which JPMorgan characterizes as an LBI account.[4025] The securities pledged in June, however, were owned by LCPI.[4026]

Lehman did not reach 100 percent triparty-investor margin by JPMorgan's original target date.[4027] On July 2, 2008, Lehman posted over $1 billion additional collateral to the LCD account: Kingfisher (an Asian CLO) and HD Supply (a corporate loan).[4028] Lehman continued to post collateral to and substitute collateral in the LCD account throughout July and August 2008, including a large position in another CDO called Verano.[4029]

("ABCP"), but most short-term debt obligations of this issuer were extendible CP also known as "secured liquidity notes" ("SLNs"). For purposes of this discussion we will refer to Fenway as ABCP. Lehman created all of these positions in 2008 (except for Fenway, which was first launched in 2007) by securitizing (the CDOs) or funding (the ABCP) its own illiquid corporate and commercial real estate loans.

[4025] JPMorgan First Written Responses, at p. 7; JPMorgan Second Written Responses, at p. 5; *see also* Spreadsheet [JPM-EXAMINER00006151] (spreadsheet showing LCD as part of DG92, an LBI dealer group). Alvarez & Marsal, however, "underst[ood] JPMorgan referred to the LCD account in a way that suggests it was a LCPI account." Alvarez & Marsal, Responses to Questions for Alvarez & Marsal/Weil, Gotshal & Manges (Dec. 7, 2009), at p. 1.

[4026] JPMorgan First Written Responses, at p. 7; *see also* e-mail from Rob Rodriguez, Lehman, to Michael Prestolino, Lehman, *et al.* (Aug. 11, 2008) [LBEX-DOCID 116020] (e-mail chain documenting "sale of CDO assets to LBHI from LCPI"); e-mail from Ricardo S. Chiavenato, JPMorgan, to Henry R. Yeagley, JPMorgan, *et al.* (Aug. 7, 2008) [JPM-2004 0008051] (discussing "collateral posted by LCPI").

[4027] *See* e-mail from Piers Murray, JPMorgan, to Paolo R. Tonucci, Lehman (July 1, 2008) [LBEX-DOCID 036475].

[4028] *See* e-mail from John N. Palchynsky, Lehman, to Richard Policke, Lehman, *et al*. (July 2, 2008) [LBEX-DOCID 077515] (e-mail chain documenting pledge); JPMorgan Second Written Responses, at p. 5.

[4029] JPMorgan Second Written Responses, at p. 6; *see* e-mail from Ricardo S. Chiavenato, JPMorgan, to Henry R. Yeagley, JPMorgan, *et al*. (Aug. 7, 2008) [JPM-2004 0008051]; JPMorgan, Position Pricing Report (Aug. 7, 2008), at p. 1 [JPM-2004 008062] (listing securities in LCD as of August 7, 2008).

Securities in the LCD account contributed to LBI's NFE requirement, which, as discussed above, was incrementally adjusted to account for triparty-investor margin.[4030] By the end of July, Lehman had posted approximately $8 billion to JPMorgan (face value), and Lehman understood that JPMorgan had "taken an official lien over $5bn . . . above and beyond what [was] required for NFE."[4031] The final adjustment to achieve 100 percent triparty-investor margin occurred on August 14, 2008.[4032]

Additionally, Lehman posted collateral in July to an LCPI clearance account called "LCP," including smaller amounts in securities known as Golden Gate (surplus notes of a captive reinsurer SPV), Loan FNG (a Lehman loan to the R3 hedge fund), Delta Topco (a non-public security comprised of high-yield loans), Cayman Partners (a Lehman loan to an SPV) and Riopelle Broadway (another Lehman loan to an SPV).[4033]

[4030] *See* JPMorgan Second Written Responses, at p. 6. JPMorgan also adjusted LBI's NFE to account for the $5 billion of risk-based margin that Lehman agreed to post. This adjustment ceased when securities were moved to the "LCE" account in early August. *See* Jenner & Block, Memorandum re November 18, 2009 Teleconference with JPMorgan Counsel (Nov. 19, 2009), at p. 3; *see also infra* at Section III.A.5.b.1.e (discussing transfer of securities).

[4031] E-mail from Craig L. Jones, Lehman, to James W. Hraska, Lehman (July 31, 2008) [LBEX-DOCID 077621].

[4032] *See* e-mail from Daniel J. Fleming, Lehman, to Paolo R. Tonucci, Lehman (Sept. 3, 2008) [LBEX-AM 000870]; JPMorgan Second Written Responses, at p. 7; *see also* Lehman, NFE Tracking Spreadsheet, at pp. 140-42 [LBEX-LL 385672] (spreadsheet of NFE tracking maintained by Craig Jones that shows NFE Adjustment increasing from $10.6 billion on August 13 to $11.6 billion on August 14).

[4033] *See* JPMorgan Second Written Responses, at pp. 7-8; e-mail from Craig L. Jones, Lehman, to Daniel J. Fleming, Lehman, *et al*. (Aug. 27, 2008) [LBEX-DOCID 454649]; Lehman, NFE Data (Aug. 27, 2008), at p. 2 [LBEX-DOCID 453380] (listing these securities as pledged collateral); *see also* Lehman, $[450],000,000 Floating Rate Surplus Notes due 20[37], First British American Reinsurance Company II, Information Memorandum (2006) [LBEX-WGM 974136] (information concerning Golden Gate); Lehman, R3 Capital Partners Strategic Acquisition Review Committee (May 20, 2008) [LBHI_SEC07940_098444] (information concerning R3 and Loan FNG); Spreadsheet [LBEX-BARFID 0016221] (information concerning Delta Topco); Spreadsheet re: Financing Trades [LBHI_SEC07940_2594028] (information concerning Riopelle Broadway and Cayman Partners). Riopelle Broadway was transferred out of LCP on August 27; Golden

Lehman also posted Pine physicals, Spruce physicals, Verano physicals and SASCO physicals to an LCPI physical account, Titan account G 72456.[4034] Although Lehman listed these securities on internal "NFE Collateral" charts,[4035] according to JPMorgan, neither LCP nor G 72456 contributed to LBI's NFE.[4036] Appendix 18 summarizes some of the significant collateral postings and movements during the summer of 2008.

(e) JPMorgan Concern Over Lehman Collateral in August 2008

By early August 2008, JPMorgan had learned that Lehman had pledged self-priced CDOs as collateral over the course of the summer.[4037] By August 9, to meet JPMorgan's margin requirements, Lehman had pledged $9.7 billion of collateral, $5.8

Gate was transferred out of LCP on August 29. *See* JPMorgan Second Written Responses, at pp. 7-8; e-mail from Craig L. Jones, Lehman, to Daniel J. Fleming, Lehman (Sept. 3, 2008) [LBEX-DOCID 055415]; Lehman, NFE Data (Sept. 2, 2008), at p. 2 [LBEX-DOCID 046772] (no longer listing these securities as pledged collateral).

[4034] *See* e-mail from Kristen Coletta, Lehman, to Craig L. Jones, Lehman (Sept. 3, 2008) [LBEX-DOCID 055422]; Lehman, NFE Data (Sept. 3, 2008), at p. 3 [LBEX-DOCID 046675] (showing new pledged CUSIPs of Pine, Spruce, Verano and SASCO); e-mail from Michael Prestolino, Lehman, to Carolyn Murillo, Lehman, *et al.* (Aug. 27, 2008) [LBEX-DOCID 046646] (identifying CUSIPs as physical notes); Collateral Pledged to JPM for Intraday As of 9/12/2008 COB [LBEX-AM 047008]; JPMorgan Second Written Responses, at p. 8.

[4035] *See, e.g.*, e-mail from Kristen Coletta, Lehman, to Craig L. Jones, Lehman, *et al.* (Sept. 11, 2008) [LBEX-DOCID 055424]; Lehman, NFE Collateral Details As of 9/10/2008 COB (Sept. 11, 2008) [LBEX-DOCID 046774]; e-mail from Craig L. Jones, Lehman, to Daniel J. Fleming, Lehman, *et al.* (Aug. 27, 2008) [LBEX-DOCID 454649]; Lehman, NFE Data (Aug. 27, 2008), at p. 2 [LBEX-DOCID 453380].

[4036] JPMorgan Second Written Responses, at pp. 7-8; JPMorgan First Written Responses, at p. 7. *But see* e-mail from John N. Palchynsky, Lehman, to Craig L. Jones, Lehman (July 15, 2008) [LBEX-DOCID 053633] (confirming that Lehman could pledge assets to LCPI's physicals box "to get . . . NFE benefit"). According to Alvarez & Marsal, Lehman believed that securities pledged in LCP and Titan account G 72456 impacted LBI's NFE. Alvarez & Marsal, Responses to Questions for Alvarez & Marsal/Weil, Gotshal & Manges (Dec. 7, 2009), at p. 1.

[4037] *See, e.g.*, e-mail from Ricardo S. Chiavenato, JPMorgan, to Mark G. Doctoroff, JPMorgan, *et al.* (Aug. 9, 2008) [JPM-2004 0006527]. Lehman attempted to pledge some of these CLOs to Citi in early August as well, namely, Kingfisher, Freedom, Spruce and Verano. E-mail from Michael Mauerstein, Citigroup, to Yingli Xie, Citigroup, *et al.* (Aug. 4, 2008) [CITI-LBHI-EXAM 00082162]. Unlike JPMorgan, Citi refused to accept the CLOs as collateral. E-mail from Michael Mauerstein, Citigroup, to Katherine Lukas, Citigroup, *et al.* (Aug. 12, 2008) [CITI-LBHI-EXAM 00021175].

billion of which were CDOs priced by Lehman, mostly at face value.[4038] JPMorgan expressed concern as to the quality of the assets that Lehman had pledged and, consequently, Lehman offered to review its valuations.[4039] Although JPMorgan remained concerned that the CDOs were not acceptable collateral,[4040] Lehman informed JPMorgan that it had no other collateral to pledge.[4041] The fact that Lehman did not have other assets to pledge raised some concerns at JPMorgan about Lehman's liquidity.[4042]

[4038] E-mail from Ricardo S. Chiavenato, JPMorgan, to Mark G. Doctoroff, JPMorgan, *et al.* (Aug. 9, 2008) [JPM-2004 0006527].

[4039] E-mail from Edward J. Corral, JPMorgan, to Ricardo S. Chiavenato, JPMorgan, *et al.* (Aug. 8, 2008) [JPM-2004 0006511]; e-mail from Edward J. Corral, JPMorgan, to Ricardo S. Chiavenato, JPMorgan, *et al.* (Aug. 8, 2008) [JPM-2004 0006515]. Chiavenato explained that only when JPMorgan finally received prospectuses for Lehman's CDOs did it realize that the CDOs were not the type of collateral that JPMorgan would typically take. Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 11; *see also* e-mail from Daniel J. Fleming, Lehman, to Mark G. Doctoroff, JPMorgan (Sept. 8, 2008) [JPM-2004 005807] (attaching offering memoranda for Pine, Spruce, Verano and SASCO). Chiavenato stated that he was unaware of Lehman ever having defended the quality of its collateral. Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 16. At least in early August 2008, however, Tonucci questioned whether JPMorgan should be the price provider. E-mail from Paolo R. Tonucci, Lehman, to Craig L. Jones, Lehman, *et al.* (Aug. 8, 2008) [LBEX-SIPA 003932]; *see also* e-mail from Mark G. Doctoroff, JPMorgan, to Ricardo S. Chiavenato, JPMorgan, *et al.* (Aug. 5, 2008) [JPM-2004 0061153] (reporting that Lehman did "not agree with [JPMorgan's] liquidity/price risk numbers"); e-mail from Paolo R. Tonucci, Lehman, to Mark G. Doctoroff, JPMorgan, *et al*. (Aug. 5, 2008) [LBHI_SEC07940_534634] ("Not sure whether it makes sense to be collateralising you on the basis [of] your wrong/erroneous information."). Corral recalled that Lehman provided prospectuses of its securities to try to persuade JPMorgan's third-party pricing provider to revise its pricing, but that provider did not change its values. Examiner's Interview of Edward J. Corral, Sept. 30, 2009, at p. 9.

[4040] *See* e-mail from Donna Dellosso, JPMorgan, to Ricardo S. Chiavenato, JPMorgan (Aug. 6, 2008) [JPM-2004 0061153] ("I . . . don't want [CDOs] as collateral for the intra-day exposure."); e-mail from Ricardo S. Chiavenato, JPMorgan, to Mark G. Doctoroff, JPMorgan, *et al.* (Aug. 9, 2008) [JPM-2004 0006527] ("We never intended to have our margin requirements met by CDOs . . . .").

[4041] E-mail from Ricardo S. Chiavenato, JPMorgan, to Donna Dellosso, JPMorgan (Aug. 6, 2008) [JPM-2004 0061153].

[4042] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 5.

At the time, the market for CDOs was illiquid generally, rendering them less desirable as collateral.[4043] With regard to the specific CDOs pledged by Lehman, JPMorgan's David Weisbrod commented in an August 6 e-mail that "[e]ssentially [Lehman was] packaging up securities it underwrote and structured and couldn't sell. [Lehman] put[] its own price on these securities . . . ."[4044] Weisbrod questioned Lehman's intentions: "[T]his strikes me as borderline insulting to think we would accept Lehman's self structured and self priced CDOs to meet our margin requirements."[4045] Chiavenato told the Examiner that Lehman had posted the worst type of collateral with Lehman's own prices attached.[4046] Yet, at the time, at least one person within JPMorgan, Mark Doctoroff, defended Lehman's conduct. Doctoroff stated in a contemporaneous e-mail that "it sounds like we think [Lehman has] been acting in bad faith, which I disagree with as we did not give clear instructions to them when we asked for the $5bn . . . ."[4047] The Examiner has not discovered evidence suggesting that JPMorgan told Lehman directly that Lehman could not post CDOs as collateral through August 2008.

[4043] *Id*. at p. 4.

[4044] E-mail from David A. Weisbrod, JPMorgan, to Edward J. Corral, JPMorgan (Aug. 6, 2008) [JPM-2004 0061153].

[4045] E-mail from David A. Weisbrod, JPMorgan, to Ricardo S. Chiavenato, JPMorgan, *et al.* (Aug. 6, 2008) [JPM-2004 0061153].

[4046] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 15.

[4047] E-mail from Mark G. Doctoroff, JPMorgan, to Ricardo S. Chiavenato, JPMorgan, *et al.* (Aug. 9, 2008) [JPM-2004 0006537].

In early August 2008, JPMorgan engaged Gifford Fong Associates ("GFA"), a third-party boutique pricing vendor, to price Lehman's difficult-to-value collateral. JPMorgan's Ed Corral noted that GFA "impressed the heck out of" him,[4048] although the managing director that oversaw JPMorgan's Investment Bank's triparty-repo business, Craig Delany, stated that he ignored almost any pricing from GFA.[4049] Delany stated that, in his experience, model pricing is materially inaccurate and could not be trusted for large, illiquid assets.[4050] Nonetheless, JPMorgan used GFA to value Lehman's self-priced CDOs and continues to use GFA to price other difficult-to-price assets in its system.[4051]

On August 8, 2008, GFA priced Lehman's collateral at a significantly lower value than the value assigned by Lehman.[4052] Chiavenato explained that, using GFA's pricing, the $5.8 billion of pledged CDOs would be worth less than $2 billion.[4053] Chiavenato likely misstated GFA's results, however. At the time, GFA had not priced Kingfisher

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[4048] E-mail from Edward J. Corral, JPMorgan, to David A. Weisbrod, JPMorgan (Aug. 7, 2008) [JPM-2004 0061153].

[4049] Examiner's Interview of Craig M. Delany, Sept. 9, 2009, at p. 8.

[4050] *Id*.

[4051] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at pp. 7, 11; Examiner's Interview of Edward J. Corral, Sept. 30, 2009, at p. 8.

[4052] *See* e-mail from Edward J. Corral, JPMorgan, to Ricardo S. Chiavenato, JPMorgan, *et al.* (Aug. 8, 2008) [JPM-2004 0008073]; e-mail from Jessie Zhang, GFA, to Edward J. Corral, JPMorgan, *et al*. (Aug. 8, 2008) [LBEX-GF 000040].

[4053] E-mail from Ricardo S. Chiavenato, JPMorgan, to Mark G. Doctoroff, JPMorgan, *et al.* (Aug. 9, 2008) [JPM-2004 0006527]. JPMorgan also learned that Lehman had $3.9 billion in CDOs in its triparty shells which, using GFA's pricing of Lehman's extra collateral as a proxy, would have been worth less than $1.5 billion. *See id.*; *see also* e-mail from Ricardo S. Chiavenato, JPMorgan, to Henry R. Yeagley, JPMorgan, *et al.* (Aug. 7, 2008) [JPM-2004 0008051]. For the reasons stated in text, the valuation applied as a proxy was likely too low.

and Verano;[4054] instead of accounting for that fact, Chiavenato apparently assigned a price of zero to Kingfisher and Verano. Excluding Kingfisher and Verano, approximately $3.5 billion of pledged CDOs were valued at about $2 billion by GFA – still a significant difference.[4055] Later in the summer, when Lehman had fewer securities pledged in the relevant collateral account, GFA again assigned a significantly lower value to Lehman's securities than had Lehman.[4056]

Upon learning that JPMorgan had been accepting dealer self-pricing, Chiavenato undertook a general analysis of dealer-priced securities tracked in JPMorgan's BDAS system. In late August, Chiavenato concluded that Lehman was providing more self-priced securities than other dealers.[4057] Those securities, he explained, were also the riskiest ones.[4058]

In addition to concerns it had with valuation, JPMorgan in early August raised concerns over the fact that LCPI, rather than LBI or LBHI, was posting collateral to

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[4054] *See* e-mail from Edward J. Corral, JPMorgan, to Ricardo S. Chiavenato, JPMorgan, *et al.* (Aug. 8, 2008) [JPM-2004 0008073]; LB Excess Collateral Priced by GF (Aug. 8, 2008) [JPM-2004 0008074].

[4055] *See* e-mail from Edward J. Corral, JPMorgan, to Ricardo S. Chiavenato, JPMorgan, *et al.* (Aug. 8, 2008) [JPM-2004 0008073]; LB Excess Collateral Priced by GF (Aug. 8, 2008) [JPM-2004 0008074].

[4056] E-mail from Edward J. Corral, JPMorgan, to David A. Weisbrod, JPMorgan, *et al.* (Sept. 4, 2008) [JPM-2004 0006562] (reporting that GFA priced three CDOs $1.5 billion lower than Lehman's assigned market value of approximately $3.25 billion); Spreadsheet (Sept. 4, 2008) [JPM-2004 0006563].

[4057] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 7; e-mail from Ricardo S. Chiavenato, JPMorgan, to Edward J. Corral, JPMorgan, *et al*. (Aug. 27, 2008) [JPM-2004 0009300] ("Lehman has the highest number and market value of self-priced securities.").

[4058] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 7; *see also* e-mail from Thomas H. Mulligan, JPMorgan, to Ricardo S. Chiavenato, JPMorgan, *et al.* (Aug. 29, 2008) [JPM-2004 0006549] ("The risk is the size of the largest securities in each of the dealers pool of securities. For example Lehman has 4 securities of dealer priced securities with a total par value of $4,900MM in its portfolio valued at 100%.").

cover intraday risk.[4059] JPMorgan preferred that "additional collateral supporting LBI's clearing exposure be provided by LBI itself, or its parent company, LBHI."[4060] Lehman – according to JPMorgan – "want[ed] to avoid substituting other collateral for this block as it would have to come from the holdco liquidity pool directly and the way they report this number would change."[4061] As of August 5, 2008, LCPI had pledged both $5 billion in "extra collateral" for risk-based margin and $4 billion related to triparty-investor margin.[4062] In order to alleviate JPMorgan's concern, Lehman transferred Spruce, Freedom, Pine, Kingfisher and Verano from LCPI to LBHI on August 8, and JPMorgan sought and obtained a guaranty from LBHI for LBI's obligations.[4063] The securities moved concurrently from LCD to "LCE," an LBHI account at JPMorgan.[4064] Lehman also transferred Fenway from LCPI to LBHI (and from LCD to LCE) on August

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[4059] *See, e.g.*, e-mail from Ricardo S. Chiavenato, JPMorgan, to Edward J. Corral, JPMorgan, *et al.* (Aug. 5, 2008) [JPM-2004 0061153].

[4060] JPMorgan First Written Responses, at p. 7.

[4061] E-mail from Piers Murray, JPMorgan, to Barry L. Zubrow, JPMorgan, *et al.* (Aug. 1, 2008) [JPM-2004 0061182].

[4062] E-mail from Ricardo S. Chiavenato, JPMorgan, to Edward J. Corral, JPMorgan, *et al.* (Aug. 5, 2008) [JPM-2004 0061153]. As discussed *supra*, these LCPI securities were posted in LCD, apparently an LBI account, according to JPMorgan. Through counsel, JPMorgan clarified that "we do not believe that there was an agreement that there would be separate collateral requirements for the approximately $4 billion in investor margin. Rather, that margin was implemented by entry of a debit to NFE each morning in the amount of the preceding night's investor margin." JPMorgan Second Written Responses, at pp. 5-6.

[4063] *See* e-mail from Michael Prestolino, Lehman, to Craig L. Jones, Lehman, *et al.* (Aug. 8, 2008) [LBEX-DOCID 046703]; Lehman, Prices for LCD Box (Aug. 8, 2008) [LBEX-DOCID 023772].

[4064] JPMorgan Second Written Responses, at pp. 6-7.

11.[4065] The guaranty from LBHI was memorialized in a new agreement, discussed below.

JPMorgan's collateral requests through the summer of 2008 were all part of JPMorgan's move toward requiring a risk-based margin.[4066] Chiavenato described Lehman's responses to JPMorgan's request as Lehman dragging its feet.[4067] In Chiavenato's view, Lehman had delayed collateral pledges and pledged collateral of questionable quality.[4068]

At least some of the Lehman personnel involved in discussions with JPMorgan believed that JPMorgan was requiring more margin than necessary.[4069] Paolo Tonucci, LBHI's Vice President and Global Treasurer, stated that JPMorgan's haircuts and related

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[4065] E-mail from Rob Rodriguez, Lehman, to Michael Prestolino, Lehman, *et al.* (Aug. 11, 2008) [LBEX-DOCID 116020]; JPMorgan Second Written Responses, at p. 7.

[4066] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at pp. 15-16. The amount of risk-based margin required increased over the course of the summer. *See, e.g.*, e-mail from David A. Weisbrod, JPMorgan, to Piers Murray, JPMorgan, *et al.* (Aug. 3, 2008) [JPM-2004 0061182] ("Based on the 7/29 numbers provided by Ricardo, our approach should be to get $6.7bn of margin to achieve coverage for the liquidity risk and price risk."). By August 22, 2008, JPMorgan calculated risk-based margin every morning and Lehman's "risk-based margin ha[d] gone up to the $8bi range due to more volume, CDOs, and higher risk factors for ABSs and CPs." E-mail from Ricardo S. Chiavenato, JPMorgan, to David A. Weisbrod, JPMorgan (Aug. 22, 2008) [JPM-2004 0061234].

[4067] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 16.

[4068] *Id*. at pp. 11, 15.

[4069] *E.g.*, Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 6. On August 5, Doctoroff reported that Lehman did "not agree with [JPMorgan's] liquidity/price risk numbers." *See* e-mail from Mark G. Doctoroff, JPMorgan, to Ricardo S. Chiavenato, JPMorgan, *et al.* (Aug. 5, 2008) [JPM-2004 0061153]; *see also* e-mail from Paolo R. Tonucci, Lehman, to Mark G. Doctoroff, JPMorgan (Aug. 5, 2008) [LBHI_SEC07940_534634] ("Not sure whether it makes sense to be collateralising you on the basis [of] your wrong/erroneous information."). Chiavenato recalled that Lehman believed its margin was higher than it should be. Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 12. In a follow-up e-mail the same day, Doctoroff stated that Lehman "agree[d]/underst[ood] the margin/price/liquidity risk." E-mail from Mark G. Doctoroff, JPMorgan, Ricardo S. Chiavenato, JPMorgan, *et al.* (Aug. 5, 2008) [JPM-2004 0061153].

collateral demands were "completely inappropriate" and made pursuant to "simplistic calculations" that were not done on a "sophisticated portfolio-wide basis."[4070] Lehman believed that JPMorgan was requiring too much margin because JPMorgan unnecessarily unwound term repos daily.[4071] Term repos lasted longer than one day, and, therefore, theoretically should not have required an extension of credit by JPMorgan every morning to unwind. But JPMorgan unwound all repos – including term repos – in the morning, apparently to allow broker-dealers to substitute allocated securities during the day.[4072] Chiavenato stated that term-repo investors had come to expect to receive cash intraday.[4073] JPMorgan did not alter this process prior to Lehman's bankruptcy.[4074] Lehman also resisted to some degree JPMorgan's risk-based margin implementation by asking for more time to meet JPMorgan's demands.[4075]

Notably, however, Dan Fleming – one of Lehman's principal contacts with JPMorgan – believed that, at least through mid-August, JPMorgan had been acting in good faith in negotiating issues surrounding NFE and the adequacy of Lehman

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[4070] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 7.

[4071] *See, e.g.*, e-mail from Thomas H. Mulligan, JPMorgan, to Ricardo S. Chiavenato, JPMorgan, *et al.* (Aug. 9, 2008) [JPM-2004 0006537] (Lehman "feel[s] that the margin will be reduced dramatically once we can stop the daily unwind of the term repo."); e-mail from Mark G. Doctoroff, JPMorgan, to David A. Weisbrod, JPMorgan, *et al.* (Aug. 3, 2008) [JPM-2004 0061182] ("Lehman's Treasurer and other seniors there believe that the liquidity and price risks are different or non-existent on certain types of repo, like the term repo that they do not think they have to unwind, as well as some open repo."); Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at p. 8; Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 6.

[4072] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 8.

[4073] *Id*.

[4074] *Id*.

[4075] *Id*. at p. 9.

collateral.[4076] Ian Lowitt also believed that until September 11 (the date of an additional collateral request, discussed below) JPMorgan had not acted unreasonably toward Lehman.[4077]

(f) The August Agreements

As discussed above, JPMorgan requested that Lehman enter into new agreements in part because JPMorgan wanted a guaranty from LBHI. In addition, JPMorgan requested the new agreements upon discovering that additional Lehman subsidiaries were conducting operations through JPMorgan's clearing system.[4078] On August 18, 2008, Doctoroff e-mailed Fleming "the documents . . . that will allow for the lien in all the clearance accounts in Lehman's broker/dealer group," that is, a draft Amendment to the Clearance Agreement, draft Guaranty and draft Security Agreement (collectively, the "August Agreements").[4079]

Paul Hespel, Lehman's outside counsel at Goodwin Procter, stated that the primary business issue animating the August Agreements was a concern by Lehman counterparties that Lehman's clearing relationship with JPMorgan consisted of an undocumented course of dealing.[4080] Specifically, several Lehman subsidiaries were already trading using JPMorgan's system, but were not formally added to the Clearance

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[4076] Examiner's Interview of Daniel J. Fleming, Apr. 22, 2009, at p. 5.
[4077] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at pp. 20-21.
[4078] Examiner's Interview of Daniel J. Fleming, Apr. 22, 2009, at p. 5.
[4079] E-mail from Mark G. Doctoroff, JPMorgan, to Daniel J. Fleming, Lehman (Aug. 18, 2008) [LBEX-DOCID 451527].
[4080] Examiner's Interview of Paul W. Hespel, Apr. 23, 2009, at p. 3.

Agreement until the August Agreements.[4081] Paolo Tonucci also explained that the August Agreements were meant to "close gaps in exposure" – multiple Lehman entities did business with JPMorgan, but JPMorgan did not believe that the obligations of these entities were adequately secured.[4082] Tonucci emphasized that the August Agreements were executed to manage exposures more efficiently and did not represent a fundamental change in the JPMorgan-Lehman clearing relationship.[4083]

The August Agreements also clarified that Lehman's collateral would secure only JPMorgan's intraday risk. In the weeks leading up to the August Agreements, JPMorgan raised the issue of collateralizing its overnight exposures as well.[4084] Lehman objected to the change.[4085] JPMorgan's request appeared to be the result of a misunderstanding: internally, JPMorgan had recognized that its goal had "always been to ensure that our intraday exposure to Lehman [was] properly collateralized."[4086] Thus,

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[4081] *Id*.

[4082] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at pp. 8-9.

[4083] *Id*. at p. 9.

[4084] Examiner's Interview of Craig L. Jones, Sept. 28, 2009, at p. 13; e-mail from Craig L. Jones, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Aug. 8, 2008) [LBEX-DOCID 457557] (relaying "an urgent call from a group at Chase" in which JPMorgan "stated they want[ed] to ensure the assets have a continuing lien and not just an intraday lien"); e-mail from Craig L. Jones, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (Aug. 14, 2008) [LBEX-AM 001764] (noting that Doctoroff apologized for JPMorgan requesting a continuing rather than intraday lien); e-mail from Edward J. Corral, JPMorgan, to Ricardo S. Chiavenato, JPMorgan, *et al*. (Aug. 8, 2008) [JPM-2004 0006527] (explaining that Fleming was concerned that JPMorgan was looking for an overnight lien but agreement was for an intraday lien only).

[4085] *See, e.g.*, e-mail from Edward J. Corral, JPMorgan, to Ricardo S. Chiavenato, JPMorgan, *et al.* (Aug. 8, 2008) [JPM-2004 0006519]. Fleming stated that JPMorgan was acting unreasonably because JPMorgan did not face an overnight exposure with Lehman. Examiner's Interview of Daniel J. Fleming, Apr. 22, 2009, at p. 5.

[4086] E-mail from Ricardo S. Chiavenato, JPMorgan, to Mark G. Doctoroff, JPMorgan, *et al.* (Aug. 9, 2008) [JPM-2004 0006519].

Doctoroff called Craig Jones, a Senior Vice President at Lehman in charge of cash and collateral management, on or about August 15 "to apologize for the issues raised when Chase requested the continuing lien" and acknowledged that "he was well aware it was only intended to be an intraday lien."[4087] The August Agreements were understood as "documentation for the intraday lien."[4088]

The August Agreements were negotiated over more than a week by legal and business representatives of both parties, with much interaction over specific terms.[4089] In the course of drafting and negotiating the August Agreements, Lehman's counsel interacted with Lehman business personnel, who provided the "big picture idea" of how the legal agreements would affect Lehman's dealings with JPMorgan.[4090]

The parties ultimately executed three documents on August 29, 2008 (though dated August 26):[4091] (i) an Amendment to the Clearance Agreement, (ii) a Guaranty and (iii) a Security Agreement. The Amendment to the Clearance Agreement and

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[4087] E-mail from Craig L. Jones, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Aug. 15, 2008) [LBEX-DOCID 457560].

[4088] *Id*.

[4089] *See, e.g.*, e-mail from Mark G. Doctoroff, JPMorgan, to Daniel J. Fleming, Lehman (Aug. 18, 2008) [LBEX-DOCID 451527]; e-mail from Daniel J. Fleming, Lehman, to Mark G. Doctoroff, JPMorgan (Aug. 21, 2008) [LBEX-DOCID 310528]; e-mail from Jeffrey Aronson, JPMorgan, to Paul W. Hespel, Goodwin Procter, *et al.* (Aug. 25, 2008) [JPM-2004 0003466]; e-mail from Nikki G. Appel, JPMorgan, to Paul W. Hespel, Goodwin Procter, *et al.* (Aug. 28, 2008) [JPM-2004 0004408].

[4090] Examiner's Interview of Paul W. Hespel, Apr. 23, 2009, at p. 3; Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 2.

[4091] *See* e-mail from Paul W. Hespel, Goodwin Procter, to Nikki G. Appel, JPMorgan, *et al.* (Aug. 29, 2008) [JPM-2004 0004629].

Security Agreement were executed by LBHI Treasurer Paolo Tonucci; the Guaranty was executed by LBHI Chief Financial Officer Ian Lowitt.[4092]

The Amendment to the Clearance Agreement expanded the reach of the Clearance Agreement in two ways. First, the parties added LBHI, Lehman Brothers International (Europe), Lehman Brothers OTC Derivatives Inc. and Lehman Brothers Japan Inc. as "Customers," that is, parties to the Clearance Agreement.[4093] In addition, pursuant to a request from Lehman,[4094] the parties added language providing that the liability of Lehman entities under the Clearance Agreement was several, not joint (with the exception of LBHI's obligations under the Security Agreement and Guaranty), and, therefore, "any security interest, lien, right of set-off or other collateral accommodation provided by any Lehman entity pursuant to" the Clearance Agreement would "not be available to support the obligations of any other Lehman entity" under that agreement.[4095]

Under the Guaranty, LBHI "unconditionally and irrevocably guarantee[d] to [JPMorgan] the punctual payment of all obligations and liabilities" of the Lehman parties to the Clearance Agreement (other than LBHI) "of whatever nature, whether

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[4092] *See* Security Agreement (Aug. 26, 2008), at p. 6 [JPM-2004 0005867]; Amendment to Clearance Agreement (Aug. 26, 2008), at pp. 1-2 [JPM-2004 0005856]; Guaranty (Aug. 26. 2008), at p. 6 [JPM-2004 0005879].

[4093] *See* Amendment to Clearance Agreement (Aug. 26, 2008), at p. 1 [JPM-2004 0005856].

[4094] *See* e-mail from Paul W. Hespel, Goodwin Procter, to Jeffrey Aronson, JPMorgan, *et al.* (Aug. 25, 2008) [JPM-2004 0003439].

[4095] Amendment to Clearance Agreement (Aug. 26, 2008), at p. 1 [JPM-2004 0005856]; *see also* e-mail from Jeffrey Aronson, JPMorgan, to Paul W. Hespel, Goodwin Procter, *et al.* (Aug. 26, 2008) [JPM-2004 0003482]; Amendment to Clearance Agreement [Draft] (Aug. 26, 2008), at p. 1 [JPM-2004 0003485].

now existing or hereinafter incurred . . . pursuant to the Clearance Agreement."[4096] The Guaranty further gave JPMorgan a right of setoff against LBHI.[4097]

The Security Agreement secured LBHI's commitments under the Guaranty and granted JPMorgan "a security interest in, and a general lien upon and/or right of set-off of" certain LBHI accounts and proceeds from these accounts.[4098] Although JPMorgan initially sought a lien on essentially all LBHI accounts,[4099] Lehman successfully narrowed the lien in the Security Agreement to cover only a "Securities Account" (known as "LCE"), a "Cash Account" (known as "DDA# 066-141-605") and certain related accounts.[4100] Andrew Yeung, Lehman in-house counsel and one of the negotiators of the August Agreements, described this as a "floating" lien that followed the proceeds of the Cash Account and the Securities Account.[4101]

The Security Agreement contained a provision that allowed LBHI to transfer collateral from its encumbered accounts to a generally lien-free "Overnight Account" at

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[4096] Guaranty (Aug. 26, 2008), at p. 1 [JPM-2004 0005879].

[4097] *See id*. at p. 4.

[4098] Security Agreement (Aug. 26, 2008), at p. 2 [JPM-2004 0005867]. Lehman initially questioned JPMorgan's request for a stand-alone Security Agreement given that the Clearance Agreement already granted JPMorgan a lien on Lehman assets for obligations incurred under the Clearance Agreement. Examiner's Interview of Paul W. Hespel, Apr. 23, 2009, at p. 3; Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 3; e-mail from James J. Killerlane, Lehman, to Jeffrey Aronson, JPMorgan, *et al.* (Aug. 22, 2008) [JPM-2004 0003332]. Yeung explained, however, that JPMorgan may have wanted the Security Agreement because it offered greater detail over the parties' rights and remedies in the event of a breach or default. Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 3.

[4099] *See* e-mail from Mark G. Doctoroff, JPMorgan, to Daniel J. Fleming, Lehman (Aug. 18, 2008) [LBEX-DOCID 451527]; Security Agreement [Draft] (Aug. 18, 2008), at p. 1 [LBEX-DOCID 448423].

[4100] Security Agreement (Aug. 26, 2008), at p. 1 [JPM-2004 0005867].

[4101] Examiner's Interview of Andrew Yeung, May 14, 2009, at p. 4.

the end of each business day if LBHI had no outstanding obligations under the Clearance Agreement.[4102] Specifically, in the overnight-account provision, the Security Agreement provided:

> Except as otherwise provided herein, at the end of a business day, if [LBHI] has determined that no [obligations under the Clearance Agreement] remain outstanding, [LBHI] may transfer to an account (the "Overnight Account") any and all Security held in or credited to or otherwise carried in the Accounts [(that is, the Securities Account, Cash Account, and certain related accounts)]. Any determination of [Lehman] that no Obligations remain outstanding shall not be binding upon the Bank.[4103]

Under the Security Agreement, JPMorgan had a general lien upon the "Security," defined as:

> (i) the Accounts, together with any security entitlements relating thereto and any and all financial assets, investment property, funds and/or other assets from time to time held in or credited to the Accounts or otherwise carried in the Accounts (or to be received for credit or in the process of delivery to the Account), (ii) any interest, dividends, cash, instruments and other property from time to time received, receivable or otherwise distributed in respect of or in exchange for any or all of the then existing Security and (iii) all proceeds of any and all of the foregoing Security.[4104]

"Accounts" was defined as:

> (i) the . . . "Securities Account" . . . , (ii) . . . the "Cash Account" . . . and (iii) any other account at [JPMorgan] to which [LBHI] transfer[ed] (A) cash from the Cash Account, (B) any interest, dividends, cash, instruments and other property from time to time received, receivable (including without limitation sales proceeds) or otherwise distributed in respect of or in

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[4102] *See* Security Agreement (Aug. 26, 2008), at p. 3 [JPM-2004 0005867]; Examiner's Interview of Andrew Yeung, May 14, 2009, at p. 5.

[4103] Security Agreement (Aug. 26, 2008), at p. 3 [JPM-2004 0005867].

[4104] *Id*. at pp. 1-2.

> exchange for any or all of the cash or securities in the Securities Account or the Cash Account or (C) any cash or securities from the Securities Account or the Cash Account during such time as [Lehman] ha[d] an outstanding obligation or liability to [JPMorgan] under the Guaranty or the Clearance Agreement.[4105]

As relevant here, with the exception of the Cash Account and Securities Account, the "Accounts" definition covered only accounts to which LBHI transferred "securities from the Securities Account . . . during such time as [Lehman] ha[d] an outstanding obligation or liability to [JPMorgan] under the Guaranty or the Clearance Agreement."[4106] Thus, were Lehman to transfer securities to the Overnight Account at a time during which it had no outstanding obligation to JPMorgan, JPMorgan would have no lien on that account.

In theory, Lehman would have only intraday liability to JPMorgan under the Clearance Agreement because, at the end of the day, cash from triparty investors repaid JPMorgan's early morning cash advances.[4107] Therefore, as a general matter, if Lehman did not have any advances or loans under the Clearance Agreement outstanding overnight (generally known as "failed financing" or "box loans"), assets in the Overnight Account transferred from the Securities Account would be lien-free.[4108]

[4105] *Id*. at p. 1.

[4106] *Id*.

[4107] *Cf.* e-mail from Daniel J. Fleming, Lehman, to Mark G. Doctoroff, JPMorgan (Aug. 21, 2008) [LBEX-DOCID 035862] ("at the end of the day (after we have settled all of our obligations with JPM) we will have the full value of the collateral in the Holdings account . . . to apply to other Leh needs . . . .").

[4108] Examiner's Interview of Andrew Yeung, May 14, 2009, at p. 5 (explaining that the Overnight Account was lien-free); Examiner's Interview of Donna Dellosso, Feb. 27, 2009, at p. 3 (collateral in Overnight Account would be free of any lien overnight but subject to a lien again in the morning).

The Security Agreement did not specifically define an "Overnight Account." According to JPMorgan's counsel, the Overnight Account was a construct that Lehman never actually sought to use.[4109] Lehman did have an LBHI account at JPMorgan called "LXH," which it had opened earlier in August.[4110] LXH was a "seg account" associated with the LBHI clearance account LCE (that is, the "Securities Account" defined in the Security Agreement and the account into which Lehman transferred securities from LCD in early August).[4111] At the end of the day, the contents of LCE were automatically transferred to LXH and to a shell referred to as "LHXX"; after the triparty unwind, those securities were swept back into LCE at the beginning of each day.[4112] Although, according to JPMorgan counsel, LHXX was not technically a "lien-free excess shell" (that is, the type of shell into which a broker-dealer would place securities not slated for

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[4109] Jenner & Block, Memorandum re November 18, 2009 Teleconference with JPMorgan Counsel (Nov. 19, 2009), at pp. 1-2. Alvarez & Marsal advised the Examiner that it was not aware of what account at JPMorgan was the "Overnight Account." Alvarez & Marsal, Responses to Questions for Alvarez & Marsal/Weil, Gotshal & Manges (Dec. 7, 2009), at p. 1.

[4110] *See* Letter from Emily M. Critchett, Lehman, to Lika Vaivao, JPMorgan (Aug. 14, 2008) [LBEX-DOCID 462130].

[4111] JPMorgan First Written Responses, at p. 9; *see* e-mail from Michael A. Mego, JPMorgan, to Janet Birney, Lehman, *et al.* (Aug. 13, 2008) [JPM-2004 0005515] (identifying LXH as a "seg account"). A "seg account" corresponded to a particular clearance account and consisted of one or more triparty-repo shell designations into which securities from the clearance account would be transferred. Shells were used in triparty repos, but could also hold securities pledged to JPMorgan to collateralize extensions of credit or be "no-lien excess shells," which would hold securities overnight not needed for triparty repos or overnight financing. JPMorgan First Written Responses, at p. 1.

[4112] JPMorgan First Written Responses, at p. 9; Jenner & Block, Memorandum re November 16, 2009 Teleconference with JPMorgan Counsel (Nov. 16, 2009), at p. 2. Jones stated that the sweep into LBI lien-free shells was not automatic but done manually by John Palchynsky. Examiner's Interview of Craig L. Jones, Sept. 28, 2009, at p. 17; Examiner's Interview of John N. Palchynsky, May 11, 2009, at p. 4.

triparty repo overnight), and LXH was a "pledge account,"[4113] from August 26 to September 9, Lehman had no outstanding overnight obligations under the Clearance Agreement.[4114] Thus, there was no obligation for LXH or the LHXX shell to secure overnight. LHXX therefore was, in practice, essentially a lien-free excess shell similar to what was described in the Security Agreement as the "Overnight Account."

According to JPMorgan's counsel, Lehman could not transfer securities out of LXH or the LHXX shell on its own; Lehman would have had to ask JPMorgan to issue such an instruction.[4115] Lehman could issue an instruction to transfer securities out of LCE, but a $5 billion NFE block imposed by JPMorgan ensured that $5 billion of

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[4113] Jenner & Block, Memorandum re November 18, 2009 Teleconference with JPMorgan Counsel (Nov. 19, 2009), at pp. 1-2. Lehman, however, sometimes internally referred to LHXX as a lien-free excess shell. *See* e-mail from John N. Palchynsky, Lehman, to Jack Fondacaro, Lehman, *et al.* (Aug. 18, 2008) [LBEX-DOCID 459729]. There is some evidence that JPMorgan – at least after Lehman's bankruptcy – referred to LHXX as such as well. *See* e-mail from Karen Donahue, JPMorgan, to Paolo R. Tonucci, Lehman (Sept. 21, 2008) [LBEX-DOCID 036183]; Spreadsheet (Sept. 21, 2008) [LBEX-DOCID 014382] (referring to LHXX as "LBHI LIEN FREE EXCESS"). And, although the account-opening letter referred to LXH as a "pledge account," Lehman attempted to put a no-lien letter in place. *See* Letter from Emily M. Critchett, Lehman, to Lika Vaivao, JPMorgan (Aug. 14, 2008) [LBEX-DOCID 462130]; e-mail from Emily M. Critchett, Lehman, to Lika Vaivao, JPMorgan, *et al.* (Aug. 18, 2008) [LBEX-DOCID 451532] ("As this account is a segregated account we will require a no-lien letter be put in place."). Yet, in his interview with the Examiner, Richard Policke, Senior Vice President of Lehman, stated that there was a lien on LHXX. Examiner's Interview of Richard Policke, May 28, 2009, at p. 6.

[4114] Jenner & Block, Memorandum re November 18, 2009 Teleconference with JPMorgan Counsel (Nov. 19, 2009), at p. 1.

[4115] Jenner & Block, Memorandum re November 16, 2009 Teleconference with JPMorgan Counsel (Nov. 16, 2009), at p. 2. According to JPMorgan, Lehman could not transfer or otherwise control securities in seg accounts, and, therefore, Lehman could not control securities in LXH – whether or not lien-free – overnight. JPMorgan First Written Responses, at pp. 1, 9. Tonucci confirmed that Lehman never attempted to remove collateral overnight from its lien-free account at JPMorgan. Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 10; Examiner's Interview of Craig L. Jones, Sept. 28, 2009, at pp. 17-18. Yeung's understanding, however, was that Lehman was able to transfer funds in the "Overnight Account," and, indeed, could transfer funds outside of JPMorgan. Examiner's Interview of Andrew Yeung, May 14, 2009, at p. 4.

securities remained in that account during the day.[4116] In other words, any attempt to remove securities from LCE that would reduce its value under $5 billion would result in negative NFE, and, thus, the transaction would be blocked.

Whether or not Lehman had the right, as a technical matter, to access the securities in LXH, it could not, as a practical matter, have transferred or monetized those securities overnight.[4117] According to Chiavenato, by the time JPMorgan freed collateral at night, it would be too late for Lehman to sell the securities because the markets would be closed.[4118] In addition, JPMorgan's BDAS system was not even accessible overnight.[4119] Furthermore, JPMorgan stated that it required almost all of the collateral the following morning to support the triparty unwind.[4120] Thus, it is unsurprising that Tonucci could not recall any instance in which Lehman transferred

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[4116] Jenner & Block, Memorandum re November 16, 2009 Teleconference with JPMorgan Counsel (Nov. 16, 2009), at p. 2; JP Morgan First Written Responses, at p. 10; *see also* e-mail from Michael A. Mego, JPMorgan, to Ray Stancil, JPMorgan, *et al*. (Sept. 12, 2008) [JPM-2004 0051670] ("Instead of putting in a Debit (WDDB) daily for $5 billion on the LCE account and having it drop overnight. We have asked to put in a $5 billion debit on the LCE intra day line of Credit so as to always have a debit on the account at all times."). Note that this "NFE Adjustment" was unrelated to LBI's NFE. LCE was an LBHI account and, therefore, the adjustment was placed on LBHI's NFE.

[4117] Lehman's ability to liquidate quickly the securities in the "Overnight Account" is relevant to an analysis of Lehman's liquidity pool, discussed in Section III.A.5.i of this Report.

[4118] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 18.

[4119] Jenner & Block, Memorandum re November 18, 2009 Teleconference with JPMorgan Counsel (Nov. 19, 2009), at p. 3.

[4120] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 18. JPMorgan confirmed each morning whether Lehman had sufficient collateral prior to the triparty unwind. Examiner's Interview of Edward J. Corral, Sept. 30, 2009, at p. 6. While Lehman did have sufficient collateral each morning, Corral confirmed that if Lehman had ever failed this test, JPMorgan could have decided not to unwind the triparty repos. *Id*. Corral dismissed the possibility that JPMorgan would partially unwind the triparty repos (and await collateral for uncovered trades) in such a scenario, noting that practically speaking, the triparty unwind was an all or nothing proposition. *Id*.

these securities (such as Spruce, Pine, Fenway and Verano) out of JPMorgan overnight.[4121] Craig Jones of Lehman Treasury also confirmed the practical impossibility of Lehman transferring the securities overnight, stating that such a move would require someone to reopen the DTC credit facility in the middle of the night.[4122] At most, Jones thought Lehman may have been able to transfer collateral overnight between its accounts at JPMorgan if JPMorgan reopened during the night, but Jones did not recall any such overnight transfer and only recalled generally the collateral movement from LCD to LCE.[4123]

According to Lehman's counsel, the overnight-account provision formalized a prior course of dealing between JPMorgan and Lehman.[4124] At least as of August 18 (around the time when the LXH account was created), securities were swept from LCE each night into a separate account overnight.[4125] Lehman understood that the overnight-account provision in the August Agreements confirmed that JPMorgan's lien operated

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[4121] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 9.

[4122] Examiner's Interview of Craig L. Jones, Sept. 28, 2009, at p. 17.

[4123] *Id.* at pp. 17-18; *see supra* at Section III.A.5.b.1.e.

[4124] Examiner's Interview of Paul W. Hespel, Apr. 23, 2009, at p. 4; Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 3 (characterizing this prior course of business as using excess funds in clearance accounts at the end of each day to fund overnight lending and describing the overnight-account provision as "mechanical"). JPMorgan's counsel stated, however, that there was no particular statement or action by Lehman or JPMorgan that made the overnight-account provision resemble a "carry-over" of a structure already in place. Jenner & Block, Memorandum re November 18, 2009 Teleconference with JPMorgan Counsel (Nov. 19, 2009), at p. 2.

[4125] *See* JPMorgan First Written Responses, at p. 9.

on an intraday basis only, and that Lehman's excess collateral was lien-free overnight.[4126]

According to JPMorgan witnesses, however, Lehman requested the overnight-account provision because Lehman needed contractual language to justify Lehman's inclusion of pledged collateral as part of Lehman's liquidity pool.[4127] Significantly, Lehman's counsel, Hespel, confirmed that the overnight-account provision was important for liquidity-reporting purposes and that assets in the Overnight Account were classified as unencumbered in Lehman's liquidity estimations.[4128] Contemporaneous internal Lehman e-mails further confirmed that the overnight-account provision related to liquidity reporting,[4129] and Lehman did, in fact, include securities pledged under the August Agreements in its liquidity pool.[4130]

[4126] *E.g.*, Examiner's Interview of Andrew Yeung, May 14, 2009, at p. 8 (Yeung recalled an e-mail exchange with Fleming in which Fleming instructed him that JPMorgan's lien was an intraday lien and that Lehman had to be able to claim for liquidity-reporting purposes the collateral was lien-free); e-mail from Daniel J. Fleming, Lehman, to Mark G. Doctoroff, JPMorgan (Aug. 21, 2008) [LBEX-DOCID 310528] ("at the end of the day (after we have settled all of our obligations with JPM) we will have the full value of the collateral in the Holdings account").

[4127] Examiner's Interview of Mark G. Doctoroff, Apr. 29, 2009, at pp. 12, 22-23 (recalling that Paolo Tonucci represented that the purpose of the overnight-account provision was to preserve Lehman's ability to include in Lehman's Liquidity Pool collateral pledged to cover JPMorgan's intraday risk); Examiner's Interview of Donna Dellosso, Feb. 27, 2009, at p. 3 (Lehman informed JPMorgan that it wanted overnight access to the collateral, presumably for its overnight liquidity pool); e-mail from Mark G. Doctoroff, JPMorgan, to David A. Weisbrod, JPMorgan, *et al.* (Sept. 2, 2008) [JPM-2004 0006556] (acknowledging that $5 billion posted by Lehman was part of Lehman's liquidity pool).

[4128] Examiner's Interview of Paul W. Hespel, Apr. 23, 2009, at p. 4.

[4129] Examiner's Interview of Andrew Yeung, May 14, 2009, at p. 8 (Yeung recalled an e-mail exchange with Fleming in which Fleming instructed him that Lehman had to be able to claim collateral pledged with JPMorgan was lien-free for liquidity reporting).

[4130] *See infra* at Section III.A.5.i (discussing the propriety of including certain assets in Lehman's liquidity pool). It should be noted, however, that Lehman had the ability to, and did, remove securities from the

(g) Background to the September 9 Collateral Request and September Agreements

In late August and September, Lehman's deteriorating financial condition became increasingly apparent.[4131] On September 4, 2008, JPMorgan executives, led by Chief Risk Officer Barry Zubrow, met with Lehman executives Ian Lowitt, Paolo Tonucci and Chris O'Meara, to discuss Lehman's upcoming third quarter results, then scheduled for release on September 18.[4132] In preparation for the meeting, JPMorgan summarized significant issues affecting Lehman:

> We expect [Lehman] will have further significant asset write-downs primarily originating from their commercial and residential real estate related assets. Their 3Q results will likely also come with announcements regarding the actions they will be taking to shore-up their balance sheet, bolster capital . . . , and to operate successfully in the coming quarters in the new market environment. Major themes in the press – (i) potential capital injection by Korea Development Bank (KDB) or other sovereign wealth fund; (ii) sale of all or part of their Investment Management Division (Neuberger Berman included) . . . ; (iii) sale of real estate assets or

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LCE account during the day as long as the value of the LCE account remained at or above $5 billion. For example, Lehman moved Kingfisher from LCE to LCD on September 2. *See* JPMorgan Second Written Responses, at p. 8; Jenner & Block, Memorandum re November 18, 2009 Teleconference with JPMorgan Counsel (Nov. 19, 2009), at p. 2.

[4131] *See supra* at Section III.A.3.a.2; *e.g.*, Andrew Ross Sorkin, *Struggling Lehman Plans to Lay Off 1,500*, N.Y. Times, Aug. 28, 2008 (Lehman shares lost 73 percent of their value between January 2008 and the end of August 2008); *see also* e-mail from Ricardo S. Chiavenato, JPMorgan, to David A. Weisbrod, JPMorgan (Aug. 22, 2008) [JPM-2004 0061226] ("Lehman may face serious problems next week if it is not acquired . . . and its losses are large.").

[4132] JPMorgan, Lehman Brothers Holdings Inc. Briefing Memorandum (Sept. 4, 2008), at p. 1 [JPM-2004 0006171]; *see also* Lehman, JP Morgan Agenda (Sept. 4, 2008) [LBEX-DOCID 445367]. Although the JPMorgan agenda indicated that the earnings call was initially scheduled for September 17, it was in fact scheduled for September 18. *See* AFP, *Lehman Brothers in Freefall as Hopes Fade for New Capital* (Sept. 9, 2008), *available at* http://afp.google.com/article/ALeqM5jEijYPZUGeWNO_FflIPEg_6CaQ7w.

> formation of a bad bank/good bank with a private equity sponsor/s may be touched on during this discussion.[4133]

Tonucci described the meeting as an opportunity for Lowitt to update JPMorgan on Lehman's third quarter earnings and the status of its "SpinCo" plans.[4134]

In the September 4 meeting between executives from Lehman and JPMorgan, the parties also discussed issues concerning triparty repo and Lehman's posted collateral,[4135] although Tonucci stated that this was not the focus of the meeting.[4136] At that time Lehman had about $8 billion of collateral (as priced by Lehman) on deposit with JPMorgan to support intraday triparty risk in the United States, and discussions were underway to secure $2 billion in intraday risk associated with European triparty exposures.[4137] Lehman believed that JPMorgan was overcollateralized against intraday risk, and JPMorgan acknowledged that Lehman disagreed with JPMorgan's collateral valuations and that collateral substitutions might be necessary.[4138] Notably, JPMorgan

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[4133] JPMorgan, Lehman Brothers Holdings Inc. Briefing Memorandum (Sept. 4, 2008), at p. 1 [JPM-2004 0006171]. JPMorgan's Briefing Memorandum also stated: "There is a strong desire at [Lehman] to have open and frank dialogue with JPM at all levels of our organizations. . . . As [Lehman]'s primary operating services provider, [Lehman] management want to ensure that we are fully briefed on their strategy and challenges as they need our support to operate their business." *Id*.

[4134] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at pp. 10-11.

[4135] *See* JPMorgan, Lehman Brothers Holdings Inc. Briefing Memorandum (Sept. 4, 2008), at pp. 1-2 [JPM-2004 0006171]; Lehman, JP Morgan Agenda (Sept. 4, 2008) [LBEX-DOCID 445367].

[4136] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 11; Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 18.

[4137] JPMorgan, Lehman Brothers Holdings Inc. Briefing Memorandum (Sept. 4, 2008), at p. 2 [JPM-2004 0006171]; Lehman, JP Morgan Agenda (Sept. 4, 2008) [LBEX-DOCID 445367].

[4138] JPMorgan, Lehman Brothers Holdings Inc. Briefing Memorandum (Sept. 4, 2008), at p. 2 [JPM-2004 0006171].

also acknowledged that Lehman's collateral postings were "part of [its] liquidity pool . . . despite their less than cash liquidity profile."[4139]

JPMorgan had its doubts about the plan that Lehman presented at the September 4 meeting.[4140] For example, Lehman walked JPMorgan through its SpinCo proposal (whereby Lehman planned to spin off its illiquid assets into a separate company in order to remove them from Lehman's balance sheet),[4141] but the proposal did not instill confidence in JPMorgan executives. Zubrow had difficulty understanding how Lehman would infuse enough money into the SpinCo entity to cover the exposure of its real estate loans.[4142] He told Lowitt that Lehman needed to provide more clarity on SpinCo, and relayed concern that Lehman's plan would "spook" the market.[4143] Tonucci confirmed to the Examiner that JPMorgan was concerned about the viability of the SpinCo plan.[4144]

JPMorgan offered to assist Lehman by providing feedback on the presentations Lehman was planning to make to the various rating agencies in the coming days.[4145] Accordingly, later in the evening of September 4, Tonucci sent to JPMorgan a draft copy of a presentation Lehman intended to give the ratings agencies, seeking JPMorgan's

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[4139] *Id*.
[4140] Examiner's Interview of Mark G. Doctoroff, Apr. 29, 2009, at p. 15.
[4141] *See* Section III.A.3.c.4 (discussing Lehman's SpinCo proposition).
[4142] Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at p. 7.
[4143] *Id*.
[4144] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 11.
[4145] Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at p. 7.

comments.[4146] Executives at JPMorgan found the presentation to be too vague and were concerned about the strategies Lehman outlined.[4147] Zubrow viewed the presentation as not detailed enough to provide confidence in Lehman's planned course of action with its SpinCo proposal.[4148] Doctoroff consolidated the feedback from JPMorgan in an e-mail to Tonucci on September 5, 2008.[4149] Among other concerns, JPMorgan identified the following: Lehman needed to be more definitive about its timeline and how its business would be operated over that timeline; Lehman should determine whether it could make its expense reduction more aggressive; and Lehman needed to address additional issues such as management changes.[4150] JPMorgan executives also expected more focus on liquidity, especially expected liquidity uses over the 12 to 18 months ahead.[4151] JPMorgan further suggested that Fuld participate in the rating agency meetings.[4152] This final point was the most important in JPMorgan's view because

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[4146] E-mail from Paolo R. Tonucci, Lehman, to Mark G. Doctoroff, JPMorgan, *et al.* (Sept. 4, 2008) [JPM-2004 0006300]. Lehman highlighted the sensitive nature of these documents multiple times. *See id*. ("There is a lot of confidential info . . . ."); e-mail from Ian T. Lowitt, Lehman, to Barry L. Zubrow, JPMorgan (Sept. 5, 2008) [JPM-2004 0006314] ("The materials we sent you are obviously very sensitive . . . ."); e-mail from Ian T. Lowitt, Lehman, to Barry L. Zubrow, JPMorgan (Sept. 7, 2008) [JPM-2004 0006317]. JPMorgan limited the circulation of the materials. *See* e-mail from Barry L. Zubrow, JPMorgan, to Ian T. Lowitt, Lehman, *et al.* (Sept. 8, 2008) [JPM-2004 006317].

[4147] Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at p. 7; *see* e-mail from Mark G. Doctoroff, JPMorgan, to Barry L. Zubrow, JPMorgan, *et al*. (Sept. 5, 2008) [JPM-2004 0006286].

[4148] Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at p. 7; *see* e-mail from Barry L. Zubrow, JPMorgan, to Mark G. Doctoroff, JPMorgan, *et al.* (Sept. 5, 2008) [JPM-2004 0006286] ("strategy is presented with a lot of equivocation").

[4149] *See* e-mail from Mark G. Doctoroff, JPMorgan, to Paolo R. Tonucci, Lehman (Sept. 5, 2008) [LBHI_SEC07940_556179].

[4150] *See id.*

[4151] *Id.*

[4152] *Id.*

Lehman needed to show the rating agencies and the larger market that Lehman was resolute about bringing its plan to completion, and that vision had to start from the top.[4153] Tonucci agreed with JPMorgan's feedback and said he would push Fuld to participate in future meetings with the agencies.[4154]

While concern was growing inside JPMorgan about Lehman's condition, Doctoroff stated that there was no serious belief within JPMorgan at the time that Lehman would file for bankruptcy.[4155] Other JPMorgan witnesses likewise stated that they did not see the bankruptcy of Lehman as a serious possibility until the weekend preceding LBHI's bankruptcy filing.[4156] JPMorgan was, however, facing increasing risks from its business with Lehman.

Also on September 5, JPMorgan's Investment Bank Risk Committee ("IBRC") met and discussed a presentation titled "Overview of Debt Maturities for Major US Broker Dealers" (the "IBRC Deck").[4157] The discussion of the IBRC Deck was led by

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[4153] *See* e-mail from Mark G. Doctoroff, JPMorgan, to Barry L. Zubrow, JPMorgan, *et al.* (Sept. 5, 2008) [JPM-2004 0006304].

[4154] *Id.*

[4155] Examiner's Interview of Mark G. Doctoroff, Apr. 29, 2009, at p. 15.

[4156] *E.g.*, Examiner's Interview of Jamie L. Dimon, Sept. 29, 2009, at p. 10 (the first time he thought Lehman may not survive was Saturday, September 13); Examiner's Interview of John J. Hogan, Sept. 17, 2009, at p. 8 (the first time he thought Lehman may not survive was Sunday, September 14). On Friday morning, September 12, however, Lowitt anticipated problems with JPMorgan over the weekend and felt that JPMorgan was "acting as though" Lehman was "filing over the weekend." E-mail from Ian T. Lowitt, Lehman, to Paolo R. Tonucci, Lehman (Sept. 12, 2008) [LBEX-DOCID 072153].

[4157] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 6; JPMorgan, Overview of Debt Maturities for Major US Broker Dealers, IBRC Presentation (Sept. 5, 2008) [JPM-EXAMINER00005998]. The details underlying this presentation are reflected in another presentation, "Lehman Brothers Exposure Overview," which calculated exposure as of September 5 (the IBRC Deck calculated exposure as of September 1). The second presentation was not discussed at the September 5 meeting. *See* JPMorgan

Piers Murray, and the meeting included broad discussions about investment banks, trading, markets and the skittishness of hedge funds regarding novations.[4158] JPMorgan was supportive of accepting novations and, thus, stepping into hedge funds' shoes to face investment banks, but discussed the risk of runs on the banks.[4159] There were particular concerns about Lehman and one other broker-dealer, but JPMorgan reiterated its support of both entities.[4160] The IBRC Deck covered a number of broker-dealers, including Lehman, and revealed that JPMorgan had a primary exposure to Lehman of $2.645 billion, the largest component of which was $1.904 billion in derivatives exposure. The IBRC Deck showed an approved limit for settlement and operating exposure of $10.681 billion intraday (but did not show how much exposure JPMorgan actually had during the day).[4161] The presentation addressed the exposure only of JPMorgan's Investment Bank, separate from the triparty-repo business.[4162]

First Written Responses, at p. 17; JPMorgan, Lehman Brothers Exposure Overview (Sept. 2008) [JPM-EXAMINER00005966].

[4158] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 6. Lehman was aware by the end of July 2008 that novation requests were increasing, and some banks were declining novation requests from Lehman counterparties. *See* e-mail from Eric Felder, Lehman, to Ian T. Lowitt, Lehman, *et al.* (July 28, 2008) [LBEX-DOCID 028924].

[4159] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 6.

[4160] *Id.*

[4161] JPMorgan, Overview of Debt Maturities for Major US Broker Dealers, IBRC Presentation (Sept. 5, 2008), at p. 6 [JPM-EXAMINER00005998].

[4162] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at pp. 2, 6-7; *see* JPMorgan, Overview of Debt Maturities for Major US Broker Dealers, IBRC Presentation (Sept. 5, 2008), at p. 6 [JPM-EXAMINER00005998]. "Intraday exposure" in the IBRC Deck referred to Investment Bank intraday exposure, not intraday exposure related to clearing activities. *See* JPMorgan, Overview of Debt Maturities for Major US Broker Dealers, IBRC Presentation (Sept. 5, 2008), at p. 6 [JPM-EXAMINER00005998]. Notably, analyzing the September 5 triparty-repo unwind data, Chiavenato concluded that JPMorgan held $9.9 billion in collateral (incorporating Gifford Fong's pricing of collateral in the LCE account) where

JPMorgan subsequently shared information discussed in IBRC meetings with the FRBNY.[4163]

Zubrow stated that after the September 5 IBRC meeting he called Lowitt to relay that JPMorgan might need an additional $5 billion in collateral given its concerns about an adverse market reaction to Lehman's plans.[4164] Zubrow characterized this as a speculative and informal conversation to provide a "place marker" in case JPMorgan followed through with a collateral request.[4165] According to Zubrow, while Lowitt hoped that JPMorgan would ultimately not make the request, Lowitt assured him that he understood the nature of the situation.[4166] Lowitt recalled speaking with Zubrow by phone, but could not be certain of when the call took place or whether Zubrow specified the precise amount of collateral sought by JPMorgan. The focus of the conversation, according to Lowitt, was the rating agency meetings.[4167]

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only $9.4 billion was needed to cover risk-based margin. E-mail from Ricardo S. Chiavenato, JPMorgan, to David A. Weisbrod, JPMorgan, *et al.* (Sept. 8, 2008) [JPM-2004 0007292]. Yet, Chiavenato also pointed out that collateral held by triparty investors overnight and securing JPMorgan's exposure intraday included "$15 bi in less liquid collateral self-priced by Lehman, with half of that priced in the 90-100+ range (which we believe is overstated) - using lower vendor prices [would] reduce" JPMorgan's margin. *Id.*

[4163] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 11; *see also* e-mail from Arthur G. Angulo, FRBNY, to Timothy F. Geithner, FRBNY, *et al.* (Sept. 10, 2008) [FRBNY to Exam. 014605] (attaching September 7, 2008 JPMorgan "Lehman Brothers Exposure Overview").

[4164] Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at p. 10.

[4165] *Id.*

[4166] *Id.*

[4167] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 18.

JPMorgan witnesses stated that JPMorgan's derivatives exposure was the primary impetus for the new collateral request.[4168] In addition, Donna Dellosso, a risk manager in JPMorgan's investment bank, stated that the $5 billion figure was grounded in the IBRC Deck analysis,[4169] and Steven Black, co-Chief Executive Officer of JPMorgan's Investment Bank, described JPMorgan's arrival at the $5 billion figure as "art, not science."[4170] JPMorgan witnesses stated that no one at JPMorgan believed a $5 billion request was too high; indeed, JPMorgan believed that it could have requested more.[4171] Through its counsel, JPMorgan explained to the Examiner that:

> The derivatives primary exposure was a principal item of focus because it was expected to increase substantially due to novations and market changes. . . . On the other hand, JPMorgan viewed the settlement and operating exposures as likely to decrease over time as Lehman de-leveraged. JPMorgan also recognized that it was possible to ameliorate the operating and settlement exposures through careful attention to the timing of payments and deliveries. Thus, JPMorgan did not feel it necessary to request collateral in the full amount of the identified settlement and operating exposures. Taking all of this into consideration, it was decided that, in order to be able to continue to support Lehman, it

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[4168] Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at p. 10; Examiner's Interview of John J. Hogan, Sept. 17, 2009, at pp. 3-4.

[4169] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 7.

[4170] Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 6.

[4171] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 8. Buyers-Russo recalled that triparty-repo stress analyses at the time showed a shortfall approaching $20 billion. Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 5. In addition, Ed Corral stated his view that JPMorgan was undercollateralized throughout the summer of 2008 and could have asked for more collateral, even in a magnitude reaching $25 billion. Examiner's Interview of Edward J. Corral, Sept. 30, 2009, at p. 12. As discussed in more detail below, there is some evidence to suggest that JPMorgan may have considered itself already adequately collateralized. *See, e.g.*, JPMorgan, Tri-Party Repo Margin Gap Analysis – Lehman – 9/10/2008 (Sept. 10, 2008), at pp. 2-3 [JPM-2004 0029886]. But, as discussed *infra*, JPMorgan asserted that its written collateral analyses assumed face values for certain illiquid Lehman collateral, and thus understated JPMorgan's exposure.

> was necessary for JPMorgan to obtain collateral of $5 billion for the existing and anticipated risks.[4172]

In addition, JPMorgan determined that it needed a "master-master" agreement with Lehman to cover the entire relationship across all Lehman and JPMorgan entities.[4173] Dellosso stated that she discussed such an agreement with Tonucci.[4174] JPMorgan witnesses also stated that during this same time period JPMorgan sought additional collateral, as well as broader guaranties and pledge agreements, from other broker-dealers in addition to Lehman.[4175]

By September 9, the following Tuesday, Lehman's situation had continued to deteriorate. Reports began to surface that The Korea Development Bank ("KDB") had abandoned (or was likely to abandon) its acquisition talks with Lehman,[4176] and Lehman's stock had dropped significantly.[4177] Ultimately, a news article reporting that

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[4172] JPMorgan First Written Responses, at p. 17.

[4173] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 8; Examiner's Interview of John J. Hogan, Sept. 17, 2009, at p. 7.

[4174] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 8.

[4175] Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 6; Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 8; *see also* JPMorgan Second Written Responses, at p. 1. Although discussions with other broker-dealers could have been taking place at this time, JPMorgan did not provide evidence of any agreements with other broker-dealers that were actually executed in late August or September prior to the date of the LBHI bankruptcy petition.

[4176] Francesco Guerrera, *et al.*, *Equities Suffer as Lehman Shares Fall 45%*, Fin. Times, Sept. 9, 2008 ("Lehman's shares fell after a newswire report cited an unnamed Korean government official as saying that Korea Development Bank, a state-run lender, had decided not to invest in Lehman."); Susanne Craig, *et al.*, *Korean Remarks Hit Lehman*, Wall St. J., Sept. 9, 2008 ("A KDB official said the comments [by the Chairman of South Korea's Financial Services Commission] would likely be strong enough to deter the bank from pursuing a Lehman deal . . . ."); *see also supra* at Section III.A.3.c.5.b.

[4177] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 11; Examiner's Interview of Donna Dellosso, Feb. 27, 2009, at p. 4; Susanne Craig, *et al.*, *Lehman Faces Mounting Pressures*, Wall St. J., Sept. 10, 2008, at A1; Susanne Craig, *et al.*, *Korean Remarks Hit Lehman*, Wall St. J., Sept. 9, 2008.

KDB had determined not to strike a deal with Lehman prompted Lehman to accelerate its earnings announcement; instead of releasing its earnings on September 18, as planned, Lehman decided to make its announcement the next morning, on September 10.[4178] Black explained that the "rumor mill" was rampant with claims that firms were no longer doing business with Lehman.[4179]

As discussed in more detail below, on September 9, JPMorgan formally requested $5 billion of additional collateral from Lehman.[4180] This collateral request intersected with already-commenced discussions about preparing new agreements with Lehman. JPMorgan insisted that the collateral be posted and the documentation signed by the following morning.[4181]

Several JPMorgan witnesses stated that in determining the amount of collateral to request, JPMorgan did not want to do anything that would harm Lehman or destabilize financial markets.[4182] For example, Jane Buyers-Russo, who heads the securities industry coverage group at JPMorgan's corporate bank, stated that JPMorgan

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[4178] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 11.

[4179] Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 6; *see also* e-mail from Pandora Setian, JPMorgan, to Jamie L. Dimon, JPMorgan, *et al.* (Sept. 9, 2008) [JPM-2004 0006332] ("Today S&P placed the ratings of Lehman Brothers on CreditWatch with negative implications.").

[4180] Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 6.

[4181] Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 6; Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 9; *see also infra* at Section III.A.5.b.1. JPMorgan was not the only bank to request additional documentation from Lehman on September 9; Lehman also executed a Guaranty Amendment with Citi and cash deeds with HSBC. *See infra* at Sections III.A.5.c.1, III.A.5.d.3.

[4182] *E.g.*, Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 6.

wanted to maintain a market-neutral stance so that outsiders would observe JPMorgan facing Lehman normally in its operating and trading businesses.[4183]

There were discussions within JPMorgan about JPMorgan's options if Lehman did not post the collateral or execute the additional agreements by September 10, and how those options related to JPMorgan's desire to remain a stabilizing force. One option available to JPMorgan was to cease unwinding triparty repos in the morning, which would result in LBI default on payment obligations (causing government securities not to trade and investors to lock up). This was an option JPMorgan retained, but was not one it wanted to use because it would be highly disruptive of the market.[4184] JPMorgan also considered limiting transfers until accounts were funded, but, again, outsiders would notice if they were not receiving payments in a timely fashion.[4185] JPMorgan further considered restricting or reducing JPMorgan's extension of intraday liquidity.[4186] JPMorgan's options fell along a spectrum: on one extreme, JPMorgan could cancel all lines and require manual approval for all Lehman transactions and, on the other extreme, JPMorgan could continue business as usual with Lehman. In between

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[4183] Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 6. There is some evidence of concern about harming Lehman in contemporaneous internal JPMorgan communications. *See* e-mail from Ricardo S. Chiavenato, JPMorgan, to Paul Wilson, JPMorgan (Sept. 9, 2008) [JPM-2004 0032609] ("For the time being we are not changing any credit limits for seclending due to our collateralization and to the fact that pulling out at this stage might make things worse and even trigger their collapse.").

[4184] Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 6.

[4185] *Id.*

[4186] *Id.*

these extremes, for example, JPMorgan could scale back lines and put personnel on alert to monitor Lehman accounts.[4187]

Jamie Dimon, JPMorgan's CEO and Chairman of the Board, asserted that in every conversation he had with Fuld, Dimon reiterated that JPMorgan wanted to help and that if anything JPMorgan was doing was hurting Lehman, Fuld should let Dimon know.[4188] Dimon stated that JPMorgan did not want to harm Lehman and that at no time did Lehman come to JPMorgan for relief on the amount of collateral sought.[4189] Dimon stated that had Fuld called him, JPMorgan probably would not have insisted on the collateral because JPMorgan did not want to be blamed for Lehman's demise.[4190] The Chief Risk Officer in JPMorgan's Investment Bank, John Hogan, stated that when he spoke with Lehman's Chief Risk Officer, Chris O'Meara, about collateral, including a call with O'Meara about the September 9 request, O'Meara expressed no acrimony and said he understood why JPMorgan needed the collateral.[4191] Hogan added that JPMorgan wanted to protect its own risk, but not to a point where it would cause

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[4187] *Id.* at pp. 6-7.

[4188] Examiner's Interview of Jamie L. Dimon, Sept. 29, 2009, at p. 2.

[4189] *Id.* at pp. 2, 10. Chiavenato stated that, although collateral return was not his decision, he would not have recommended that JPMorgan return any collateral in August in response to a request from Lehman. At that point, JPMorgan claimed it did not have enough collateral. Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at pp. 15-16; Examiner's Interview of Edward J. Corral, Sept. 30, 2009, at p. 12.

[4190] Examiner's Interview of Jamie L. Dimon, Sept. 29, 2009, at p. 10.

[4191] Examiner's Interview of John J. Hogan, Sept. 17, 2009, at p. 4.

Lehman any distress; he stated he had heard from others that Fuld had no issue with the September 9 collateral request.[4192]

Finally, Ed Corral, JPMorgan's head of Fixed Income Clearing, stated that he believed that JPMorgan did not ask for nearly as much collateral as it could or should have because it wanted to help Lehman.[4193] While the Examiner gives little weight to these statements made long after the fact and in light of pending claims between Lehman and JPMorgan (in particular the suggestion that JPMorgan would have backed down from its collateral requests if Fuld had just asked), it is significant that in contemporaneous notes made on September 9, Buyers-Russo wrote that JPMorgan "[did]n't want to push [Lehman] over edge or signal to market."[4194] And, on a conference call with the FRBNY the following afternoon, when the FRBNY questioned whether "senior management ha[d] put forth any triggers or course of events that would signal a desire by JPMC to stop trading, cut lines, and run from Lehman," JPMorgan risk executives "reiterated, as they [had] in the past, that they [did] not want to be the first one to make that call and [were] mindful of the implications of such a decision. However, they did state that they [did] not want to be the last one to make

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[4192] *Id*. at p. 5.

[4193] Examiner's Interview of Edward J. Corral, Sept. 30, 2009, at pp. 2, 11; Examiner's Interview of Donna Dellosso, Feb. 27, 2009, at p. 4 (stating that the September 9 collateral request should have been higher given JPMorgan's aggregate risk exposures to Lehman).

[4194] Jane Buyers-Russo, JPMorgan, Unpublished Notes (Sept. 9, 2008), at p. 2 [JPM-EXAMINER00006052]; *see also* e-mail from Jane Buyers-Russo, JPMorgan, to Kelly A. Mathieson, JPMorgan, *et al.* (Sept. 12, 2008) [JPM-2004 0050097] ("The goal was to protect jpm without pushing [Lehman] over the edge.").

that decision . . . ."[4195] The evidence suggests that JPMorgan exhibited some flexibility as to the amount of collateral it would accept from Lehman,[4196] but there is no contemporaneous evidence suggesting JPMorgan would have eliminated its September collateral requests in the face of resistance from Lehman.

(h) September 9 Calls Between Steven Black and Richard Fuld

According to JPMorgan witnesses, Black communicated the $5 billion collateral request to Richard Fuld by telephone on September 9.[4197] Black stated that he explained that the collateral was intended to cover JPMorgan's exposure to Lehman in its entirety, and was not limited to triparty-repo exposure.[4198] Ultimately, according to Black, Lehman offered to post $3 billion immediately and post an additional $2 billion at a later time.[4199] There is some evidence, however, that Lehman agreed only to top up to $4 billion.[4200]

[4195] E-mail from Gregory Gaare, FRBNY, to William A. Rutledge, FRBNY, *et al.* (Sept. 10, 2008) [FRBNY to Exam. 014605].

[4196] *See* Section III.A.5.b.1.h.

[4197] Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 6; Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at p. 10; Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 7. Deciphering a contemporaneous note, Buyers-Russo recalled that JPMorgan would ask for $5 billion, but accept $3 billion from Lehman. Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 9; Jane Buyers-Russo, JPMorgan, Unpublished Notes (Sept. 9, 2008), at p. 1 [JPM-EXAMINER00006052]. In a later contemporaneous note on September 9, Buyers-Russo wrote, "Black called Dick[,] asked for $3B – said ok." Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 10; Jane Buyers-Russo, JPMorgan, Unpublished Notes (Sept. 9, 2008), at p. 3 [JPM-EXAMINER00006052].

[4198] Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 7. Note, however, that Dellosso, in an internal e-mail, referred to the new collateral as covering intraday exposure. *See* e-mail from Donna Dellosso, JPMorgan, to Steven D. Black, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0006377] ("[Lehman] will maintain collateral of $4bln to cover intra-day exposure.").

[4199] Examiner's Interview of Steven D. Black, Sept. 23, 2009, at pp. 6, 9; *see also* JPMorgan First Written Responses, at p. 17. Black's communications did not occur in a single telephone call with Lehman that

Black stated that he relayed to Fuld that JPMorgan was not trying to solve JPMorgan's problem by creating new problems for Lehman. He asserted that he told Fuld that, if Lehman was "near the edge," Fuld should say so. According to Black, Fuld asked whether JPMorgan was interested in making a capital infusion, but JPMorgan was not. Black stated that he advised Fuld that if Lehman were skating close to the edge, Lehman should call the Federal Reserve so that the Federal Reserve could "herd the cats" needed to assist Lehman. According to Black, Fuld said Lehman was not anywhere close to the point of needing such assistance.[4201]

Taking advantage of JPMorgan's offer to help in another way, Fuld asked Black to send a JPMorgan team to a meeting that evening with Citi and Lehman to discuss a capital markets plan.[4202] JPMorgan did so.[4203] The JPMorgan team reported back that Lehman had not offered a viable plan and that a preannouncement of Lehman's

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day, but in multiple calls. Examiner's Interview of Steven D. Black, Sept. 23, 2009, at pp. 6-9. Lehman's acceptance of the $3 billion request is consistent with the September Guaranty which specifically invoked that figure in establishing maximum liability. Guaranty (Sept. 9, 2008), at p. 2 [JPM-2004 0005813] ("The Guarantor's maximum liability under this Guaranty shall be THREE BILLION DOLLARS ($3,000,000,000) or such greater amount that the Bank has requested from time to time as further security in support of this Guaranty.").

[4200] *See* e-mail from Donna Dellosso, JPMorgan, to Steven D. Black, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0006377] ("[Lehman] will maintain collateral of $4bln to cover intra-day exposure."); e-mail from Daniel J. Fleming, Lehman, to Mark G. Doctoroff, JPMorgan (Sept. 12, 2008) [LBEX-DOCID 405652] ("JPM now has a total of 4.6bn, 600mm more then agreed.").

[4201] Examiner's Interview of Steven D. Black, Sept. 23, 2009, at pp. 6-7.

[4202] *Id*. at p. 7.

[4203] *See* e-mail from Jane Buyers-Russo, JPMorgan, to Tim Main, JPMorgan (Sept. 9, 2008) [JPM-2004 0006361].

earnings without a plan in place was unwise.[4204] The JPMorgan team also noted that Lehman had sent junior executives who pitched a "good bank/bad bank" proposal, but who could not answer specific questions or provide enough detail for JPMorgan to take the proposal seriously.[4205]

Black also stated that he told Fuld that if JPMorgan ultimately did not need the collateral that Lehman was pledging, JPMorgan would return it.[4206] In response to the Examiner's questions about issues that may have come up in JPMorgan's discussions with Lehman that evening concerning whether the collateral would be available to Lehman overnight, Black recalled that there was a "capital issue" that Lehman was attempting to solve vis-à-vis the September Agreements, but he was not involved in specific discussions about it.[4207]

Internal JPMorgan documents are consistent with the statements by JPMorgan executives to the Examiner that on September 9, 2008, Black requested additional

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[4204] *See* e-mail from John J. Hogan, JPMorgan, to Steven D. Black, JPMorgan (Sept. 9, 2008) [JPM-2004 0006362]; Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 7. JPMorgan's Investment Bank Management Committee listened to Lehman's earnings call the next morning. Black stated that JPMorgan's concerns from the night before were realized. JPMorgan became concerned after the call because, in Black's words, it revealed that "the emperor had no clothes." Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 9.

[4205] Examiner's Interview of John J. Hogan, Sept. 17, 2009, at p. 8; e-mail from John J. Hogan, JPMorgan, to Steven D. Black, JPMorgan (Sept. 9, 2008) [JPM-2004 0006362]. This proposal is discussed in more detail *supra* at Section III.A.3.c.4.

[4206] Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 8.

[4207] *Id.* The "capital issue" that Black recalled was likely Lehman's request for a three-day notice period to call its collateral back so that Lehman could count the cash as part of its liquidity pool.

collateral from Fuld, who agreed to the request.[4208] Fuld, however, denied having made any such agreement. Indeed, he stated that he did not even have the authority to agree to changes in collateral.[4209]

Although there is a September 9 entry in Fuld's call log reflecting a call with Black,[4210] Fuld stated that he had no recollection of any such call.[4211] Fuld explained that he was reminded of the call by Thomas Russo (Lehman's Chief Legal Officer) weeks after LBHI's bankruptcy, who suggested that Fuld would not recall a conversation with Black because Fuld had asked Russo to return Black's call.[4212] However, Russo said he did not recall speaking with Black specifically, but did recall speaking with someone at JPMorgan related to an agreement that JPMorgan wanted signed quickly.[4213] Fuld, however, recalled Russo reporting to him that the topic of the call was collateral and that Russo did not have authority to agree to changes in collateral.[4214]

Lehman's posting of additional collateral on September 9 and 10 is consistent with statements by witnesses from JPMorgan to the Examiner that Lehman did agree on

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[4208] E-mail from Jane Buyers-Russo, JPMorgan, to Susan Stevens, JPMorgan, *et al.* (Sept. 9, 2008) [JPM-2004 0006331] ("Black spoke with Fuld who agreed to the $3B."); Jane Buyers-Russo, JPMorgan, Unpublished Notes (Sept. 9, 2008), at p. 3 [JPM-EXAMINER00006052] ("Black called Dick[,] asked for $3B – said ok.") Doctoroff was informed of the conversation by Buyers-Russo and instructed to work with Fleming to put the request in place. Examiner's Interview of Mark G. Doctoroff, Apr. 29, 2009, at p. 11.

[4209] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at pp. 15-16.

[4210] OOC Client Activity Log (03/15/2008-09/15/2008), at p. 66 [LBHI_SEC07940_016911].

[4211] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at pp. 15-16; Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at p. 4.

[4212] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at pp. 15-16.

[4213] Examiner's Interview of Thomas A. Russo, May 11, 2009, at p. 4.

[4214] Examiner's Interview of Richard S. Fuld, May 6, 2009, at p. 16.

September 9 to post up to $3 billion in collateral. On September 9, Lehman pledged to JPMorgan $1 billion in cash and approximately $1.7 billion of money market funds.[4215] The next day Lehman "top[ped] [JPMorgan] up to $3Bn" by delivering another $300 million cash.[4216]

On September 10, Lehman requested that JPMorgan substitute corporate bonds (from LBI) for a portion of the $3 billion Lehman had just posted.[4217] Lehman transferred approximately $1.6 billion of corporate bonds to JPMorgan, which were placed into an account subject to JPMorgan's lien and held by JPMorgan overnight.[4218] JPMorgan endeavored to value the corporate bonds that Lehman provided, haircutting them to approximately $1 billion.[4219] On September 11, Lehman posted an additional

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[4215] JPMorgan Second Written Responses, at p. 9; Lehman, Collateral Pledged to JPM for Intraday As of 9/12/2008 COB [LBEX-AM 047008]; *see also* e-mail from Mark G. Doctoroff, JPMorgan, to Jane Buyers-Russo, JPMorgan, *et al.* (Sept. 9, 2008) [JPM-2004 0032520]; e-mail from Daniel J. Fleming, Lehman, to Paolo R. Tonucci, Lehman (Sept. 9, 2008) [LBEX-DOCID 073380].

[4216] E-mail from Mark G. Doctoroff, JPMorgan, to Donna Dellosso, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0032634]; *see also* e-mail from Mark G. Doctoroff, JPMorgan, to Donna Dellosso, JPMorgan (Sept. 10, 2008) [JPM-2004 0010289]; JPMorgan Second Written Responses, at p. 9; Lehman, Collateral Pledged to JPM for Intraday As of 9/12/2008 COB [LBEX-AM 047008].

[4217] *See* e-mail from Mark G. Doctoroff, JPMorgan, to Donna Dellosso, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0010289]; e-mail from John N. Palchynsky, Lehman, to Jon Ciciola, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0002216]; e-mail from Mark G. Doctoroff, JPMorgan, to Donna Dellosso, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0032634]; JPMorgan Second Written Responses, at p. 2. As described *infra*, JPMorgan ultimately did not agree to this substitution.

[4218] JPMorgan Second Written Responses, at pp. 2-3; e-mail from Mark G. Doctoroff, JPMorgan, to Donna Dellosso, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0032684]; e-mail from Mark G. Doctoroff, JPMorgan, to Donna Dellosso, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0032634]; e-mail from Mark G. Doctoroff, JPMorgan, to Daniel J. Fleming, Lehman (Sept. 10, 2008) [LBEX-DOCID 035938]. Initially, on September 10, Lehman provided ABSs and CMOs to JPMorgan as well, but JPMorgan informed Lehman that it would not consider that collateral. JPMorgan Second Written Responses, at p. 2; e-mail from Mark G. Doctoroff, JPMorgan, to Donna Dellosso, JPMorgan, *et al.* (Sept. 11, 2008) [JPM-2004 0032684].

[4219] JPMorgan Second Written Responses, at pp. 2-3; e-mail from Mark G. Doctoroff, JPMorgan, to Daniel J. Fleming, Lehman (Sept. 10, 2008) [LBEX-DOCID 035938]; e-mail from Donna Dellosso, JPMorgan, to

$600 million in cash[4220] and requested that $500 million of the corporate bonds be returned.[4221] JPMorgan released a portion of the bonds to Lehman, but retained approximately $1 billion (market value according to Lehman) of them.[4222] The posting of the additional $600 million in cash, as well as JPMorgan's retention – at least temporarily – of some of the corporate bond collateral, is consistent with Black's statement that Lehman had agreed to post $3 billion initially and supplement the collateral at a later date. Thus, at the end of the day on September 11, JPMorgan held $1.9 billion in cash, approximately $1.7 billion in money market funds and approximately $1 billion in corporate bonds from Lehman (in addition to the securities collateral pledged by Lehman over the course of the summer).

(i) September Agreements

Shortly before 9:00 p.m. on September 9, JPMorgan sent draft guaranty and security agreements to Yeung.[4223] A draft amendment to the Clearance Agreement

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Matthew E. Zames, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0010289]; e-mail from Craig M. Delany, JPMorgan, to Henry E. Steuart, JPMorgan (Sept. 11, 2008) [JPM-EXAMINER00006219].

[4220] Collateral Pledged to JPM for Intraday As of 9/12/2008 COB [LBEX-AM 047008]; Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 12; e-mail from Mark G. Doctoroff, JPMorgan, to Henry E. Steuart, JPMorgan, *et al.* (Sept. 11, 2008) [JPM-2004 0062065]; JPMorgan Second Written Responses, at p. 9.

[4221] JPMorgan Second Written Responses, at p. 3; e-mail from Mark G. Doctoroff, JPMorgan, to Henry E. Steuart, JPMorgan, *et al.* (Sept. 11, 2008) [JPM-2004 0062065].

[4222] JPMorgan Second Written Responses, at p. 3; *see* e-mail from Henry E. Steuart, JPMorgan, to Jane Buyers-Russo, JPMorgan, *et al.* (Sept. 12, 2008) [JPM-EXAMINER00006225]; e-mail from Robert H. Milam, JPMorgan, to John J. Hogan, JPMorgan, *et al.* (Sept. 11, 2008) [JPM-EXAMINER00006222]. The remainder of these bonds was returned on September 12. *See infra* at Section III.A.5.b.1.m.

[4223] E-mail from Jeffrey Aronson, JPMorgan, to Andrew Yeung, Lehman, *et al.* (Sept. 9, 2008) [JPM-2004 0005594]; Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4.

arrived later that night.[4224] The new agreements surprised Yeung, both because they came so soon after the August Agreements were negotiated and executed, and because small wording changes dramatically expanded the scope of JPMorgan's lien and the scope of obligations guaranteed by LBHI.[4225]

Yeung stated that while reviewing the draft documents that evening, he placed a call to Gail Inaba, a JPMorgan in-house counsel.[4226] According to Yeung, Inaba explained that the changes to the agreements had already been agreed upon in a conversation between Black and Fuld.[4227] She further explained that the agreements had to be executed prior to Lehman's accelerated earnings announcement scheduled for the next morning.[4228] This message was communicated among business personnel as well. Dellosso stated that she called Tonucci on the night of September 9 and told him that the documents needed to be signed. According to Dellosso, Tonucci replied that he

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[4224] E-mail from Jeffrey Aronson, JPMorgan, to Andrew Yeung, Lehman, *et al.* (Sept. 9, 2008) [JPM-2004 0005039]. A draft Aurora Guaranty and draft Control Agreement were sent with the draft Amendment to the Clearance Agreement as well. *See id*. The September Guaranty, Security Agreement and Amendment to the Clearance Agreement are referred to herein as the "September Agreements."

[4225] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 3.

[4226] *Id*. at p. 4. Inaba did not recall Yeung calling her that night. Examiner's Interview of Gail Inaba, Apr. 28, 2009, at p. 7.

[4227] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4. According to Yeung, when he expressed his concern over the expanded scope of the collateral pledge, Inaba said "if you have concerns about this we will contact Dick Fuld." *Id.* Although she did not remember Yeung calling her, Inaba stated to the Examiner that she told Yeung and Hespel that an agreement had been reached by very senior management at both firms, though not necessarily that Fuld and Black had reached agreement. Examiner's Interview of Gail Inaba, Apr. 28, 2009, at p. 7.

[4228] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4; Examiner's Interview of Gail Inaba, Apr. 28, 2009, at p. 8.

needed to speak to Lowitt, who was sleeping at the time.[4229] Dellosso further said that Tonucci told her that he needed Lowitt's approval of the agreements, but she did not recall any follow-up information from Tonucci as to whether Lowitt was consulted.[4230] Similarly, Mark Doctoroff, at the instruction of Dellosso, told Dan Fleming between 10 p.m. and 11 p.m. that Lehman needed to wake Lowitt up because the agreements had to be completed.[4231]

Tonucci recalled an evening phone call with Buyers-Russo on September 9. According to Tonucci, Buyers-Russo inquired whether Lowitt had reviewed the agreements; he had not. Tonucci reported that Lowitt was likely asleep and, although Buyers-Russo requested that Tonucci wake him up, Tonucci decided not to do so.[4232] Buyers-Russo did not discuss any such call with the Examiner,[4233] and it may be that Tonucci was mistaken in saying that the call was with Buyers-Russo rather than Dellosso.[4234]

Yeung and Hespel negotiated the agreement with JPMorgan. The core JPMorgan in-house legal team consisted of Inaba, who took the lead in the negotiations, Jeffrey

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[4229] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 9.

[4230] *Id*.

[4231] Examiner's Interview of Mark G. Doctoroff, Apr. 29, 2009, at p. 19; Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 9.

[4232] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 13.

[4233] Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at pp. 6-11.

[4234] This interpretation is supported by the fact that Buyers-Russo's notes from September 9 do not refer to such a conversation with Tonucci. *See* Jane Buyers-Russo, JPMorgan, Unpublished Notes (Sept. 9, 2008), at pp. 1-5 [JPM-EXAMINER00006052]. Her September 11 notes, by comparison, do record conversations with Tonucci. *See* Jane Buyers-Russo, JPMorgan, Unpublished Notes (Sept. 11, 2008), at p. 5 [JPM-EXAMINER00006040].

Aronson, who worked on the Guaranty and Security Agreement, and Nikki Appel, who worked on the Amendment to the Clearance Agreement.[4235]

The draft agreements raised several concerns for Yeung, which he identified in e-mails to Tonucci and others.[4236] Thus, notwithstanding the representation from Inaba that the agreements reflected an understanding between senior executives of Lehman and JPMorgan, Yeung took the step of identifying his concerns to Lehman business personnel in order to confirm their understanding. In response, Fleming instructed Yeung to proceed as if Lehman would ultimately agree to all of JPMorgan's proposed terms.[4237] According to Yeung, Fleming separately instructed Yeung to do everything required to advance the agreements as quickly as possible, and that Tonucci would review them eventually.[4238]

Through the night and into the next morning, Yeung and Hespel negotiated the agreements with JPMorgan's legal team. Yeung said he felt he was under "significant

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[4235] Examiner's Interview of Gail Inaba, Apr. 28, 2008, at p. 6. In addition, Peter Wasserman worked on a separate LBHI Guaranty on behalf of Aurora Loan Services, LLC. *Id.*

[4236] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4; Examiner's Interview of Andrew Yeung, May 14, 2009, at p. 9. As discussed below, Tonucci stated that he did not review his e-mails that evening. Yeung stated that Fleming told him that the agreements had already been agreed to, but Yeung responded that he would review them and provide comments nonetheless. Examiner's Interview of Andrew Yeung, May 14, 2009, at p. 9.

[4237] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4. Fleming stated that he consulted with Tonucci before responding to Yeung's e-mail. Examiner's Interview of Daniel J. Fleming, Apr. 22, 2009, at p. 7. Tonucci did not report any such consultation and instead noted that after forwarding the original drafts of the agreements to Yeung and Fleming, he "paid no attention" to the issue on the evening of September 9. Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 13. Further, Tonucci added that he turned his Blackberry off that night and recalled that Fleming was likely the only business contact working with counsel on the night of September 9. *Id*.

[4238] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4.

pressure" and subject to a "very fast time-frame." He felt the terms of the proposed agreements were "dictated" rather than negotiated, and that JPMorgan did not expect substantive changes or any "drawn-out discussion" on material provisions.[4239] Appel, by contrast, described the negotiations as "professional" and "cordial."[4240] Although JPMorgan continually emphasized that the agreements had to be in place by the next morning, no Lehman witness on either the legal or business side told the Examiner that anyone at JPMorgan made any explicit threat during the negotiation to cease clearing services for Lehman if Lehman did not sign by the morning.[4241]

According to Dellosso, if Lehman did not sign the agreements, it would have been difficult for JPMorgan to extend credit to and continue being supportive of Lehman. Dellosso recalled discussing with Tonucci JPMorgan's desire to continue to support Lehman in the public domain and JPMorgan's extension of credit to Lehman.[4242] Tonucci did not recall any specific threat from Dellosso (or anyone else at JPMorgan)

[4239] *Id*. at p. 5. Hespel described the negotiations as "acrimonious." Examiner's Interview of Paul W. Hespel, Apr. 23, 2009, at p. 6. While different in tone and manner from the August negotiations, the September Agreements were not the first time Lehman had experienced difficulties negotiating with JPMorgan. For instance, when JPMorgan was negotiating a SubCustodial agreement with Lehman and one of its triparty investors, Federated, one of the Lehman negotiators commented: "In the past year or so, JPMorgan has become increasingly uncooperative, reneging on previous agreements regarding acceptable language, dictating the form of agreements that they will review . . . and taking positions contrary to either the clear language of an agreement . . . or refusing to take language acceptable in the Lehman-boilerplate form if inserted in a different form provided by the counterparty . . . ." E-mail from Charles Witek, Lehman, to George V. Van Schaick, Lehman, *et al.* (Apr. 23, 2008) [LBEX-DOCID 110245].

[4240] Examiner's Interview of Nikki G. Appel, Sept. 11, 2009, at p. 4.

[4241] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4; Examiner's Interview of Paul W. Hespel, Apr. 23, 2009, at p. 6; Examiner's Interview of Daniel J. Fleming, Apr. 22, 2009, at p. 7; Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 15.

[4242] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 9; *see* e-mail from Donna Dellosso, JPMorgan, to Steven D. Black, JPMorgan, *et al*. (Sept. 10, 2008) [JPM-2004 0061485].

concerning what would happen if the agreements were not signed.[4243] Indeed, Tonucci believed that JPMorgan would have continued to clear for Lehman without the agreements in place, albeit with "friction," "stress," and "operational difficulties" for Lehman.[4244]

Other than the general instructions from Fleming to proceed with the agreements, Yeung received almost no guidance that night from Lehman's business-side regarding the crucial September Agreements.[4245] Yeung believed that the September Agreements had already been agreed to in principle, and stated that Fleming had specifically told him that the agreements had been agreed to; accordingly, Yeung reported that Fleming was not expecting too much from Yeung by way of comments.[4246] Yeung's only communication from Tonucci occurred on the morning of September 10, and was for the limited purpose of executing the final documents.[4247] Tonucci confirmed that he "paid no attention" to the agreements during the evening of September 9.[4248] Indeed, while the September Agreements were being negotiated, Lehman senior management was immersed in all-night meetings to ready the earnings

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[4243] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 15.

[4244] *Id*.

[4245] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at pp. 4-5; Examiner's Interview of Andrew Yeung, May 14, 2009, at p. 9.

[4246] Examiner's Interview of Andrew Yeung, May 14, 2009, at p. 9. Fleming repeatedly attempted to distance himself from any role in providing business guidance, stating it was not his job. He said: "This is why we have lawyers." Examiner's Interview of Daniel J. Fleming, Apr. 22, 2009, at pp. 2, 6.

[4247] Examiner's Interview of Andrew Yeung, May 14, 2009, at p. 9.

[4248] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 13.

report for early release on the morning of September 10.[4249] According to Tonucci, he and Lowitt were off e-mail the entire night.[4250] Thus, it appears that there was no Lehman executive-level review of the agreements or even an effort by Lehman executives to obtain a summary of the terms or impact of the proposed agreements.

Although in the course of the negotiations JPMorgan did not significantly alter the scope of the Security Agreement and Guaranty from JPMorgan's original proposal, JPMorgan did make some changes to the proposed agreements at Lehman's request. For example, JPMorgan agreed to change language in the Guaranty to reference collateral "request[s]" rather than stronger language suggestive of an obligation or demand.[4251] JPMorgan also removed language by which LBHI guaranteed performance obligations.[4252] In the Amendment to the Clearance Agreement, although initially against the change,[4253] JPMorgan ultimately removed references to affiliates in the lien

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[4249] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4. According to Yeung, Lowitt left the earnings meeting that night because he felt ill. *Id.*

[4250] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at pp. 2, 13; Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 19.

[4251] *Compare* Guaranty [Draft] (Sept. 9, 2008), at p. 2 [JPM-2004 0005596] ("maximum liability" is $3 billion or "such greater amount that the Bank has notified the Guarantor it must deliver to the Bank in support of this Guaranty"), *with* Guaranty (Sept. 9, 2008), at p. 2 [JPM-2004 0005813] ("maximum liability" is $3 billion or "such greater amount that the Bank has requested from time to time as further security in support of this Guaranty").

[4252] *Compare* Guaranty [Draft] (Sept. 9, 2008), at p. 1 [JPM-2004 0005595] (guaranteeing "punctual payment and performance of all obligations and liabilities"), *with* Guaranty (Sept. 9, 2008), at p. 1 [JPM-2004 0005813] (guaranteeing "punctual payment of all obligations and liabilities").

[4253] *See* e-mail from Nikki G. Appel, JPMorgan, to Andrew Yeung, Lehman, *et al*. (Sept. 10, 2008) [JPM-2004 0001997].

provision intended to provide for cross-collateralization.[4254] These changes did not involve the most significant aspects of the agreements, but it is clear that at least some give-and-take occurred during the negotiation.

At 6:30 a.m. on September 10, Yeung e-mailed JPMorgan counsel and reported that he had sent the agreements "on to our executive officers for their final approval and signature."[4255] Yeung instructed Fleming to prepare Lowitt to sign the agreements,[4256] but Tonucci signed them. Shortly after 7:00 a.m., Fleming e-mailed Doctoroff and informed him that "Andrew [was] on his way . . . to pick up signed docs from Paolo/Ian."[4257] Yeung forwarded the signature pages to JPMorgan at approximately 7:30 a.m.[4258] Appel stated that JPMorgan did not request any type of

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[4254] *Compare* Amendment to Clearance Agreement [Draft] (Sept. 9, 2008), at p. 1 [JPM-2004 0005055], *with* Amendment to Clearance Agreement (Sept. 9, 2008), at p. 1 [JPM-2004 0005861]. Examiner's Interview of Gail Inaba, Apr. 28, 2009, at p. 7.

[4255] E-mail from Andrew Yeung, Lehman, to Gail Inaba, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0002032]. Under Lehman's Code of Authorities, other than for a "Guaranteed Subsidiary," a Holdings' guaranty of a subsidiary's obligations for over $500 million or for an unspecified amount must be approved by LBHI's CEO, President, COO or CFO. LBHI & LBI, Amended and Restated Code of Authorities (July 1, 2004), at Ex. 3 [LBEX-AM 043802]. LBI – one of the entities covered by the September Guaranty – is not a "Guaranteed Subsidiary," and thus this provision governs. *See* Alvarez & Marsal, Responses to Questions for Alvarez & Marsal/Weil, Gotshal & Manges (Dec. 7, 2009), at p. 1 (confirming LBI was not a "Guaranteed Subsidiary"). The Code of Authorities also provides, however, that "[i]f the required approval is obtained, any proper officer of Holdings . . . may sign documents." LBHI & LBI, Amended and Restated Code of Authorities (July 1, 2004), at Ex. 1 [LBEX-AM 043802].

[4256] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 5.

[4257] E-mail from Daniel J. Fleming, Lehman, to Mark G. Doctoroff, JPMorgan (Sept. 10, 2008) [LBEX-DOCID 457582].

[4258] E-mail from Andrew Yeung, Lehman, to Gail Inaba, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0005218].

certification of Tonucci's authority; she stated that JPMorgan relied on apparent authority.[4259]

Notably, Tonucci told the Examiner that he "did not understand" the terms of the agreements when he signed them and, if he had, he would have been "reluctant" to sign.[4260] Lowitt spoke with Tonucci about the September Agreements after the earnings call on September 10 (after the agreements were signed). Lowitt did not recall communicating with anyone about the agreements prior to that point.[4261] Tonucci relayed to Lowitt that JPMorgan had wanted Lowitt to sign the agreements the night before, but that Tonucci had decided not to bother Lowitt. In response to questions from the Examiner, Lowitt recalled having no concern about Tonucci's authority to sign the agreements, citing the fact that even though JPMorgan wanted Lowitt to sign, they accepted Tonucci's signature.[4262] In any event, neither Lowitt nor anyone else at Lehman sought to rescind the agreements based on Tonucci's lack of authority.

As executed, the September Amendment to the Clearance Agreement expanded JPMorgan's lien on the Lehman parties' accounts, securing their "existing or future indebtedness, obligations and liabilities of any kind" to JPMorgan whether arising

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[4259] Examiner's Interview of Nikki G. Appel, Sept. 11, 2009, at p. 6.

[4260] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 14.

[4261] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at pp. 19-20. Yeung did e-mail Lowitt that evening, but Lowitt did not respond. Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4; *see also* e-mail from Paul W. Hespel, Goodwin Procter, to Jeffrey Aronson, JPMorgan (Sept. 10, 2008) [LBEX-AM 039572] (forwarding Lehman comments on draft Guaranty and Security Agreement to JPMorgan, copying Lowitt).

[4262] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 19. Lowitt's reasoning does not, of course, address the issue of Lehman's chain-of-authority requirements.

under the Clearance Agreement or not.[4263] The September Guaranty also extended LBHI's liability. LBHI "unconditionally and irrevocably guarantee[d] to [JPMorgan] the punctual payment of all obligations and liabilities of" all direct or indirect subsidiaries of LBHI to JPMorgan and its affiliates, subsidiaries, successors and assigns "of whatever nature, whether now existing or hereinafter incurred."[4264] Not only did the universe of guaranteed Lehman entities expand, but LBHI guaranteed obligations irrespective of whether they accrued pursuant to the Clearance Agreement and guaranteed obligations to all JPMorgan affiliates as well.

In addition, as requested by Lehman, the September Guaranty imposed a three-day written notice requirement[4265] on Lehman to transfer any security:

> . . . [LBHI] may upon three written days notice to [JPMorgan] transfer any Security . . . , provided that [LBHI] shall not transfer any such Security if [JPMorgan] has exercised or been stayed or otherwise prohibited from exercising any of its rights under this Guaranty or the Security Agreement or in the event any default . . . has occurred and is continuing, in any such case, prior to the end of the three day notice period.[4266]

[4263] Amendment to Clearance Agreement (Sept. 9, 2008), at p. 1 [JPM-2004 0005861]. The September Amendment to the Clearance Agreement contained a recital of consideration. It stated that it was entered "for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged." *Id*.

[4264] Guaranty (Sept. 9, 2008), at p. 1 [JPM-2004 0005813]. The September Guaranty contained a recital of consideration. It stated that it was entered "for good and valuable consideration and in order to induce the Bank from time to time, to extend or continue to extend credit, clearing advances, clearing loans or other financial accommodations to [LBHI and its subsidiaries] and/or to transact business, trade or enter into derivative transactions with [LBHI and its subsidiaries]." *Id*. It further noted that "[t]his Guaranty shall be in addition to and does not replace that certain Guaranty dated August 26, 2008." *Id.* Neither the September Guaranty nor the September Security Agreement defined the term "affiliates."

[4265] The three-day provision first appeared in Bank of America's agreement with Lehman, discussed in more detail in Section III.A.5.e, *infra*.

[4266] Guaranty (Sept. 9, 2008), at p. 2 [JPM-2004 0005813].

Although Yeung stated that the three-day-notice provision in the draft Guaranty originated with JPMorgan,[4267] all other evidence supports the view that it was Lehman that first requested the provision.[4268] As reported in a contemporaneous e-mail from Doctoroff, Lehman would provide collateral only if JPMorgan agreed to "a 3-day notice period to call the cash back."[4269] He explained that Lehman had requested this condition to "allow [Lehman] to count the cash as part of their liquidity pool."[4270] Lehman's "logic [was] that with a 3-day notice [JPMorgan could] effectively stop doing business that creates exposure if [Lehman] want[ed] to take [the collateral] back."[4271] If JPMorgan did not agree, Doctoroff noted that there would be "the public issue of [Lehman's] liquidity pool having to drop."[4272] Discussion of Lehman's request occurred among several JPMorgan executives, including Dellosso, Corral, Hogan, Buyers-Russo and Murray, and the group decided to accede to Lehman's request.[4273] Buyers-Russo regarded Lehman's proposal as giving Lehman the right to make a request for a return of

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[4267] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 5; Examiner's Interview of Andrew Yeung, May 14, 2009, at p. 7.

[4268] *E.g.*, Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at pp. 7-8; Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 8; Examiner's Interview of Paul W. Hespel, Apr. 23, 2009, at pp. 5-6.

[4269] E-mail from Mark G. Doctoroff, JPMorgan, to Jane Buyers-Russo, JPMorgan, *et al.* (Sept. 9, 2008) [JPM-2004 0032520].

[4270] *Id*.

[4271] *Id*.

[4272] *Id*.

[4273] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 8.

collateral, but imposing no obligation on JPMorgan. She understood having just the right to request that collateral be returned to be meaningless.[4274]

In parallel, the September Security Agreement expanded the definition of "Accounts" in which JPMorgan held a security interest; instead of just one cash account, one securities account and related accounts, it now included "all accounts of [LBHI] at [JPMorgan or its affiliates] . . . or any shares or accounts held by or registered to [LBHI] or any nominee in any money market fund issued, managed, advised or subadvised by [JPMorgan or its affiliates]," except for the Overnight Account.[4275] A three-day notice provision was repeated in the September Security Agreement as well.[4276]

Three other Lehman entities executed clearance agreements with JPMorgan on the morning of September 10: Lehman Brothers Bankhaus, Lehman Brothers Commercial Bank and Lehman Brothers Bank FSB.[4277] According to Nikki Appel, those entities maintained essentially inactive clearance boxes at the time, and JPMorgan

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[4274] Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 7.

[4275] Security Agreement (Sept. 9, 2008), at p. 1 [JPM-2004 0005873]. The September Security Agreement contained a recital of consideration. It stated that it was entered "[i]n consideration of [JPMorgan] extending credit to and/or transacting business, trading or engaging in derivative transactions with [Lehman and subsidiaries]." *Id*.

[4276] *Id.* at p. 3.

[4277] *See* e-mail from Andrew Yeung, Lehman, to Gail Inaba, JPMorgan, *et al*. (Sept. 10, 2008) [JPM-2004 0005696]; e-mail from Andrew Yeung, Lehman, to Gail Inaba, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0002093]; e-mail from Andrew Yeung, Lehman, to Gail Inaba, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0002133]. These agreements had been discussed earlier in the week. E-mail from Daniel J. Fleming, Lehman, to Mark G. Doctoroff, JPMorgan (Sept. 8, 2008) [JPM-2004 005807] ("Paul, our outside counsel, received a call today from JPM asking that the three banking entities we left off the amended clearance agreement be added back on. . . . I think the preferred route is to execute a separate agreement for each.").

wanted to ensure clearance agreements were in place in case Lehman moved any assets into them.[4278]

Consistent with the broad reach of the September Agreements,[4279] once the agreements were executed, JPMorgan notified LBIE that its previously unsecured credit line of $2 billion was effectively secured by the execution of the agreements.[4280]

[4278] Examiner's Interview of Nikki G. Appel, Sept. 11, 2009, at p. 6. When JPMorgan initially did not receive the clearance agreement for Lehman Brothers Bank FSB, it informed Lehman that it would "close its account this morning." E-mail from Jeffrey Aronson, JPMorgan, to Andrew Yeung, Lehman (Sept. 10, 2008) [JPM-2004 0002124]. Lehman quickly informed JPMorgan that the document would be executed shortly. E-mail from Andrew Yeung, Lehman, to Jeffrey Aronson, JPMorgan (Sept. 10, 2008) [JPM-2004 0002124].

[4279] The Examiner's financial advisors have estimated the potential impact of the September Agreements to be as follows: First, JPMorgan applied LBHI collateral to set off claims totaling approximately $10.6 million that LBHI had not guaranteed prior to entering the September Agreements. Second, JPMorgan applied LBHI collateral to set off claims totaling approximately $1.94 billion from collateral it pledged pursuant to the September Agreements for obligations that had been unsecured prior to LBHI entering the September Agreements. Third, JPMorgan received payments in excess of $1.1 billion (against the newly secured obligations) through setoff of collateral other than the LBHI collateral obtained under the September Agreements (*i.e.,* collateral held at LBHI subsidiaries). Fourth, JPMorgan asserts claims that are not yet paid for approximately $943 million related to lost fees and losses in managed funds. Duff & Phelps, Impact on LBHI Claim Payments of the September 9 Agreements (Jan. 5, 2010). Thus, assuming *arguendo* the validity of the JPMorgan claims, the September Agreements may have had a $4 billion impact on LBHI.

[4280] *See* e-mail from Kelly A. Mathieson, JPMorgan, to Daniel J. Fleming, Lehman, *et al.* (Sept. 10, 2008) [JPM-2004 0032674]; Examiner's Interview of Kelly A. Mathieson, Oct. 7, 2009, at pp. 11, 13-14; *see also* Lehman, JPM Chase Triparty Repo, at p. 1 [LBEX-DOCID 014562] ("JPM Chase provides a $2bn line of unsecured credit to facilitate triparty repo in Europe. JPM Chase has indicated that they want to change the line from unsecured to secured."). Lehman's U.K. executives understood even during the summer of 2008 that JPMorgan's discussions with Tonucci and O'Meara were part of a "high-level" discussion to further collateralize the clearance business. E-mail from Joseph Igoe, Lehman, to Philip Morgan, Lehman, *et al.* (July 31, 2008) [LBEX-DOCID 075820]. While the September Agreements were being negotiated, JPMorgan's executives in charge of global collateral management were preparing for possible options if Lehman refused to sign. *See* e-mail from Kelly A. Mathieson, JPMorgan, to Steven X. Taylor, JPMorgan (Sept. 10, 2008) [JPM-2004 0032521]; Examiner's Interview of Kelly A. Mathieson, Oct. 7, 2009, at pp. 14-15. At 5:17 a.m. London time on September 10 when the September Agreements were still not executed, Kelly Mathieson reported instructions from Barry Zubrow and Mark Doctoroff to move LBIE's unsecured credit line to $1.1 billion – the amount that LBIE was using at that time – until the agreements were executed. *See* e-mail from Kelly A. Mathieson, JPMorgan, to Colleen T. Morris, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0029858]; Examiner's Interview of Kelly A. Mathieson, Oct. 7, 2009, at p. 14.

(j) Daily Liquidity Pool Updates From Lehman to JPMorgan

In September, Dellosso received daily liquidity pool updates from Lehman.[4281] Dellosso believed that Doctoroff and others at JPMorgan also received these updates. After Lehman posted collateral in response to JPMorgan's September 9 request, Dellosso realized that Lehman's liquidity pool had not changed, and at the same time Dellosso recalled the three-day notice provision in the September Agreements. Dellosso linked the three-day notice provision to the unchanged Lehman liquidity-pool number. She made that observation to JPMorgan senior managers, but did not discuss the issue with anyone at Lehman. Dellosso stated to the Examiner that she would not have counted Lehman's collateral pledge in a liquidity pool.[4282] Dellosso explained that if Lehman had requested collateral back on three days' notice, JPMorgan would have needed to consider factors such as JPMorgan's exposure before agreeing to return any collateral.[4283] Thus, to Dellosso, Lehman's pledged assets seemed like encumbered assets.[4284]

[4281] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 11; e-mail from Edward A. Deleon, JPMorgan, to Donna Dellosso, JPMorgan (Sept. 4, 2008) [JPM-2004 0001065]; e-mail from Mark G. Doctoroff, JPMorgan, to Donna Dellosso, JPMorgan, *et al.* (Sept. 11, 2008) [JPM-2004 0002262].

[4282] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 11.

[4283] *Id.* at pp. 3, 8.

[4284] *Id.* at p. 8. Dimon stated that there were no firm industry rules and there may be circumstances under which one might count a pledged asset in a liquidity pool. However, he noted that he would not have characterized as liquid the collateral that Lehman posted with JPMorgan because it was the subject of valuation disputes between Lehman and JPMorgan. Examiner's Interview of Jamie L. Dimon, Sept. 29, 2009, at p. 12.

Similarly, Tonucci, while defending Lehman's decision to include collateral posted to JPMorgan in the liquidity pool, stated that he understood Lehman would have needed JPMorgan's permission to withdraw the collateral.[4285] Lowitt stated that collateral pledged with JPMorgan was ultimately Lehman's money, although he acknowledged that JPMorgan probably would have been "reluctant" to give back the collateral.[4286]

When Dellosso advised Buyers-Russo that Lehman's reported liquidity had not changed despite pledges of collateral to JPMorgan, Buyers-Russo also "connected the dots" between the three-day notice provision and Lehman's liquidity pool.[4287] Buyers-Russo stated to the Examiner that she also believed it was inappropriate for Lehman to include encumbered assets in its liquidity pool.[4288] Buyers-Russo did not understand the three-day notice provision as rendering Lehman's collateral unencumbered because, in her view, JPMorgan had no duty to return that collateral upon Lehman's request.[4289]

[4285] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 20. Lehman outside counsel Hespel also believed that the return of collateral to Lehman upon the end of the three-day period was not mandatory and that JPMorgan could refuse to return it. Examiner's Interview of Paul W. Hespel, Apr. 23, 2009, at p. 6.

[4286] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 22. While JPMorgan's Hogan offered no general view as to whether the assets pledged by Lehman should have been included in Lehman's liquidity pool, he believed that, hypothetically speaking, Lehman could have taken back its collateral on a couple of days' notice. Examiner's Interview of John J. Hogan, Sept. 17, 2009, at p. 7.

[4287] Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 8.

[4288] *Id*.

[4289] *Id*.

Even if JPMorgan did have such a duty, Buyers-Russo explained, Lehman should not have counted pledged collateral in its liquidity pool until that collateral was returned.[4290]

(k) September 11 Collateral Request Pursuant to the September Agreements

After September 9, JPMorgan continued to evaluate its exposure to Lehman and the value of Lehman's collateral. On September 10, Chiavenato prepared a presentation titled, "Tri-Party Repo Margin Gap Analysis - Lehman - 9/10/2008."[4291] The presentation analyzed the previous night's triparty-repo portfolio.[4292] Chiavenato concluded that "Lehman's total intraday margin on 9/10 was sufficient to cover JPM's risk-based margin, which was calculated as US$9.2 billion based on the estimated one-day liquidation risk and the price risk of the collateral."[4293] Chiavenato explained that this

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[4290] *Id.*

[4291] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 17; JPMorgan, Tri-Party Repo Margin Gap Analysis – Lehman – 9/10/2008 (Sept. 10, 2008), at pp. 1-4 [JPM-2004 0029886]. There is at least one earlier version of this analysis, JPMorgan, Tri-Party Repo Margin Gap Analysis – Lehman – 9/9/2008 (Sept. 9, 2008) [JPM-EXAMINER00006009], though it is not clear whether Chiavenato or Weisbrod authored it, *see* e-mail from Ricardo S. Chiavenato, JPMorgan, to David A. Weisbrod, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0029885] (sending Weisbrod the September 10 analysis and stating, "[h]ere is the 3-page deck you sent for Lehman with this morning's numbers").

[4292] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 17; JPMorgan, Tri-Party Repo Margin Gap Analysis – Lehman – 9/10/2008 (Sept. 10, 2008), at p. 2 [JPM-2004 0029886].

[4293] JPMorgan, Tri-Party Repo Margin Gap Analysis – Lehman – 9/10/2008 (Sept. 10, 2008), at p. 2 [JPM-2004 0029886]; Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 17. Chiavenato further analyzed a "worst-case scenario" that would occur if no triparty investor rolled and Lehman had to rely on the PDCF for overnight financing. In that situation, Chiavenato concluded that JPMorgan would be 116 percent collateralized. JPMorgan, Tri-Party Repo Margin Gap Analysis – Lehman – 9/10/2008 (Sept. 10, 2008), at p. 3 [JPM-2004 0029886]. Chiavenato repeated this analysis on September 12 and concluded that JPMorgan would be 117 percent collateralized in a triparty worst-case scenario. JPMorgan, Tri-Party Repos and Collateral – Lehman – 9/11/08 (Sept. 12, 2008), at p. 3 [JPM-EXAMINER00006022]. Notably, this analysis did not account for the $3 billion posted on September 9-10 or the $5 billion posted on September 12. *Id.* Chiavenato performed this analysis again on September 13 and concluded that JPMorgan would be 125 percent collateralized during a September 15 unwind in a triparty-worst-case

conclusion did not mean that JPMorgan was overcollateralized, however, because JPMorgan was still valuing the "extra collateral" (*i.e.*, collateral in the LCE account) Lehman had posted at $4.5 billion. Even though that number reflected GFA's pricing, Chiavenato explained that there was a problem with the Fenway commercial paper (valued at $3 billion) that had not yet been resolved. In addition, Chiavenato stated that his analysis did not account for dealer-pricing of collateral in the triparty shell.[4294]

Although there had been conversations within JPMorgan in August concerning valuation of Lehman collateral, JPMorgan witnesses stated that it was not until September 11, during a widely attended internal meeting, that JPMorgan concluded that much of the collateral that Lehman had posted was not worth anything near what Lehman had represented.[4295] Black stated that this came as a surprise to many people at the September 11 meeting.[4296] JPMorgan's outside counsel described the substance of the meeting as follows:

> Questions were raised by senior management about the value of each of the non-cash items of JPMorgan's additional collateral [posted by Lehman]. Specifically, there was considerable doubt expressed about the value of the "conduit CP" [Fenway] and the CLOs [Spruce, Pine and Verano], all of which had been represented by Lehman to be worth par,

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scenario. JPMorgan, Tri-Party Repos and Collateral – Lehman – 9/12/08 (Sept. 13, 2008), at p. 3 [JPM-2004 0033219]. This analysis, however, also valued the "extra collateral" posted by Lehman at Gifford Fong prices of $4.5 billion. *Id*. at pp. 2-3. While the analysis recognized that JPMorgan would have "the additional US$5 billion cash collateral" obtained on September 12 "as a cushion," the analysis noted that that collateral "covers all JPM's credit exposure" and not just intraday financing. *Id*. at p. 2.

[4294] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at pp. 17-18.

[4295] Examiner's Interview of Barry L. Zubrow, Oct. 20, 2009, at pp. 4-5; Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 12; Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 14.

[4296] Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 12.

> with a total face value of $6.7 billion. . . . Craig Delany and analysts working with him were asked to provide a ballpark estimate of the value of these and other large securitized positions in the tri-party repo portfolio, and the conclusion that was brought back to senior management was that the collateral securities and some of the securities in the tri-party portfolio could not be relied upon to be worth anything near par if liquidated. As a result, JPMorgan believed it had at least a $5 billion deficiency in its existing collateral, and informed Lehman that it had to have $5 billion in cash collateral in order to continue to extend credit and support Lehman the next day.[4297]

Black described JPMorgan's formulation of the $5 billion amount as "part art, part science, and part catch up."[4298]

[4297] JPMorgan First Written Responses, at p. 18. Through counsel, JPMorgan also identified one document, "Collateral Detail," prepared by a member of Dellosso's team, as the only document that constitutes a quantitative analysis underlying JPMorgan's September 11 collateral request. *See* JPMorgan, Collateral Detail, at p. 1 [JPM-2004 0084867]. Buyers-Russo, however, did not recall any particular document being discussed at the September 11 meeting. Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 14. Delany confirmed that the first file he received that contained the collateral he was tasked with pricing was sent to him around 8:00 p.m. that night (although he received an incorrect file around 5:00 p.m.). Examiner's Interview of Craig M. Delany, Sept. 9, 2009, at pp. 5-6; e-mail from Edward J. Corral, JPMorgan, to Craig M. Delany, JPMorgan (Sept. 11, 2008) [JPM-2004 0013515]. An analyst sent Delany a spreadsheet containing a "net exposure" analysis a few hours later. E-mail from Jonathan D. Platt, JPMorgan, to Craig M. Delany, JPMorgan (Sept. 11, 2008) [JPM-2004 0017401] (attaching spreadsheet calculating "net exposure"). Although Delany's written analysis was not completed until after the meeting, JPMorgan counsel stated that Delany had conversations throughout the day with Matt Zames, who led the JPMorgan trading desk, and that Zames made oral reports to the meeting about Lehman's collateral valuation. Jenner & Block, Memorandum re November 18, 2009 Teleconference with JPMorgan Counsel (Nov. 19, 2009), at p. 4.

[4298] Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 12 n.4. In addition, by September 11, JPMorgan knew there were "key reductions" from Lehman counterparties, as well as an "uptick in novations" with Lehman. Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at pp. 16-17; Jane Buyers-Russo, JPMorgan, Unpublished Notes (Sept. 11, 2008), at pp. 6-7 [JPM-EXAMINER00006040]; *see also* e-mail from Eric S. Rosen, JPMorgan, to Steven D. Black, JPMorgan, *et al.* (Sept. 11, 2008) [JPM-2004 0006397] ("[M]oody's suggested a downgrade to Baa if asset sales were not completed quickly with a real counterparty."). JPMorgan also believed that Lehman had liquidity in the order of $20 billion to $40 billion such that a $5 billion request would not hurt Lehman. Examiner's Interview of Barry L. Zubrow, Oct. 20, 2009, at p. 5; Examiner's Interview of Donna Dellosso, Feb. 27, 2009, at pp. 7-8. By the early evening, however, when the call was made to Lehman, JPMorgan had reason to believe that Lehman's liquidity was not so robust. E-mail from John J. Hogan, JPMorgan, to Barry L. Zubrow, JPMorgan, *et al*. (Sept. 11, 2008) [JPM-2004 0006404] (Chris O'Meara, Chief Risk Officer at Lehman, "did not know at this

After the internal JPMorgan meeting, Black and Dimon called Fuld, who brought Lowitt into the conversation.[4299] Tonucci from Lehman and Zubrow from JPMorgan recalled participating in the conversation as well.[4300] On that call, Black and Dimon requested $5 billion in collateral from Lehman, in cash, by the next morning.[4301] JPMorgan witnesses stated to the Examiner that they informed Lehman that JPMorgan was concerned about the value of the collateral that Lehman had previously provided.[4302] According to Black, the collateral request was also based, in part, on the fact that Lehman had provided only $3.6 billion in response to JPMorgan's September 9

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moment where the liquidity stood relative to the $36 bio they quoted on the earnings call . . . ."). Further, JPMorgan was aware of the changes in Lehman's triparty-repo book. E-mail from Jane Buyers-Russo, JPMorgan, to Barry L. Zubrow, JPMorgan, *et al.* (Sept. 11, 2008) [JPM-2004 0029932] (Trend analysis shows "how the balances have reduced from a peak of $222B to $123B last night. While much of this decline up to last week has been self imposed and they've been fairly steady for the past month or so, there was an $18B decline last night, which I believe was replaced with funding via the FICC's GCF product."); *see also* e-mail from Ricardo S. Chiavenato, JPMorgan, to Barry L. Zubrow, JPMorgan, *et al.* (Sept. 12, 2008) [JPM-2004 0050420]; e-mail from Julia A. Fox, JPMorgan, to Edward J. Corral, JPMorgan, *et al.* (Sept. 12, 2008) [JPM-2004 0006456] ("Fidelity has requested back all the TPR overnight deals with Lehman."). At the same time, JPMorgan was aware of the effects its decisions with respect to Lehman's triparty repo book might have on Lehman. E-mail from Jane Buyers-Russo, JPMorgan, to Heidi Miller, JPMorgan (Sept. 11, 2008) [JPM-2004 0029932] ("It will cause an immediate liquidity issue for [Lehman] if we give them zero intraday value for the non-pdcf collateral.").

[4299] Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 12; e-mail from Jane Buyers-Russo, JPMorgan, to Bryn Thomas, JPMorgan, *et al.* (Sept. 12, 2008) [JPM-2004 0050095] ("Jamie Dimon and Steve Black spoke with Fuld and Ian Lowitt last night.").

[4300] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 16; Examiner's Interview of Barry L. Zubrow, Oct. 20, 2009, at pp. 5-6. Lowitt recalled Tonucci being on the call. Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 21.

[4301] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 13; Examiner's Interview of Jamie L. Dimon, Sept. 29, 2009, at pp. 9-10; Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 12; Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 21.

[4302] Examiner's Interview of Jamie L. Dimon, Sept. 29, 2009, at p. 10; Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 12; Examiner's Interview of Barry L. Zubrow, Oct. 20, 2009, at p. 6. Tonucci stated that JPMorgan did not give any reason for the collateral call. Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 16.

collateral request for $5 billion; Black stated that Lehman understood that it still needed to provide $1.4 billion in response to the September 9 request.[4303]

Tonucci recalled that during the call, or on a separate call the same day, he asked why JPMorgan wanted the collateral. According to Tonucci, one of the JPMorgan participants, perhaps Jamie Dimon, responded "no reason." Tonucci stated that he then asked: "What is to keep you from asking for $10 billion tomorrow?" to which someone, perhaps Dimon, responded: "nothing" and "maybe we will."[4304] Zubrow recalled that when questions were raised by Lehman executives about having to send more collateral, Lehman's Herbert "Bart" McDade cut off the discussion and stated that Lehman understood what JPMorgan needed, and that Lehman would forward the collateral to JPMorgan as soon as possible.[4305]

Fuld stated to the Examiner that Dimon told both him and Lowitt that JPMorgan would give the collateral back at the end of the day.[4306] Dimon, however, had no

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[4303] Examiner's Interview of Steven D. Black, Sept. 23, 2009, at pp. 12-13. As discussed, *supra*, however, Lehman did post corporate bonds (at least temporarily) as well, and may have understood its obligation as posting $4 billion.

[4304] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 16. Dimon did not recall anyone asking this question on the call, but stated that he could understand why someone would. Examiner's Interview of Jamie L. Dimon, Sept. 29, 2009, at p. 10.

[4305] Examiner's Interview of Barry L. Zubrow, Oct. 20, 2009, at p. 6.

[4306] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 13. The Examiner is unaware of any contemporaneous e-mail documenting this understanding. In the early morning of September 12, Ian Lowitt e-mailed Paolo Tonucci to ask "Deposit to jpm. Do we have ability to call it back at end of the day or could they hold it over weekend?" E-mail from Ian T. Lowitt, Lehman, to Paolo R. Tonucci, Lehman (Sept. 12, 2008) [LBEX-DOCID 70144]. Tonucci responded, "We should be be able to call back." E-mail from Paolo R. Tonucci, Lehman, to Ian T. Lowitt, Lehman (Sept. 12, 2008) [LBEX-DOCID 70144].

recollection as to whether he made that promise.[4307] Lowitt also did not recall any discussion about Lehman retrieving its collateral from JPMorgan.[4308] However, Tonucci believed that the $5 billion discussed on the call was meant to collateralize only intraday exposure, but also stated that this point was not clarified during the call.[4309] According to Black, when Lehman agreed to post $5 billion cash collateral, Lehman asked JPMorgan to return some of the "detritus" (Black's description) that JPMorgan was holding in exchange. JPMorgan did give some of it back, although Black was not involved in the details.[4310]

Dellosso and Buyers-Russo separately relayed the $5 billion collateral request to Lehman through Tonucci. On a September 11 telephone call, they said that they wanted to continue to be supportive of Lehman through the extension of credit and other services.[4311] Buyers-Russo told Tonucci that, in order to execute the triparty unwind, JPMorgan needed additional collateral.[4312] According to Buyers-Russo, JPMorgan wanted to continue to support Lehman in as public and as stabilizing a way as possible; thus, Buyers-Russo advised Tonucci that JPMorgan preferred to have Lehman post collateral rather than reducing lines of credit or ceasing trading, which

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[4307] Examiner's Interview of Jamie L. Dimon, Sept. 29, 2009, at p. 8.
[4308] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 22.
[4309] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 16.
[4310] Examiner's Interview of Steven D. Black, Sept. 23, 2009, at p. 13. *See* Section III.A.5.b.1.m, *infra* (discussing return of selected collateral).
[4311] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 10.
[4312] Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 13.

would be more visible to the market.[4313] Buyers-Russo stated that Tonucci responded that JPMorgan was making things difficult for Lehman.[4314] Dellosso recalled that Tonucci said that he was not sure whether he should continue doing business with JPMorgan.[4315] According to Buyers-Russo, Tonucci also defended Lehman's valuation of its collateral.[4316] He additionally said, according to Dellosso, that he needed to discuss the request with Lowitt.[4317] Buyers-Russo recalled referring to Lehman's $35 billion liquidity pool in her conversation with Tonucci; Tonucci responded that Lehman's liquidity pool was not, in fact, $35 billion: $15 billion of the liquidity pool was already encumbered.[4318] Buyers-Russo recorded this statement in contemporaneous notes.[4319]

Buyers-Russo later forwarded Tonucci written notice of the $5 billion collateral call "as discussed between senior management."[4320] Pursuant to the notice, if JPMorgan did not receive this collateral by the opening of business on September 12, 2008, JPMorgan would "exercise [its] right to decline to extend credit to [Lehman] under the

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[4313] *Id*. at pp. 13-14.

[4314] *Id*. at p. 13.

[4315] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 10.

[4316] Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 14.

[4317] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 10. During his interview with the Examiner, Tonucci did not have a clear recollection of a call with just Dellosso and Buyers-Russo, and may have been conflating various calls he had with JPMorgan. Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 16 (recalling call with Buyers-Russo, Dellosso, Dimon, and others from JPMorgan).

[4318] Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 15.

[4319] *See* Jane Buyers-Russo, JPMorgan, Unpublished Notes (Sept. 11, 2008), at p. 12 [JPM-EXAMINER00006040] ("15 of 35 is encumber[e]d intraday"); Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 17.

[4320] E-mail from Jane Buyers-Russo, JPMorgan, to Paolo R. Tonucci, Lehman (Sept. 11, 2008) [JPM-2004 0005411].

[Clearance] Agreement."[4321] The Notice made no mention of JPMorgan returning the collateral at night.

Lehman delivered the full $5 billion cash collateral to JPMorgan by the following afternoon.[4322] Much of the cash was delivered from LBHI's cash account at Citi.[4323]

(l) Additional Valuation Analyses by JPMorgan Beginning September 11

As discussed above, on September 11, 2008, Craig Delany, a managing director at JPMorgan's Investment Bank, had been asked to review the valuation of Lehman's securities. Delany had not had any significant involvement with Lehman collateral before that point.[4324]

Delany first reviewed the valuation of selected securities, and stressed problems with the valuations of two in particular: RACERS, which was part of the triparty shell

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[4321] *Id.* at p. 2 (Revised Notice re Credit Extension attachment). At the same time, JPMorgan revised credit lines for some Lehman entities. E-mail from David A. Weisbrod, JPMorgan, to Kelly A. Mathieson, JPMorgan (Sept. 12, 2008) [JPM-2004 0050026] (revised LBIE credit line from $2 billion to $1.4 billion); Examiner's Interview of Kelly A. Mathieson, Oct. 7, 2009, at pp. 16-17.

[4322] E-mail from Christopher D. Carlin, JPMorgan, to Barry L. Zubrow, JPMorgan, *et al*. (Sept. 12, 2008) [JPM-2004 0033002] ("At 1130 EDT current balance in the Lehman Holding Co account is 4 billion 450 million vs the target 5 billion."); e-mail from Christopher D. Carlin, JPMorgan, to Barry L. Zubrow, JPMorgan, *et al.* (Sept. 12, 2008) [JPM-2004 0050902] ("Last 550 million received from Citi at 1:26PM NY time . . . balance in the Lehman Holding co account is now at 5 billion . . . ."); *see also* e-mail from Paolo R. Tonucci, Lehman, to Ian T. Lowitt, Lehman (Sept. 12, 2008) [LBEX-DOCID 4050567] ("JP should have their $5 bn.").

[4323] Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at p. 14; Jane Buyers-Russo, JPMorgan, Unpublished Notes (Sept. 11, 2008), at p. 12 [JPM-EXAMINER00006040] (Buyers-Russo's notes indicating "3B coming from Citi"); e-mail from Mark G. Doctoroff, JPMorgan, to Christopher D. Carlin, JPMorgan, *et al.* (Sept. 12, 2008) [JPM-2004 0006447] (e-mail chain showing accumulation and sources of $5 billion cash collateral); s*ee also* e-mail from Katherine Lukas, Citigroup, to Tom Isaac, Citigroup, *et al.* (Sept. 11, 2008) [CITI-LBHI-EXAM 00014488] (Lehman deposited $3.02 billion with Citi on the evening of September 11 in addition to Lehman's $2 billion cash deposit).

[4324] Examiner's Interview of Craig M. Delany, Sept. 9, 2009, at pp. 3-4.

(and, thus, pledged to third-party investors overnight and held by JPMorgan during the day), and Fenway, which was collateral pledged by Lehman outside of the triparty shell (*i.e.*, it was in the LCE account).[4325] Delany concluded that the two securities were problematic because of their structure (commercial paper and short-term notes credit-enhanced by Lehman) and because of the illiquidity of the underlying assets.[4326] Delany concluded that RACERS and Fenway should be considered greatly devalued, far below their $8 billion assigned face value.[4327]

Although Fenway positions had been pledged to JPMorgan since June, Delany may have been the first person to question Fenway's value as collateral. GFA had not priced Fenway, and, as of September 4, Corral had indicated "we have no issue with its value."[4328] On September 12, Delany wrote Corral and expressed that "the real dicey position is" Fenway and "you should not accept this collateral."[4329]

At the same time, Delany valued the other collateral posted by Lehman in the LCE account, namely the Pine, Spruce and Verano CDOs. He priced Pine at 70 percent

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[4325] *Id*. at p. 6.

[4326] *Id*. at pp. 6-8.

[4327] *Id*. at pp. 7, 9.

[4328] E-mail from Edward J. Corral, JPMorgan, to David A. Weisbrod, JPMorgan (Sept. 4, 2008) [JPM-2004 0006562]; *see also* e-mail from Edward J. Corral, JPMorgan, to David A. Weisbrod, JPMorgan, *et al.* (Sept. 3, 2008) [JPM-2004 0006557] ("we are OK with [Fenway's] value"); e-mail from Mark G. Doctoroff, JPMorgan, to Jane Buyers-Russo, JPMorgan, *et al.* (Sept. 3, 2008) [JPM-2004 0006558] ("at least the $3bn is firm").

[4329] E-mail from Craig M. Delany, JPMorgan, to Edward J. Corral, JPMorgan (Sept. 12, 2008) [JPM-2004 0050997]. Chiavenato explained, however, that he learned by late August that Fenway was worth nothing. Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 16.

face value and Spruce and Verano at 50 percent.[4330] Although GFA had priced Verano similarly, it priced Pine and Spruce at a lower value than Delany had.[4331]

Delany also determined new margin requirements by collateral type and produced a series of spreadsheets that calculated JPMorgan's "net exposure" vis-à-vis Lehman's triparty book, factoring in the additional collateral that Lehman had posted. One version of Delany's spreadsheets suggests that, including the $5 billion cash deposit that day, JPMorgan was *over*collateralized by as much as $6.1 billion on September 12.[4332] Delany stressed in his interview with the Examiner, however, that the resultant number was not a real "net exposure" because, for the triparty shell, he accepted all market values contained in the BDAS system as accurate.[4333] (Delany did, however, incorporate his own valuations for collateral in the LCE account; he assigned no value to Fenway.)[4334] Delany stated that in retrospect his spreadsheets should have

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[4330] E-mail from Craig M. Delany, JPMorgan, to Edward J. Corral, JPMorgan (Sept. 12, 2008) [JPM-2004 0050997].

[4331] E-mail from Edward J. Corral, JPMorgan, to David A. Weisbrod, JPMorgan (Sept. 4, 2008) [JPM-2004 0006562].

[4332] *See* JPMorgan, Spreadsheet, at p. 8 [JPM-2004 0029769]; *see also* JPMorgan, Spreadsheet, at p. 1 [JPM-2004 0017402] (similar exposure analysis); JPMorgan, Spreadsheet, at p. 4 [JPM-2004 0025920] (similar exposure analysis).

[4333] Examiner's Interview of Craig M. Delany, Sept. 9, 2009, at p. 9; *see* e-mail from Craig M. Delany, JPMorgan, to Mike Cavanagh, JPMorgan, *et al.* (Sept. 14, 2008) [JPM-2004 0025947] (noting that analysis "[a]ssumes all tss market values are correct mid market valuations" and that "[t]his may NOT be a good assumption for collateral priced by the collateral provider").

[4334] Examiner's Interview of Craig M. Delany, Sept. 9, 2009, at p. 9 n.11.

made clear that JPMorgan did not agree with the values in BDAS, citing RACERS as an example.[4335]

(m) Lehman Requests for Return of Collateral

Lehman sought the return of some of its collateral between September 10 and September 15. On September 10, for example, Lehman advised JPMorgan that Lehman would request that $1.3 billion of its cash collateral be returned in connection with discussions about separately securing LBIE's $2 billion line of credit.[4336] Lehman believed it was overcollateralized with JPMorgan,[4337] insisting that it had excess securities in both its U.S. and U.K. clearance accounts and that the value of these securities, coupled with the $3 billion in cash Lehman posted, exceeded $4 billion (the amount Tonucci allegedly assured JPMorgan that Lehman would post).[4338] At the time, Lehman had the impression that JPMorgan's "requests for collateral (more top-ups) [were] somewhat arbitrary and also that the collateral valuation [was] arbitrary, which [caused] some confusion/mistrust."[4339] JPMorgan ultimately determined that the

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[4335] *Id.* at p. 9.

[4336] JPMorgan Second Written Responses, at p. 3; e-mail from Mark G. Doctoroff, JPMorgan, to Donna Dellosso, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0032684].

[4337] E-mail from Mark G. Doctoroff, JPMorgan, to Donna Dellosso, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0032684].

[4338] JPMorgan Second Written Responses, at p. 3; e-mail from Donna Dellosso, JPMorgan, to Steven D. Black, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0006377] ("After speaking with LEH's Treasurer, we have confirmed that they will maintain collateral of $4bln to cover intra-day exposure."). Note that Black stated that Lehman agreed to post $3 billion collateral immediately on September 9 and top up to $5 billion (not $4 billion) collateral shortly thereafter. Examiner's Interview of Steven D. Black, Sept. 23, 2009, at pp. 8-9.

[4339] E-mail from Mark G. Doctoroff, JPMorgan, to Donna Dellosso, JPMorgan, *et al.* (Sept. 11, 2008) [JPM-2004 0061651].

collateral posted under the September Agreements was needed to cover the LBIE $2 billion line (among other things).[4340] Thus, that collateral was not returned.

On September 12, JPMorgan released nearly $1 billion of the Pine CLO back to Lehman upon Lehman's request.[4341] Although JPMorgan initially agreed to release Pine on the condition that Lehman replace it with cash,[4342] Pine was ultimately released without any provision of additional cash.[4343] Through counsel, JPMorgan explained that the conditions for the release of that collateral changed once Lehman posted the full $5 billion JPMorgan had requested on September 11.[4344] JPMorgan's counsel also stated that Lehman operationally could have removed Pine from LCE without asking JPMorgan first, and that Lehman likely made the request, rather than effecting the transfer itself, as a matter of relationship management.[4345]

[4340] JPMorgan Second Written Responses, at p. 3.

[4341] E-mail from Edward J. Corral, JPMorgan, to Michael A. Mego, JPMorgan, *et al*. (Sept. 12, 2008) [JPM-EXAMINER00005961] ("Let the CLO go."); e-mail from Michael A. Mego, JPMorgan, to Mark G. Doctoroff, JPMorgan, *et al.* (Sept. 12, 2008) [JPM-EXAMINER00005936] ("Lehman Brothers is looking to Release $1 billion from the $6.2 billion held on their LCE account."); e-mail from Edward J. Corral, JPMorgan, to Jane Buyers-Russo, JPMorgan (Sept. 12, 2008) [JPM-2004 0033023] ("JBR, my gut tells me to let Lehman do what they want here. We have so heavily discounted the value of this security (one of the CLOs), that we (JPM) isn't giving much up."); e-mail from Michael A. Mego, JPMorgan, to Ray Stancil, JPMorgan, *et al*. (Sept. 12, 2008) [JPM-2004 0050888] ("Lehman wants to release CUSIP # 722490AA7 for $1,000,000,000."); JPMorgan Second Written Responses, at p. 10.

[4342] E-mail from Henry E. Steuart, JPMorgan, to Jon Ciciola, JPMorgan, *et al.* (Sept. 12, 2008) [JPM-EXAMINER00005961] (stating conditions for agreement including JPMorgan wanting "to receive the face value of the CLO ($1.025B) back in cash"); e-mail from Mark G. Doctoroff, JPMorgan, to Edward J. Corral, JPMorgan, *et al*. (Sept. 12, 2008) [JPM-2004 0032972].

[4343] Examiner's Interview of Edward J. Corral, Sept. 30, 2009, at p. 11 (Corral was not aware of any condition attached to the release of the Pine CLO); JPMorgan Second Written Responses, at p. 10.

[4344] JPMorgan Second Written Responses, at p. 10.

[4345] Jenner & Block, Memorandum re November 18, 2009 Teleconference with JPMorgan Counsel (Nov. 19, 2009), at p. 2.

In addition, on September 12, Lehman requested that JPMorgan release $600 million of the approximately $1 billion of corporate bond collateral that JPMorgan was still holding so that Lehman could fund part of JPMorgan's $5 billion collateral request.[4346] JPMorgan agreed to do this and, by the end of the day, all of these corporate bonds that JPMorgan was still holding at the time were released back to Lehman.[4347]

There is also evidence to suggest that after the close of business on Friday, September 12, Lehman sought the return of its $5 billion in collateral posted in response to JPMorgan's September 11 request. Tonucci reported to Lowitt at 6:10 p.m. that Lehman may end up long in its account with JPMorgan.[4348] When Lowitt asked if JPMorgan would release cash to Lehman that night, Tonucci replied that it was too late to get cash that night, but that JPMorgan should release cash on Monday (September 15).[4349]

In addition, on the evening of September 12, there were conversations within Lehman about the need to pressure JPMorgan to return collateral, including with

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[4346] JPMorgan Second Written Responses, at p. 3; e-mail from Mark G. Doctoroff, JPMorgan, to Jane Buyers-Russo, JPMorgan (Sept. 12, 2008) [JPM-2004 0050446].

[4347] JPMorgan's Second Written Responses, at p. 3; e-mail from Edward J. Corral, JPMorgan, to Mark G. Doctoroff, JPMorgan, *et al.* (Sept. 12, 2008) [JPM-2004 0050913]; e-mail from Lika Vaivao, JPMorgan, to Karen M. Sharf, JPMorgan, *et al.* (Sept. 12, 2008) [JPM-EXAMINER00006236]; Examiner's Interview of Mark G. Doctoroff, Apr. 29, 2009, at p. 23; Examiner's Interview of Edward J. Corral, Sept. 30, 2009, at p. 12; Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 9. *Compare* Lehman, Collateral Pledged to JPM for Intraday As of 9/10/2008 COB [LBEX-DOCID 046681] (showing corporate bonds pledged), *with* Lehman, Collateral Pledged to JPM for Intraday As of 9/12/2008 COB [LBEX-DOCID 046684] (no longer showing corporate bonds pledged).

[4348] E-mail from Paolo R. Tonucci, Lehman, to Ian T. Lowitt, Lehman (Sept. 12, 2008) [LBEX-DOCID 3331070].

[4349] E-mail chain between Paolo R. Tonucci, Lehman, and Ian T. Lowitt, Lehman (Sept. 12, 2008) [LBEX-DOCID 3331070].

assistance from the FRBNY.[4350] Then-President of the FRBNY, Timothy Geithner, did contact Dimon about concerns surrounding JPMorgan's collateral requests. Dimon insisted, however, that Geithner was merely reporting what he had heard, rather than having those concerns himself.[4351] In addition, Steven Berkenfeld, Head of the Legal, Compliance, and Audit Division at Lehman Brothers, stated that on the afternoon of September 14 he participated in a call between Dimon and several Lehman executives in which Dimon expressed sympathy that LBHI would be filing for bankruptcy and that he wished JPMorgan could assist further. Berkenfeld replied to Dimon that the decision to file for bankruptcy was not yet made, and that JPMorgan could assist by returning Lehman's collateral.[4352] According to Berkenfeld, Dimon then left the call without responding to Berkenfeld, and the call ended.[4353]

The Examiner is not aware of any written request or notice by Lehman to JPMorgan for return of collateral pursuant to the September Agreements. It is clear, however, that by the end of the weekend of September 13 to 14, Lehman had made

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[4350] E-mail from Michael Gelband, Lehman, to Herbert H. (Bart) McDade III, Lehman (Sept. 12, 2008) [LBEX-AM 001337].

[4351] Examiner's Interview of Jamie L. Dimon, Sept. 29, 2009, at pp. 8-9.

[4352] Examiner's Interview of Steven Berkenfeld, Oct. 5 & 7, 2009, at p. 21. Although Lowitt recalled speaking to Dimon with Berkenfeld on September 14, Lowitt stated that the call was not about collateral. Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 21.

[4353] Examiner's Interview of Steven Berkenfeld, Oct. 5 & 7, 2009, at p. 21. At 8:31 p.m. on that same day, September 14, Berkenfeld sent an e-mail directly to Stephen Cutler, JPMorgan's General Counsel, titled "Urgent - Need to speak to you as soon as possible" that read: "It is extremely important and could have devastating consequences if we do not resolve it tonight." E-mail from Steven Berkenfeld, Lehman, to Stephen M. Cutler, JPMorgan (Sept. 14, 2008) [JPM-2004 0047020]. The e-mail, however, does not specify what Berkenfeld needed to speak to Cutler about, and came at a frantic time just hours before LBHI declared bankruptcy. *See id*.

several calls to JPMorgan requesting the return of collateral,[4354] and that JPMorgan had not responded by the time LBHI filed for bankruptcy.[4355]

(2) Analysis of Potential Claims

After receiving substantial evidence from the interested parties, the Examiner has analyzed a number of potential common-law claims arising out of the facts discussed above. The Examiner has not attempted to analyze all conceivable claims and has excluded, for example, potential claims that appeared particularly weak on their face.

This Section of the Report focuses on several possible common law claims relating to JPMorgan's collateral demands.[4356] The Examiner's legal analysis is based on his review of documents and interviews of Lehman and JPMorgan witnesses.[4357] Formal

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[4354] E-mail from Ian T. Lowitt, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (Sept. 14, 2008) [LBEX-AM 5640836] (At 5:18 p.m., Lowitt wrote, "Can you press jpm to get our cash back?"); e-mail from Ian T. Lowitt, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (Sept. 14, 2008) [LBEX-AM 5640835] (At 9:21 p.m., Lowitt followed up with an e-mail titled "Where do we stand getting cash from chase?" and asks if Tonucci or Berkenfeld had spoken to "jane," presumably Buyers-Russo).

[4355] *See* e-mail from Heidi Miller, JPMorgan, to Jamie L. Dimon, JPMorgan, *et al.* (Sept. 15, 2008) [JPM-2004 0006510] ("[W]e need to talk this morning about the calls Leh has been making about having us return a portion of our excess collateral to their holding co."); e-mail from Heidi Miller, JPMorgan, to Matthew E. Zames, JPMorgan, *et al.* (Sept. 15, 2008) [JPM-2004 0029748] (Miller explained that Lehman had "a full court press on to get us to release"); e-mail from Barry L. Zubrow, JPMorgan, to Heidi Miller, JPMorgan, *et al.* (Sept. 15, 2008) [JPM-2004 0068975] ("We have to make sure that we do not allow LEH to suck our collateral away from us thru these different requests."); e-mail from Jane Buyers-Russo, JPMorgan, to Heidi Miller, JPMorgan, *et al.* (Sept. 15, 2008) [JPM-2004 0029748] ("I am of the opinion we should not give any collateral back to Lehman if we are going to continue to operate for them.").

[4356] See Section III.B below for a discussion of potential avoidance and preference actions. See Section III.C below for a discussion of potential claims against JPMorgan arising out of the Barclays transaction.

[4357] In addition to the many witness interviews conducted and documents reviewed by the Examiner, the Examiner sought and obtained information from Alvarez & Marsal, counsel for the Debtors, counsel for JPMorgan, and counsel for the Creditors' Committee relating to the issues discussed in this Section of the Report.

discovery between the parties could lead to additional evidence that could materially affect the legal analysis of these claims.

This Section of the Report discusses the following common-law theories under which the September Agreements between Lehman and JPMorgan could be deemed invalid: economic duress, lack of consideration, lack of authority and fraudulent inducement. In addition, this Section discusses theories of breach of the September Agreements and the implied covenant of good faith and fair dealing, assuming the agreements are enforceable.[4358]

(a) The Evidence Does Not Support a Colorable Claim Against JPMorgan for Economic Duress

The evidence available to the Examiner does not support a colorable claim that the agreements Lehman executed with JPMorgan in September 2008 are invalid due to economic duress.[4359]

(i) Legal Background: Economic Duress

Under New York law, "[a] contract may be voided and a party may recover damages 'when it establishes that it was compelled to agree to the contract terms because of a wrongful threat by the other party which precluded the exercise of its free will.'"[4360] The Examiner has analyzed the available evidence to determine if the

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[4358] The Examiner is not aware of any plausible common law claim to invalidate the August Agreements between Lehman and JPMorgan and thus does not address that issue.

[4359] For a discussion of the September Agreements, see Section III.A.5.b.1 of this Report.

[4360] *Madey v. Carman*, 858 N.Y.S.2d 784, 786 (App. Div. 2008) (quoting *805 Third Ave. Co. v. M.W. Realty Assocs.*, 448 N.E.2d 445, 447 (N.Y. 1983)).

following elements of economic duress are present: "(1) a threat, (2) which was unlawfully made, and (3) caused involuntary acceptance of contract terms, (4) because the circumstances permitted no other alternative."[4361]

The burden on a party seeking to invalidate a contract on grounds of economic duress is formidable.[4362] "This is so regardless of evidence that one side enjoyed a decided economic advantage over the other at the moment the agreements were executed."[4363] The burden is particularly difficult to meet where, as here, the parties involved are sophisticated entities represented by both in-house and outside counsel. Significantly, "to establish a claim of economic duress, a sophisticated party must do more than merely claim that the other party knew about and used his or her poor financial condition to obtain an advantage in contract negotiations. Rather, the plaintiff must demonstrate that the defendant's actions deprived him of his free will, and that the ordinary remedy of an action for breach of contract would not be adequate."[4364]

(ii) There Is No Available Evidence of an Express Unlawful Threat Made by JPMorgan in Connection With the Formation of the September Agreements

The September Agreements were negotiated and executed by the parties under an atmosphere that was rushed, and JPMorgan had considerable leverage over Lehman.

[4361] *Kamerman v. Steinberg*, 891 F.2d 424, 431 (2d Cir. 1989) (quoting *Gulf & W. Corp. v. Craftique Prods., Inc.*, 523 F. Supp. 603, 610 (S.D.N.Y. 1981)).

[4362] *Davis & Assocs., Inc. v. Health Mgmt. Servs., Inc.*, 168 F. Supp. 2d 109, 114 (S.D.N.Y. 2001) ("The party seeking to void" an agreement "on grounds of economic duress shoulders a heavy burden." (internal quotation marks and citation omitted)).

[4363] *Id.* (internal quotation marks and citation omitted).

[4364] *Id.* (internal quotation marks and citation omitted).

Lehman's stock price was plummeting and reports had surfaced that at least one of its major survival strategies, involving KDB, had fallen through.[4365] Lehman could ill afford to challenge its primary clearing bank in the face of intense market pressures, and any attempt to change clearing banks overnight, when Lehman was attempting to restore market confidence, would have been exceedingly difficult if not impossible. The negotiation of the agreements occurred literally overnight, at a time when senior Lehman executives were engaged in an evaluation of survival strategies and how to approach a critical earnings call the next morning.[4366] Nevertheless, JPMorgan's substantial leverage and pressure on Lehman to sign the agreements by the morning are not sufficient under New York law to invalidate the agreements due to economic duress.

Rather, evidence of an actual and wrongful threat made by JPMorgan is a necessary element of any claim against JPMorgan for economic duress. The Examiner has found no evidence of an explicit threat by JPMorgan, much less a wrongful explicit threat. Key Lehman witnesses each denied that any JPMorgan employee made an express threat to them during the negotiation of the September Agreements.[4367] And Yeung, Fleming and Tonucci, as well as Lehman's outside counsel, Hespel, were each

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[4365] *See* Section III.A.3.c.5.b of this Report, which discusses Lehman's potential deal with KDB.

[4366] *See supra* at Section III.A.5.b.1.i.

[4367] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4; Examiner's Interview of Paul W. Hespel, Apr. 23, 2009, at p. 7; Examiner's Interview of Daniel J. Fleming, Apr. 22, 2009, at p. 7; Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 15.

questioned by the Examiner on the issue.[4368] The Examiner finds this testimony particularly credible given the absence of any discussion of a JPMorgan threat in any contemporaneous *internal* Lehman correspondence related to the September Agreements. Had such a threat been made, someone at Lehman, either at the time of the negotiations or when questioned by the Examiner, would have identified the threat and its effect on Lehman's actions.

Although the Examiner places much less weight on after-the-fact statements made when the parties were contemplating litigation, Dimon, Inaba and Doctoroff all denied that any JPMorgan employee made any threats to Lehman in connection with the negotiation of the September Agreements. However, Dellosso stated that if Lehman had not signed the September Agreements, it would have been difficult for JPMorgan to extend credit to and continue being supportive of Lehman. She stated that she recalled discussing being supportive and "extending credit" with Tonucci.[4369] Significantly, however, Tonucci did not recall Dellosso ever threatening him that JPMorgan would stop advancing credit if the September Agreements were not put in place.[4370] To the contrary, Tonucci stated he believed JPMorgan would have continued to clear for

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[4368] Yeung and Hespel were Lehman's counsel who negotiated the agreements directly with JPMorgan; their only direct business contact at Lehman that evening was Fleming, as Lowitt and Tonucci did not check their e-mails that evening. *See supra* Section III.A.5.b.1.i.

[4369] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 9.

[4370] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 15.

Lehman even if Lehman had refused to execute the September Agreements.[4371] There is also no evidence that Tonucci directed others at Lehman to proceed with the agreements because of an express threat by JPMorgan.

In addition, "[t]he threatened exercise of a legal right cannot constitute duress."[4372] Even before September 9, under the agreement governing the clearance arrangement between Lehman and JPMorgan (including the amendments made pursuant to the August Agreements), the decision to advance credit was wholly within JPMorgan's discretion.[4373]

As noted above, there is little doubt that Lehman was experiencing extraordinary economic difficulty and that JPMorgan's provision of clearing services was particularly crucial to Lehman at the time. Economic difficulty, however, even in the exceptional circumstances confronted by Lehman, is not sufficient by itself to establish economic duress. "Duress may 'take the form of unlawful restraint of property or use of wrongful economic compulsion to force a party to yield to demands that would otherwise be rejected,' but it 'may not be found merely from the existence of a difficult bargaining position or the pressure of financial circumstances.'"[4374] The testimony of

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[4371] *Id.*

[4372] *Marine Midland Bank v. Stukey*, 427 N.Y.S.2d 123, 123 (App. Div. 1980); *Kamerman*, 891 F.2d at 432.

[4373] Clearance Agreement (June 7, 2000), at p. 4 [JPM-2004 0031786] (Section 5 provides that JPMorgan "may at any time decline to extend such credit at [its] discretion, with notice"). This remained so even after the August Amendments to the Clearance Agreement.

[4374] *Del Turco v. BRB Ceramic Tiles Marble & Stone*, 03 CV 1516(JG), 2006 U.S. Dist. LEXIS 61390, at *17 (E.D.N.Y. Aug. 18, 2006) (quoting *McIntosh v. Consolidated Edison Co.*, No. 96-3624, 1999 WL 1511102, at *2 (S.D.N.Y. Mar. 19, 1999)).

Lehman witnesses that there was no direct threat, and the absence of any mention of such a threat in Lehman's internal e-mails during the negotiation, lead the Examiner to conclude there is no colorable claim that the September Agreements are invalid due to economic duress.

(iii) The Available Evidence Suggests JPMorgan Did Not Have an Improper Purpose

In the context of a claim of economic duress, a threat can be considered wrongful or unlawfully made when motivated by an improper purpose.[4375] Nevertheless, the threatened exercise of a legal right does not generally constitute an improper purpose.[4376]

Some courts applying New York law have suggested that to establish a claim of business or economic duress, improper purposes "may be accomplished through lawful means . . . if they are used to trade upon the victim's poor financial condition with the improper purpose of securing personal advantage."[4377] "A necessary element of [this] type of business compulsion, however, is a showing that the victim's financial straits

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[4375] *See* 28 Williston on Contracts § 78:13 (4th ed. 2009).

[4376] *Marine Midland Bank*, 427 N.Y.S.2d at 123 ("The threatened exercise of a legal right cannot constitute duress."); *Kamerman*, 891 F.2d at 432 (same).

[4377] *US West Fin. Servs., Inc. v. Tollman*, 786 F. Supp. 333, 338 (S.D.N.Y. 1992) (*quoting Nat. Am. Corp. v. Fed. Republic of Nigeria*, 448 F. Supp. 622, 644 (S.D.N.Y. 1978), *aff'd*, 597 F.2d 314 (2d Cir. 1979)). In *US West*, Judge Mukasey found that a bank requiring a guaranty from an investor group did not cause the financial distress of the investor group even though the bank knew of the investor group's precarious financial condition and the bank's actions "may have further destabilized" the investor group's financial condition. *Id.* at 339-340.

were caused by the other party."[4378] Thus, even under this view, Lehman would have to demonstrate that its underlying financial straits had been caused by JPMorgan. There is no credible basis to conclude that prior to September 9, JPMorgan was the cause of Lehman's financial straits.

Furthermore, by September 9 Lehman's creditors had a reasonable basis for concern as to whether Lehman would default on its obligations.[4379] JPMorgan had witnessed how rapidly Bear Stearns had declined, and JPMorgan executives had analyzed and expressed serious concerns with Lehman's survival plans.[4380] For example, JPMorgan was concerned about the viability of Lehman's SpinCo proposal, which had been discussed at a September 4 meeting involving JPMorgan and Lehman executives.[4381] JPMorgan similarly expressed concerns about presentations that Lehman prepared for the rating agencies, including Lehman's presentation of survival strategies.[4382]

In addition, JPMorgan's Investment Bank Risk Committee met on September 5 and reviewed the exposure of JPMorgan's Investment Bank to Lehman. At that time, JPMorgan had a primary exposure to Lehman of $2.645 billion, the largest component

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[4378] *Id*. at 338.

[4379] *See* Section III.A.3 of this Report, which discusses Lehman's survival strategies, and Appendix 15 of this Report, which discusses the events of the week of September 8, 2008.

[4380] *See id.*

[4381] *See* Section III.A.5.b.1 of this Report.

[4382] Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at p. 7; *see* e-mail from Barry L. Zubrow, JPMorgan, to Mark G. Doctoroff, JPMorgan, *et al.* (Sept. 5, 2008) [JPM-2004 0006286].

of which was a $1.904 billion derivatives exposure.[4383] Several JPMorgan witnesses focused on JPMorgan's derivative exposure as the key factor motivating the September 9 collateral request.[4384] Moreover, on September 9, public reports surfaced stating that KDB had abandoned (or was likely to abandon) its acquisition talks with Lehman.[4385] As an apparent result, Lehman's stock had dropped significantly.[4386]

Furthermore, the FRBNY had been discussing with JPMorgan for months the need for better protection against a broker-dealer failure.[4387] The fact that other banks were demanding more protection from Lehman at the same time further demonstrates

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[4383] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at pp. 6-7; JPMorgan, IBRC Presentation, Overview of Debt Maturities for Major US Broker Dealers (Sept. 5, 2008), at p. 6 [JPM-EXAMINER00005998].

[4384] Examiner's Interview of Barry L. Zubrow, Sept. 17, 2009, at pp. 9-11; Examiner's Interview of John J. Hogan, Sept. 17, 2009, at p. 4.

[4385] Francesco Guerrera, *et al.*, *Equities Suffer as Lehman Shares Fall 45%*, FT.com, Sept. 9, 2008 ("Lehman's shares fell after a newswire report cited an unnamed Korean government official as saying that Korea Development Bank, a state-run lender, had decided not to invest in Lehman."); Susanne Craig, *et al.*, *Korean Remarks Hit Lehman*, Wall St. J., Sept. 9, 2008; *see also supra* at Section III.A.3.c.5.b.

[4386] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 11; Examiner's Interview of Donna Dellosso, Feb. 27, 2009, at p. 4; *Lehman Drops 45%*; Wall St. J., Sept. 10, 2008; Susanne Craig, *et al.*, *Korean Remarks Hit Lehman*, Wall St. J., Sept. 9, 2008.

[4387] *See, e.g.*, e-mail from Janet Birney, Lehman, to Daniel J. Fleming, Lehman, *et al.* (Feb. 26, 2008) [LBEX-DOCID 280175] ("The recent market turmoil has prompted the Fed to question JPMC on the viability of Triparty financing in the event of a broker dealer default."); e-mail from Janet Birney, Lehman, to Daniel J. Fleming, Lehman, *et al.* (May 5, 2008) [LBEX-DOCID 065656] (JPMorgan reevaluation of risk associated with Triparty financing "prompted by discussions with the FED"); e-mail from Lucinda Brickler, FRBNY, to Timothy F. Geithner, FRBNY, *et al.* (July 16, 2008) [FRBNY to Exam. 034046] (attaching "talking points" the FRBNY developed for a July 17, 2008 meeting with "Dimon and Kelly regarding near-term measures to enhance the stability of the triparty repo market"); Talking Points, at p. 1 [FRBNY to Exam. 034047] (noting "[i]n the event of the default of a large borrower, the potential for systemic risk to materialize co[u]ld be reduced").

that there was overall market concern with Lehman's viability, and that it was not improper for JPMorgan to seek greater security.[4388]

The Examiner concludes that there is insufficient evidence to support a colorable claim that JPMorgan had an improper purpose in seeking the September Agreements.[4389]

(iv) There Was a Degree of Negotiation Over the Terms of the September Agreements

Lehman counsel Hespel and Yeung suggested that, for all practical purposes, JPMorgan dictated the material terms of the September Agreements.[4390] Even if there had been no meaningful negotiation, there is no colorable claim of economic duress because the Examiner has found no evidence of an explicit and wrongful threat. That conclusion is further supported by the evidence of a limited negotiation between the parties.

During the overnight negotiations of the September Agreements, JPMorgan agreed to certain changes proposed by Yeung, including (a) changing the language regarding additional collateral from "obligations" to "requests"; (b) agreeing to remove performance obligations of Lehman subsidiaries; and (c) agreeing to remove reference

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[4388] *See* Sections III.A.5.c and III.A.5.d of this Report, which discuss Lehman's dealings with Citi and HSBC, respectively.

[4389] Whether JPMorgan truly "needed" the full amount of collateral it demanded on September 9 and September 11 is a different question, but the Examiner concludes that JPMorgan had a legitimate basis for seeking additional protection in the form of the September Agreements.

[4390] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 5; Examiner's Interview of Paul W. Hespel, Apr. 23, 2009, at p. 6.

to Lehman's affiliates in the Amendment to the Clearance Agreement.[4391] The change to the Amendment to the Clearance Agreement is of note because JPMorgan had originally rejected this proposed change at 3:11 a.m. on September 10.[4392] When asked by the Examiner about the degree of negotiation of the agreements, JPMorgan counsel Inaba pointed to the deletion of these references as one of the points of negotiation between the parties.[4393]

The negotiation never reached the point of Lehman fully testing whether JPMorgan might yield on the core issues, such as the expansion of the agreements to cover all Lehman liabilities of any type. Yeung made some effort to confirm with Lehman business managers whether Lehman had actually agreed in principle to expand the agreements to cover all Lehman liabilities. Yeung did not, however, recommend to senior executives that Lehman resist the proposed terms or escalate any issues to senior JPMorgan executives. Whether or not JPMorgan would have agreed to remove terms that expanded the agreements to cover all liabilities if Lehman had escalated the dispute, Lehman's failure to push the issue and fully test JPMorgan's

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[4391] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 5; Examiner's Interview of Gail Inaba, Apr. 28, 2009, at p. 7.

[4392] E-mail from Nikki G. Appel, JPMorgan, to Andrew Yeung, Lehman, *et al*. (Sept. 10, 2008) [JPM-2004 0001997] (Appel told Yeung that JPMorgan had reviewed Lehman's proposed changes to the Amendment to the Clearance Agreement and JPMorgan requested "that the scope of the amendment stay unchanged.").

[4393] Examiner's Interview of Gail Inaba, Apr. 28, 2009, at p. 7.

resolve – knowing JPMorgan had agreed to at least some changes Lehman requested – creates yet another significant hurdle to a viable claim of economic duress.[4394]

(b) There Is Insufficient Evidence to Support a Colorable Claim That the September Agreements Are Invalid for Lack of Consideration

The Examiner concludes that there is insufficient evidence to support a colorable claim against JPMorgan to invalidate or rescind the September Agreements for lack of consideration.[4395] Consideration is "either a benefit to the promisor *or* a detriment to the promisee."[4396] "Failure of consideration gives the disappointed party the right to rescind the contract."[4397] By New York statute, however, a contract modification "shall not be invalid because of the absence of consideration, provided that the [modification] agreement . . . shall be in writing and signed by the party against whom it is sought to enforce the . . . modification . . . or by his agent."[4398]

The September Amendment to the Clearance Agreement is a modification to an existing contract (that is, the 2000 Clearance Agreement), in writing, and signed by both Lehman and JPMorgan. It therefore requires no additional consideration.[4399]

[4394] *See* Section III.A.5.b.1 of this Report, which notes that JPMorgan agreed to at least some of the changes that Lehman requested to current drafts.

[4395] *See* Section III.B.3.g of this Report.

[4396] *Holt v. Feigenbaum*, 419 N.E.2d 332, 336 (N.Y. 1981).

[4397] *Fugelsang v. Fugelsang*, 517 N.Y.S.2d 176, 177 (App. Div. 1987).

[4398] N.Y. Gen. Oblig. Law § 5-1103 (2009); *see also Deutsche Bank Secs. Inc. v. Rhodes*, 578 F. Supp. 2d 652, 660 (S.D.N.Y. 2008).

[4399] *See* Amendment to Clearance Agreement (Sept. 9, 2008), at pp. 1-6 [JPM-2004 005861]. In addition, the September Amendment to the Clearance Agreement states that it was entered "for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged." *Id*.

The September Guaranty and the September Security Agreement, however, are best understood as new agreements. The September Guaranty explicitly states that it is "in addition to and does not replace that certain Guaranty dated August 26, 2008" made by LBHI.[4400] The September Security Agreement expressly references the September Guaranty, and includes a reference to the "Existing Security Agreement," that is, the August Security Agreement.[4401] The question thus arises whether the September Guaranty and Security Agreement are supported by consideration.

Both agreements contain recitations of consideration. The September Guaranty expressly notes:

> The Guarantor and each of the direct or indirect subsidiaries of the Guarantor . . . desires to transact business and/or trade with and/or enter into derivative transactions with and/or to obtain credit, clearing advances, clearing loans or other financial accommodation from the Bank and to continue such business, trading, derivative activity and/or such extensions of credit, clearing advances, clearing loans or other financial accommodation and *the Bank has requested that it receive the following guaranty of the undersigned before it will consider extending such credit*.[4402]

The September Security Agreement provides:

> In consideration of JPMORGAN CHASE BANK, N.A. or any of its affiliates, subsidiaries, successors and assigns . . . extending credit to and/or transacting business, trading or engaging in derivative transactions with the undersigned and/or its subsidiaries, the undersigned hereby

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[4400] Guaranty (Sept. 9, 2008), at p. 1 [JPM-2004 0005813].

[4401] Security Agreement (Sept. 9, 2008), at p. 1 [JPM-2004 0005873].

[4402] Guaranty (Sept. 9, 2008), at p. 1 [JPM-2004 0005813] (emphasis added) (the recitation of consideration states "for good and valuable consideration and in order to induce the Bank from time to time, to extend or continue to extend credit, clearing advances, clearing loans, or other financial accommodations to the Borrowers and/or to transact business, trade or enter into derivative transactions with the Borrowers.").

> agree(s) that the Bank shall have the rights, remedies and benefits hereinafter set forth.[4403]

Even when a contract includes a recitation of consideration, however, a party may use parol evidence to challenge that recitation.[4404] Having reviewed all available evidence, the Examiner concludes that there is no colorable claim that the September Agreements were not supported by sufficient consideration.

Although "[a] promise by one party to do that which he is already under a legal obligation to perform is insufficient as a consideration to support a contract,"[4405] an agreement to continue to act where there is no obligation to do so is proper consideration.[4406] The September Agreements are supported, *inter alia*, by JPMorgan's agreement to continue extending credit to Lehman. Under the Clearance Agreement, that extension of credit was discretionary.[4407] Buyers-Russo confirmed that JPMorgan considered ceasing or limiting credit extensions as an option if Lehman did not sign the

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[4403] Security Agreement (Sept. 9, 2008), at p. 1 [JPM-2004 0005873].

[4404] *See Diamond v. Scudder*, 845 N.Y.S.2d 452, 453-54 (App. Div. 2007); *see also Ehrlich v. Am. Moninger Greenhouse Mfg. Corp.*, 257 N.E.2d 890, 892 (N.Y. 1970) ("The recitation of receipt of consideration is a mere admission of a fact which, like all such admissions, may be explained or disputed by parol evidence." (citation and internal quotation marks omitted)).

[4405] *Carpenter v. Taylor*, 58 N.E. 53, 55 (N.Y. 1900); *see also Roth v. Isomed, Inc.*, 746 F. Supp. 316, 319 (S.D.N.Y. 1990).

[4406] *See Andre v. Gaines Berland, Inc.*, No. 95-10524, 1996 U.S. Dist. LEXIS 9383, at *6-7 (S.D.N.Y. July 8, 1996) (where "ongoing professional services relationship [was] terminable at-will," there was no obligation to continue providing such services and, thus, continued services constituted valid consideration for subsequent agreements); *see also* 3 WILLISTON ON CONTRACTS § 7:41 (4th ed.) ("If one is privileged to avoid a contractual duty or to refuse to perform under a contract, and promises to perform or does perform in consideration of the promise of some additional payment by another . . . the promise to perform or the actual performance is consideration . . . .").

[4407] Clearance Agreement (June 7, 2000), at p. 4 [JPM-2004 0031786].

September Agreements.[4408] Dellosso also recalled discussing the extension of credit with Tonucci in the context of the September Agreements.[4409] JPMorgan's agreement to continue extending discretionary credit to Lehman is sufficient consideration to support the September Agreements.[4410]

(c) There is Sufficient Evidence to Support the Existence of a Technical, But Not Colorable, Claim That the September Agreements Are Invalid for Lack of Authority

The Examiner concludes that there is sufficient evidence to support a technical claim that the September Agreements are invalid for lack of authority but that the claim is not colorable because of substantial evidence supporting defenses to such a claim, including that Lehman ratified the agreements when it posted collateral on September 12.

Tonucci, Lehman's Treasurer, signed the September Agreements on LBHI's behalf.[4411] However, under Lehman's Code of Authorities, an LBHI guaranty of a subsidiary's obligations – other than certain "Guaranteed Subsidiaries" – for over $500

[4408] Examiner's Interview of Jane Buyers-Russo, Sept. 25, 2009, at pp. 6-7. JPMorgan did in fact continue extending credit to Lehman in the days after the September Agreements were executed. For example, it continued to unwind Lehman's triparty repos. JPMorgan also extended discretionary credit when, after the execution of the September Agreements, it restored to LBIE a $2 billion line of credit. In addition, there is evidence that JPMorgan continued accepting novations from Lehman counterparties after September 9, even with rumors that others were abandoning Lehman. *See* e-mail from John J. Hogan, JPMorgan, to Donna Dellosso, JPMorgan, *et al*. (Sept. 12, 2008) [JPM-2004 0050952] (recognizing that JPMorgan was still "trading" with Lehman in that they were still allowing Lehman derivative credit).

[4409] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 9.

[4410] *See, e.g.*, *Weiss v. Weiss*, 41 N.Y.S.2d 777, 777 (App. Div. 1943) ("Performance by a promisee of an act which he is not obligated to perform, or the surrender by him of a privilege which he has the legal right to assert, is sufficient consideration for a promise . . . .").

[4411] *See* Security Agreement (Sept. 9, 2008), at p. 6 [JPM-2004 0005873]; Guaranty (Sept. 9, 2008), at p. 6 [JPM-2004 0005813]; Amendment to Clearance Agreement (Sept. 9, 2008), at p. 3 [JPM-2004 0005861].

million or an unspecified amount required the approval of LBHI's CEO, President, COO or CFO.[4412] LBI – one of the entities covered by the September Guaranty – was not a "Guaranteed Subsidiary."[4413] Notably, "[i]f the required approval [was] obtained, any proper officer of Holdings . . . [could] sign documents."[4414] Thus, for Tonucci to have had actual authority to sign the September Guaranty, the agreement had to have been approved by Lowitt or Fuld.

The Code of Authorities is less clear about Tonucci's authority to sign the September Security Agreement and Amendment to the Clearance Agreement.[4415]

[4412] LBHI & LBI, Amended and Restated Code of Authorities (July 1, 2004), at p. 7 [LBEX-AM 043802].

[4413] *See* Alvarez & Marsal, Responses to Questions for Alvarez & Marsal/Weil, Gotshal & Manges (Dec. 7, 2009), at p. 1.

[4414] LBHI & LBI, Amended and Restated Code of Authorities (July 1, 2004), at p. 2 [LBEX-AM 043802].

[4415] According to Alvarez & Marsal, the Amendment to the Clearance Agreement was governed by the "secured borrowings" provision of the Code of Authorities, which provided that "[a]ny secured borrowings (excluding any collateral arrangement authorized under the Trading Lines)" requires approval of the "CEO, President, COO, CFO, or Treasurer." LBHI & LBI, Amended & Restated Code of Authorities (July 1, 2004), at Ex. 6 [LBEX-AM 043802]; Alvarez & Marsal, Responses to Questions for Alvarez & Marsal/Weil, Gotshal & Manges (Dec. 7, 2009), at p. 2. It thus appears that Tonucci had actual authority to sign the Amendment to the Clearance Agreement. Alvarez & Marsal also stated that Lehman personnel evidently believed that the Security Agreement was governed by the "secured borrowings" provision as well, but stated no opinion as to whether this belief was correct. *See* Alvarez & Marsal, Responses to Questions for Alvarez & Marsal/Weil, Gotshal & Manges (Dec. 7, 2009), at p. 2. The Estate may argue that the September Agreements are so intertwined as to constitute a single agreement, and, thus, if one of the September Agreements is invalid, then they all must be. *See Tecorp Entm't Ltd. v. Heartbreakers, Inc.*, No. 209861, 2001 Mich. App. LEXIS 661, at *9-10 (Mich. Ct. App. Feb. 9, 2001) (per curiam) (affirming trial court's holding that, where management agreement was void ab initio because there was no meeting of the minds, asset purchase agreement was void ab initio given that agreements were interdependent). Agreements contained in separate documents are generally presumed to be separable in the absence of a clear indication that the parties intended otherwise. *See Nat. Union Fire Ins. Co. v. Clairmont*, 662 N.Y.S.2d 110, 112 (N.Y App. Div. 1997); *Ripley v. Int'l Rys. of Central Am.*, 171 N.E.2d 443, 446 (N.Y. 1960). "In determining whether contracts are separable or entire, the primary standard is the intent manifested, viewed in the surrounding circumstances." *Rudman v. Cowles Commc'ns, Inc.*, 280 N.E. 2d 867, 873 (N.Y. 1972). Although there may be a reasonable argument that the September Guaranty and Security Agreement are integrated given that, for example, both documents were executed by LBHI and the Security Agreement incorporated the Guaranty's definition of "Liabilities," *see* Security

Yeung, Lehman's counsel, did not differentiate among the September Agreements and explained that they all required Lowitt's approval.[4416] Yet, somewhat inconsistently, he also noted that the August agreements were executed in a "typical" fashion, with Tonucci signing the Amendment to the Clearance Agreement and Security Agreement, and Lowitt signing the Guaranty, per Lehman's Code of Authorities.[4417]

According to JPMorgan's Donna Dellosso, Tonucci informed her on the evening of September 9 that the agreements had to be approved by Lowitt, who was sleeping at the time. Tonucci also informed the Examiner that Buyers-Russo called him on the night of September 9 to inquire whether Lowitt had reviewed the agreements.[4418] According to Tonucci, Lowitt had not reviewed the agreements – he had left Lehman's headquarters earlier that evening to rest in advance of the following morning's earnings call, which Lowitt would lead, and was likely asleep at the time of Buyers-Russo's call.

Agreement (Sept. 9, 2008), at p. 1 [JPM-2004 0005873], an argument that the Amendment to the Clearance Agreement is integrated with the other September Agreements is weaker. The Amendment to the Clearance Agreement, for example, was executed by several Lehman parties in addition to LBHI. *See* Amendment to the Clearance Agreement (Sept. 9, 2008), at pp. 1-3 [JPM-2004 0005861]. It also modifies an already existing standalone agreement – the Clearance Agreement – that was not intertwined with the September Security Agreement and Guaranty. In addition, while New York courts have suggested that a breach of one agreement may be a breach of another agreement with which it is interrelated, *see, e.g.*, *Rudman*, 280 N.E.2d at 873, the Examiner is unaware of any case under New York law in which the invalidity of one agreement requires the invalidity of another agreement with which it is interrelated but that is not subject to the same infirmity. This issue, of course, is not relevant if JPMorgan is able to establish that Tonucci acted with apparent authority or that Lehman ratified the September Guaranty.

[4416] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 5.

[4417] *Id*. at p. 3.

[4418] Tonucci may have confused a phone call with Dellosso for one with Buyers-Russo.

Tonucci recalled that although Buyers-Russo asked Tonucci to wake up Lowitt, Tonucci did not do so.[4419]

Lowitt spoke with Tonucci about the September Agreements after the earnings call on September 10 (and thus *after* they were signed). Lowitt did not recall whether he communicated with anyone about the agreements prior to that point.[4420] Tonucci relayed to Lowitt that JPMorgan had wanted Lowitt to sign the agreements the night before, but that Tonucci had decided not to bother Lowitt.[4421] Thus, the available evidence suggests that Lowitt had not approved of the September Agreements before Tonucci signed them.[4422]

Lowitt told the Examiner that he had no questions about Tonucci's authority to sign the agreements, citing the fact that even though JPMorgan wanted Lowitt to sign,

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[4419] Doctoroff stated that he called Fleming between 10:00 and 11:00 p.m. on September 9 at the direction of Dellosso to tell Fleming to wake Lowitt up. Examiner's Interview of Mark G. Doctoroff, Apr. 29, 2009, at p. 19.

[4420] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at pp. 19-20. Yeung did e-mail Lowitt that evening, but Lowitt did not respond. Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4; *see also* e-mail from Paul W. Hespel, Goodwin Procter, to Jeffrey Aronson, JPMorgan (Sept. 10, 2008) [LBEX-AM 039572] (forwarding Lehman comments on draft Guaranty and Security Agreement to JPMorgan, copying Lowitt).

[4421] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 19.

[4422] Notably, despite Lowitt's lack of approval of the September Agreements with JPMorgan before they were executed, Lowitt had approved an amendment to Lehman's Guaranty with Citi on September 9. E-mail from Paolo R. Tonucci, Lehman, to Emil R. Cornejo, Lehman (Sept. 9, 2008) [LBEX-AM 008564] (reporting that Lowitt signed Lehman's Guaranty amendment with Citi); Amendment 1 to Guaranty (Sept. 9, 2008) [LBEX-DOCID 4263143] (executed amendment with Lowitt's signature). Indeed, Lowitt was told that he was "required to sign" the Guaranty amendment with Citi. E-mail from Emil F. Cornejo, Lehman, to Ian T. Lowitt, Lehman, et al. (Sept. 9, 2008) [LBEX-AM 008571].

JPMorgan had accepted Tonucci's signature.[4423] Fuld denied knowing about the agreements until after Lehman filed for bankruptcy, [4424] although there is evidence that the agreements were based at least in part on a high-level agreement reached between Fuld and JPMorgan's Steven Black.[4425]

(i) Tonucci May Have Acted With Apparent Authority

Assuming that Tonucci lacked actual authority to sign the September Guaranty, he may have acted with apparent authority. Apparent authority is established by the words or conduct of the principal, *i.e.*, Lehman, vis-à-vis the third party, *i.e.*, JPMorgan.[4426] Apparent authority "arises when a principal places an agent in a position where it appears that the agent has certain powers which he may or may not possess. If a third person holds the reasonable belief that the agent was acting within the scope of his authority and changes his position in reliance on the agent's act, the principal is estopped to deny that the agent's act was not authorized."[4427] Formulated slightly differently, "a principal may be estopped from denying apparent authority if (1) the principal's intentional or negligent acts, including acts of omission, created an appearance of authority in the agent, (2) on which a third party reasonably and in good

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[4423] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 19. This reasoning is not relevant to a legal analysis of apparent authority, but does reflect Lowitt's personal views.
[4424] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at pp. 15-16.
[4425] *See supra* at Section III.A.5.b.1.h.
[4426] *See Fennell v. TLB Kent Co.*, 865 F.2d 498, 502 (2d Cir. 1989).
[4427] *Gen. Overseas Films, Ltd. v. Robin Int'l, Inc.*, 542 F. Supp. 684, 688-89 (S.D.N.Y. 1982) (citation and internal quotation marks omitted).

faith relied and (3) such reliance resulted in a detrimental change in position on the part of the third party."[4428]

Under New York law, in the apparent authority context, a duty of inquiry arises when "(1) the facts and circumstances are such as to put the third party on inquiry, (2) the transaction is extraordinary, or (3) the novelty of the transaction alerts the third party to a danger of fraud."[4429] The duty of inquiry is an "alternative way of asking whether reliance was reasonable."[4430] The question whether JPMorgan reasonably relied on Tonucci's apparent authority is essentially a question of fact.[4431]

There are disputed issues of fact on the issue of apparent authority. JPMorgan, on the one hand, can point to the fact that at the conclusion of negotiations, Yeung e-mailed JPMorgan counsel and reported that he had sent the agreements "on to our executive officers for their final approval and signature."[4432] Later, Fleming e-mailed Doctoroff and informed him that "Andrew [was] on his way . . . to pick up signed docs from Paolo/Ian."[4433] As noted above, Paolo Tonucci, as LBHI's Vice President and Global Treasurer, signed the agreements on LBHI's behalf. The fact that JPMorgan sent the agreements to Lehman's counsel, who returned them signed by Tonucci – coupled

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[4428] *Minskoff v. Am. Express Travel Related Servs. Co.*, 98 F.3d 703, 708 (2d Cir. 1996).
[4429] *FDIC v. Providence Coll.*, 115 F.3d 136, 141 (2d Cir. 1997).
[4430] *Providence Coll.*, 115 F.3d at 142.
[4431] *See C.E. Towers Co. v. Trinidad & Tobago (BWIA Int'l) Airways Corp.*, 903 F. Supp. 515, 524 (S.D.N.Y. 1995).
[4432] E-mail from Andrew Yeung, Lehman, to Gail Inaba, JPMorgan, *et al*. (Sept. 10, 2008) [JPM-2004 0002032].
[4433] E-mail from Daniel J. Fleming, Lehman, to Mark Doctoroff, JPMorgan (Sept. 10, 2008) [LBEX-DOCID 457582].

with Tonucci's title – could establish that JPMorgan reasonably relied on Tonucci's apparent authority.[4434] In addition, the fact that Tonucci signed the August Amendment to the Clearance Agreement and Security Agreement further bolsters his apparent authority to sign analogous agreements in September.[4435] Moreover, the statements that the agreements had been sent to the "executive officers for their final approval" and that the signed documents were being picked up from "Paolo/Ian," and not just "Paolo," could have led to a reasonable conclusion by JPMorgan that Lowitt had approved of the agreements, even though they were signed by Tonucci. (JPMorgan counsel Appel stated to the Examiner that JPMorgan relied on "apparent authority" as to the September Agreements, but the Examiner places little weight on this after-the-fact statement at a time when litigation was contemplated between JPMorgan and Lehman.[4436] Appel further explained that JPMorgan generally did not require regular customers to provide certification of authority.)[4437]

The Estate and Creditors Committee, on the other hand, can point to the fact that JPMorgan apparently knew that Lowitt had to approve the agreements but was asleep on the night of September 9. Indeed, JPMorgan encouraged Tonucci to wake Lowitt, but did not pursue the inquiry to determine if Lehman had done so and obtained

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[4434] *Cf. C.E. Towers Co.*, 903 F. Supp. at 524.

[4435] *See Indosuez Int'l Fin. B.V. v. Nat'l Reserve Bank*, 774 N.E.2d 696, 700-01 (N.Y. 2002) (third-party's reliance on apparent authority was reasonable where agent executed similar agreements on behalf of principal in past).

[4436] Examiner's Interview of Nikki G. Appel, Sept. 11, 2009, at p. 6.

[4437] *See id.*

Lowitt's approval. JPMorgan was also aware that it was Lowitt, not Tonucci, who had signed the August Guaranty.[4438] JPMorgan may therefore have been under a duty to conduct further inquiries concerning Tonucci's authority.[4439]

(ii) There Is Substantial Evidence That Lehman Ratified the September Agreements

Ratification is "the express or implied adoption of acts of another by one for whom the other assumes to be acting but without authority."[4440] Consequently, "a principal may ratify and thereby become liable for the acts of an agent even if those acts were initially unauthorized."[4441] Whether express or implied, the principal's intent to ratify the unauthorized act "must be clearly established and may not be inferred from

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[4438] The Estate and Creditors Committee may also argue that Yeung's statements concerning approval of the agreements do not constitute actions by the "principal" because Yeung was not a senior executive.

[4439] *See Providence Coll.*, 115 F.3d at 141 (duty of inquiry arises when "the facts and circumstances are such as to put the third party on inquiry"); *Herbert Constr. Co. v. Continental Ins. Co.*, 931 F.2d 989, 996 (2d Cir. 1991) ("Apparent authority can exist only as long as the third person, to whom the principal has made a manifestation of authority, continues reasonably to believe that the agent is authorized." (citation and internal quotation mark omitted)); *Scientific Holding Co. v. Plessey Inc.*, 510 F.2d 15, 24 (2d Cir. 1974) ("a person with notice of a limitation which has been placed on an agent's authority cannot subject the principal to liability upon a transaction with the agent if he knows or should know that it is outside the scope of the agent's authority"). Among other factors relevant to the issue of inquiry notice is whether the underlying transaction was "extraordinary." *Providence Coll.*, 115 F.3d at 141. Although courts have held the guaranty of a debt of an unrelated corporation to be "extraordinary" and, thus, sufficient to trigger the duty of inquiry, *see, e.g.*, *Gen. Overseas Films*, 542 F. Supp. at 691, here, LBI and other Holdings' subsidiaries were far from unrelated to LBHI. Indeed, LBHI entered into a Guaranty on behalf of several subsidiaries (including LBI) just a few weeks earlier. Nevertheless, expansion of the agreements to extend to all Lehman liabilities, as part of an overnight negotiation and at a time when Lehman was rapidly deteriorating, could be viewed as "extraordinary." *Cf. Gen. Overseas Films, Ltd. v. Robin Int'l, Inc.*, 542 F. Supp. 684, 691 (S.D.N.Y. 1982) (extraordinary transaction where corporate treasurer executed agreement to guarantee debt of unrelated corporation).

[4440] *Prisco v. New York*, 804 F. Supp. 518, 523 (S.D.N.Y. 1992); *see also Hamm v. United States*, 483 F.3d 135, 140 (2d Cir. 2007).

[4441] *Prisco*, 804 F. Supp. at 523.

doubtful or equivocal acts or language."[4442] In order for a ratification to be effective, the individual ratifying an unauthorized contract must have been able to authorize the contract originally.[4443] In other words, only those individuals who could have originally authorized a certain contract or act on behalf of the corporation can ratify it after it has been made without authority or performed.[4444] The question of ratification is a question of fact.[4445]

A principal ratifies an act by manifesting assent or by conduct that justifies a reasonable assumption that the principal consents to becoming subject to the legal consequences of the act.[4446] Lehman received a notice from JPMorgan on September 11 explicitly requesting funds to "be held by JPMorgan as collateral under the Security Agreement, dated September 9, between [LBHI] and JPMorgan."[4447] JPMorgan initially sent the notice to Tonucci, who forwarded it to Lowitt.[4448] On September 12, Lehman

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[4442] *Holm v. C.M.P. Sheet Metal, Inc.*, 455 N.Y.S.2d 429, 432 (App. Div. 1982).

[4443] *N.Y. State Med. Transporters Ass'n, Inc. v. Perales*, 566 N.E.2d 134, 138 (N.Y. 1990) (citing RESTATEMENT (SECOND) OF AGENCY § 84(2) (1958)).

[4444] *Schwab v. E.G. Potter Co.*, 87 N.E. 670, 673 (N.Y. 1909); *Aronoff v. Albanese*, 446 N.Y.S.2d 368, 370 (App. Div. 1982); *see also* 11 William Meade Fletcher et al., Fletcher Cyclopedia of the Law of Corporations § 763 (rev. vol. 2009) ("[T]he president or other like officer of a corporation may ratify a contract that he or she has authority to make; but an unauthorized contract . . . cannot be binding on the corporation, even though it has been ratified by both the president and secretary, if they themselves possessed no power to enter such a contract.").

[4445] *See In re Nigeria Charter Flights Contract Litig.*, 520 F. Supp. 2d 447, 466 (E.D.N.Y. 2007).

[4446] RESTATEMENT (THIRD) OF AGENCY § 4.01 (2009).

[4447] E-mail from Jane Buyers-Russo, JPMorgan, to Paolo R. Tonucci, Lehman (Sept. 11, 2008) [JPM-2004 0005411] (September 11, 2008 Notice attachment).

[4448] E-mail from Paolo R. Tonucci, Lehman, to Ian T. Lowitt, Lehman (Sept. 12, 2008) [LBEX-DOCID 036127].

pledged $5 billion in cash collateral in response. Such affirmative conduct, in and of itself, suggests that Lehman intended to be bound by the September Agreements.

Ratification can also occur "when the principal, upon learning of an unauthorized act of its agent, acquiesces in, or affirms that act through his conduct by retaining any benefits of the compromise."[4449] As discussed above, the September Agreements allowed Lehman to continue to receive credit from JPMorgan. Lehman continued to take advantage of JPMorgan's extensions of credit after the agreements were signed, and posted collateral pursuant to those agreements in order to continue receiving such credit. [4450]

Not only did Lehman explicitly perform under the September Agreements, but the Examiner is aware of no instance in which Lehman sought to repudiate the September Agreements due to concerns over Tonucci's authority to sign them. Upon learning on September 10 that Tonucci had signed the September Agreements, Lowitt took no action to repudiate them.[4451] Failure to repudiate is considered evidence from which ratification may be inferred,[4452] and will often support a presumption of

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[4449] *Marnell v. Carbo*, 499 F. Supp. 2d 202, 208 (N.D.N.Y. 2007) (citation and internal quotation mark omitted).

[4450] The September notice stated, "[i]f JPMorgan does not receive such monies by opening of business tomorrow . . . we intend to exercise our right to decline to extend credit to you under the [Clearance Agreement]." E-mail from Jane Buyers-Russo, JPMorgan, to Paolo R. Tonucci, Lehman (Sept. 11, 2008) [JPM-2004 0005411] (September 11, 2008 Notice attachment).

[4451] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 19.

[4452] 2A N.Y. Jur. 2d *Agency* § 197 (1979); *see also Suncoast Capital Corp. v. Global Intellicom, Inc.*, 719 N.Y.S.2d 652, 652 (App. Div. 2001) (where principal's attorney did not renounce stipulation when copy was faxed

ratification.[4453] In determining whether a principal's silence demonstrates a failure to repudiate, courts look to the relationship between the agent and the principal. The principal's silence is generally more significant where, as here, an agency relationship exists and the agent in the particular case has exceeded the delegated powers.[4454]

The principal performing an allegedly ratifying act generally must have knowledge of the material facts of the unauthorized contract.[4455] While Fuld and Lowitt arguably may not have had full knowledge of the material facts of the September Agreements at the time of the September 12 pledge,[4456] they cannot avoid the effect of ratification if they were in a position to learn those facts at that time.[4457] A principal "having once ratified its agents' acts, cannot afterwards avoid the effect of such ratification by showing that it was not acquainted with all of the facts of the transactions ratified, when it was always in a position and was in possession of means of learning them."[4458] Lowitt knew that the September Agreements had been signed as of

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to him immediately upon execution, and only renounced it six months later in response to a motion to enforce, such silence constituted ratification of agent's authority).

[4453] *Agency*, § 197 (citing *Goldstein v. Tank*, 134 N.Y.S. 262, 264 (App. Div. 1912)).

[4454] *Id.* § 199 (1979) (citing *Merritt v. Bissell*, 50 N.E. 280 (N.Y. 1898)).

[4455] *See Perales*, 566 N.E.2d at 138 (1990); *Cooperative Agricole Groupement de Producteurs Bovins de L'Ouest v. Banesto Banking Corp.*, No. 86-8921, 1989 WL 82454, at *16 (S.D.N.Y. July 19, 1989) ("Ratification requires knowledge by the principal of the material facts of a transaction, coupled with the retention of benefits."), *aff'd*, 904 F.2d 35 (2d Cir. 1990).

[4456] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 3; Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at pp. 19-20; Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at pp. 13-14.

[4457] *See Orix Credit Alliance v. Phillips-Mahnen, Inc.*, No. 89-8376, 1993 WL 183766, at *5 (May 26, 1993) (a principal "may be deemed to have ratified the acts of an agent through silence when there is an opportunity to speak and, under the circumstances, a desire to repudiate would normally be expressed").

[4458] *Harvey v. J. P. Morgan & Co.*, 2 N.Y.S.2d 520, 531 (N.Y. Mun. Ct. 1937), *rev'd on other grounds*, 25 N.Y.S.2d 636 (N.Y. App. Term 1938) (per curiam).

September 10;[4459] he clearly was in a position to read the agreements himself or confer with others more familiar with them.

Despite this evidence of ratification, the Estate could argue that Lehman did not have adequate time in which to knowingly ratify or repudiate the September Agreements given that Lehman filed for bankruptcy shortly after the agreements were executed.[4460] Although a principal does have a "reasonable time"[4461] to repudiate, Lehman did more than simply remain silent or tacitly acquiesce after the September Agreements were executed; it had knowledge of the agreements and, instead of repudiating them, affirmatively acted under them. Finally, if Lehman ratified the agreements by posting collateral in response to the September 11 request, any later repudiation would be ineffective; once ratified, an act is as binding as if it had been originally authorized by the principal.[4462] Accordingly, the Examiner concludes that a claim to invalidate the September Agreements based on a lack of authority is not colorable in light of substantial evidence of apparent authority and/or ratification.

[4459] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 19.

[4460] In addition, JPMorgan terminated the Clearance Agreement as to LBI on September 22, 2008. Letter from Edward J. Corral, JPMorgan, to Paolo R. Tonucci, Lehman, re: termination of Clearance Agreement (Sept. 22, 2008), at p. 1 [LBEX-DOCID 088860].

[4461] *See, e.g.*, *Merex A.G. v. Fairchild Weston Sys., Inc.*, 810 F. Supp. 1356, 1370-71 (S.D.N.Y. 1993).

[4462] *See Hamm*, 483 F.3d at 140.

(d) There Is Insufficient Evidence to Support a Colorable Claim That JPMorgan Fraudulently Induced the September Agreements

The Examiner concludes that there is insufficient evidence to support a colorable claim that JPMorgan fraudulently induced the September Agreements when Inaba told Yeung in the midst of their negotiation that an agreement in principle had already been reached by senior management at Lehman and JPMorgan.[4463]

Under New York law, a fraud claim has five elements: "(1) a material misrepresentation or omission of fact (2) made by defendant with knowledge of its falsity (3) and intent to defraud; (4) reasonable reliance on the part of the plaintiff; and (5) resulting damage to the plaintiff."[4464]

As recounted above, if Inaba's statement was true, that would of course defeat a claim of fraud. Regardless of the outcome of that disputed issue of fact, however, it does not appear that Yeung in fact relied on Inaba's statement or reasonably could have. When Inaba told Yeung about the alleged agreement, Yeung said he would confirm Inaba's understanding with Lehman's "business guys."[4465] Yeung e-mailed Lowitt, Tonucci and others, identifying issues of concern in the draft agreements and seeking to

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[4463] Yeung recalled that Inaba relayed that the terms of the September Agreements had been agreed upon by Steven Black and Richard Fuld. Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4. Inaba recalled that she advised Yeung that the September Agreements were agreed to in principle by very senior management, but did not recall whether she mentioned Black and Fuld specifically. Examiner's Interview of Gail Inaba, Apr. 28, 2009, at p. 7.

[4464] *Fierro v. Gallucci*, No. 06-5189, 2008 WL 2039545, at *7 (E.D.N.Y. May 12, 2008) (citations and internal quotation marks omitted).

[4465] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4.

confirm their understanding.[4466] It is therefore clear that Yeung did not solely rely on JPMorgan's representation as to the alleged executive-level understanding. Fleming responded by instructing Yeung to proceed as if Lehman would ultimately agree to all of JPMorgan's proposed terms.[4467] This evidence establishes that despite Inaba's representation, Yeung sought business-side approval of key terms and was instructed by Fleming to proceed.

Moreover, even if Yeung had relied on Inaba's statement, that reliance would not have been reasonable.[4468] The Examiner does not believe it would be reasonable for counsel negotiating a major agreement to accept the representation of the counterparty that critical terms had already been agreed to by the client, without at least confirming that representation with the client. This is not a case in which the critical facts – whether a lawyer's own client had consented to the terms of an agreement – were in the sole possession of the counterparty or otherwise inaccessible to the party claiming fraudulent inducement. There is insufficient evidence to support a colorable claim for fraudulent inducement because it would not have been reasonable for Lehman to have

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[4466] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4; Examiner's Interview of Andrew Yeung, May 14, 2009, at p. 9.

[4467] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4. Yeung stated that Fleming confirmed to Yeung that the September Agreements had already been agreed to, but that Yeung responded that he would review the agreements and comment on them nonetheless. Examiner's Interview of Andrew Yeung, May 14, 2009, at p. 9.

[4468] *See Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 737 (2d Cir. 1984) ("Where sophisticated businessmen engaged in major transactions enjoy access to critical information, but fail to take advantage of that access, New York courts are particularly disinclined to entertain claims of justifiable reliance.").

relied without verification on a general statement by JPMorgan that Lehman had previously consented to the proposed terms, and because Lehman did not in fact rely on such a representation.

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Next, the Examiner analyzes claims arising under the September Agreements – assuming that they are, in fact, enforceable – based on JPMorgan's collateral demands and failure to return collateral to Lehman in its final week.

(e) There Is Insufficient Evidence to Support a Colorable Claim for Breach of Contract of the September Agreements Based on JPMorgan's Refusal to Return Collateral

After considering all available evidence, the Examiner concludes that there is insufficient evidence to support a colorable claim against JPMorgan for breach of contract for failure to return collateral to Lehman.

(i) Legal Background: Contractual Obligations Under September Agreements

From the period of February 26 to September 11, 2008, JPMorgan made a number of collateral requests to Lehman pursuant to the 2000 Clearance Agreement and amendments thereto, the August and September Guaranties, and the August and September Security Agreements. By the close of business on Friday, September 12,

2008, Lehman had posted collateral totaling nearly $17 billion as a result of these requests.[4469]

The three dominant collateral components were (i) JPMorgan's clearing-related margin requirements aggregating to roughly $8 billion during 2008, (ii) JPMorgan's request of $5 billion on September 9, 2008, primarily relating to the exposure of its Investment Bank to Lehman entities and (iii) JPMorgan's request for $5 billion cash on September 11, 2008. Derivative termination risk (that is, the risk that the non-defaulting party will not be properly compensated by posted collateral) was the dominant factor of the September 9 collateral request.[4470] Primary elements of the September 11 request were a perceived deficit in Lehman's fulfillment of the earlier September 9 request and JPMorgan's determination that collateral in the form of securities it had already received was valued inappropriately or otherwise constituted inappropriate collateral.[4471]

The Examiner has considered whether there is a colorable claim that JPMorgan breached any of the September agreements by refusing to return to Lehman collateral that JPMorgan was not entitled to retain. The Examiner is not aware of any requests by Lehman for return of allegedly "excess" collateral prior to the execution of the

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[4469] E-mail from Edward J. Corral, JPMorgan, to Michael A. Mego, JPMorgan (Sept. 12, 2008) [JPM-2004 0050402]. As discussed in Section III.A.5.b.1 above, the value of the collateral is disputed.
[4470] *See supra* at Section III.A.5.b.1.g.
[4471] *See supra* at Section III.A.5.b.1.g.

September Agreements.[4472] Thus, while the Examiner provides a description of the evolving contractual landscape between Lehman and JPMorgan during the period from February 2008 until September 15, 2008, the most relevant set of contractual obligations for JPMorgan are those established by the September Agreements.

(1) February 2008 to August 26, 2008. Between February 2008 and the execution of the August Agreements, JPMorgan and Lehman were bound by the terms of the 2000 Clearance Agreement. Under that agreement, JPMorgan agreed to act as Lehman's "non-exclusive clearance agent for securities transactions."[4473]

To accomplish this purpose, Section 3 of the Clearance Agreement authorized JPMorgan:

> (a) to receive and transfer securities for any purpose whatsoever, including, without limitation, as a pledge of collateral; (b) to make payments and collections of monies; (c) to permit [Lehman] to make transfers between the Clearing Account(s), Custody Account(s) and the Segregated Account(s) or other accounts, it being understood that we shall only permit transfers from the Clearing Account(s) to the Custody Account(s) or Segregated Account(s) to the extent that after such transfer we remain fully collateralized; have been fully paid with respect to any securities being transferred into the Segregated Account(s) or other accounts; and (d) to transfer securities which we hold for [Lehman] as such securities may be needed to secure loans with such entities as [Lehman] may specify; (e) to receive from such entities as [Lehman] may specify securities held as collateral for loans against the payment of funds

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[4472] When asked by the Examiner, Alvarez & Marsal and counsel for JPMorgan were not able to identify any evidence of requests by Lehman for return of allegedly "excess" collateral prior to the execution of the September Agreements. The Examiner is aware of certain collateral movements, however, such as the removal of Freedom from LCD on August 15 and the transfer of Kingfisher from LCE to LCD on September 2.

[4473] Clearance Agreement (June 7, 2000), at p. 1 [JPM-2004 0031786].

> required to obtain the release of [Lehman's] collateral; (f) to perform any other act incidental or necessary to the performance of the above.[4474]

This contractual provision enabled JPMorgan to clear triparty repurchase transactions for Lehman. In doing so, JPMorgan reserved the following right: "All credits to the Account in connection with triparty repo transactions and physical securities, regardless of how characterized, are conditioned upon the actual receipt of final payment and may be reversed to the extent payment is not received."[4475] Further, under the same Section 4(d), JPMorgan could credit the Clearing Account with proceeds from sales from triparty repurchase prior to actual receipt of final payment (*e.g.*, "immediately available" or "same day" funds). JPMorgan had the discretion but not the obligation to allow Lehman to use any such funds prior to final payment.[4476]

Importantly, under Section 5, while JPMorgan could – solely at its discretion – advance or loan Lehman funds, the 2000 Clearance Agreement emphasized JPMorgan's right to decline credit: "Notwithstanding the fact that we may from time to time make advances or loans pursuant to this paragraph or otherwise extend credit to you, whether or not as a regular pattern, we may at any time decline to extend such credit at our discretion, with notice and if we are precluded from extending such credit as a result of any law, regulation or applicable ruling."[4477]

[4474] *Id.* at pp. 1-2 (§ 3).
[4475] *Id.* at p. 3 (§ 4(d)).
[4476] *See id*.
[4477] *Id.* at p. 4 (§ 5).

The 2000 Clearance Agreement provided several liens to JPMorgan "in consideration of any advances or loans [JPMorgan] may extend to [Lehman] pursuant to this Agreement."[4478] Specifically, Section 11 of the Clearance Agreement provided:

- a continuing security interest, lien upon and right of a setoff as to all collateral;
- if any advances or loans are outstanding at the end of a business day, a right to, with notice to Lehman, carry any collateral in JPMorgan's general account and to sell, transfer, assign, pledge, re-pledge, hypothecate and re-hypothecate any collateral;
- if any advances or loans are not re-paid, the right to sell collateral;
- the ability to maintain that all collateral is in its "possession" and under its "control" unless and until JPMorgan receives full and final payment for advances or loans;
- no denial of JPMorgan's status as a bona fide purchaser of all or part of any collateral;
- status as securities intermediary with respect to any securities accounts maintained with JPMorgan, which entitles JPMorgan to a priority lien over all property maintained in such accounts pursuant to Section 8-106(e).[4479]

Thus, in operation, the 2000 Clearance Agreement provided a framework for clearance services, including triparty repos, which enabled JPMorgan to provide "same day" and "immediately available" loans or advances to Lehman, and in return conferred liens on Lehman accounts with respect to such advances or loans.

This Agreement, as amended by the parties, was the operative contractual framework prior to the execution of the August Agreements.

[4478] *Id*. at pp. 12 (§ 11).

[4479] *See id*. at pp. 12-14 (§ 11).

(2) August Agreements. The operative contractual framework was modified by the three August Agreements.

The August Amendment to the Clearance Agreement expanded the reach of the 2000 Clearance Agreement by (1) adding several Lehman entities (LBHI, LBIE, LB OTD Derivatives and LBJI); and (2) including a provision clarifying that liability was several and not joint for all Lehman entities under the Clearance Agreement.[4480]

The parties also executed Guaranty and Security Agreements. The Security Agreement included an "Overnight Account" provision to the effect that "[e]xcept as otherwise provided herein, at the end of a business day, if the undersigned has determined that no" advances or loans "remain outstanding, the [undersigned Lehman entities] may transfer to an account (the "Overnight Account") any and all Security held in or credited to or otherwise carried in their Accounts."[4481]

(3) September Agreements. Shortly after execution of the August Agreements, JPMorgan and Lehman once again executed a set of agreements that changed their contractual obligations.

As discussed above, the September 9 Amendment to the Clearance Agreement broadened the scope of the obligation in Section 11 of the Clearance Agreement, by

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[4480] Amendment to Clearance Agreement (Aug. 26, 2008), at p. 1 [JPM-2004 0005856]. LCPI had been added as a Customer in May. Amendment to Clearance Agreement (May 30, 2008), at p. 1 [JPM-2004 0085662].

[4481] Security Agreement (Aug. 26, 2008), at p. 3 [JPM-2004 0005867]. The Security Agreement was silent as to what type of account Lehman had the right of transfer.

replacing language that limited Section 11 to clearing-related advances and loans with the following:

> In consideration of any credit, advances, loans or other financial accommodations [JPMorgan] may extend to [Lehman] and in order to induce [JPMorgan] from time to time, in our discretion, to extend or continue to extend credit, clearing advances, clearing loans or other financial accommodations to any of the Customers and/or to transact business, trade or enter into derivative transactions with any of the Customers and as security for the payment of all of your existing or future indebtedness, obligations, and liabilities of any kind to [JPMorgan] including, without limitation, arising in connection with trades, derivative transactions, settlement of securities hereunder or any other business (hereinafter the "Obligations") you hereby:[4482]

The September Amendment to the Clearance Agreement thus greatly expanded the scope of "Obligations" from being limited to loans and advances specifically in connection with clearing services to encompassing any indebtedness or obligation *of any kind* with JPMorgan. This language significantly expanded the scope of JPMorgan's security liens.

In addition, the parties executed a Guaranty and a Security Agreement that likewise expanded the scope of JPMorgan's lien. For purposes of evaluating whether a colorable breach of contract claim exists, a few provisions are salient.

First, the Security Agreement states: "As security for the payment of all the Liabilities, the undersigned hereby grant(s) to the Bank a security interest in, and a

[4482] Amendment to Clearance Agreement (Sept. 9, 2008), at p. 1 [JPM-2004 0005861] (emphasis added).

general lien upon and/or right of set-off of, the Security."[4483] The Security Agreement incorporates the Guaranty's broad definition of "Liabilities," which includes "all obligations and liabilities of the Borrowers to the Bank of whatever nature" with the proviso that: "The Guarantor's maximum liability under this Guaranty shall be THREE BILLION DOLLARS ($3,000,000,000) or such greater amount that the Bank has requested from time to time as further security in support of this Guaranty."[4484] This last provision of the Guaranty is also consistent with a clause in the Security Agreement that states: "The undersigned acknowledges and agrees that the Bank may from time to time request further security or payments on account of any of the Liabilities."[4485]

The practical effect of this language was that JPMorgan could, under the September Agreements, make collateral requests to cover the broad definition of Liabilities.

The September Agreements also altered Lehman's ability to secure the return of collateral – and JPMorgan's contractual obligation to do so. The Security Agreement included a "three-day notice provision" for the return of a Security to Lehman:

> Notwithstanding anything provided for herein, the undersigned may upon *three days written notice* to the Bank transfer any Security, provided that the undersigned shall not transfer any Security if the Bank has exercised or been stayed or otherwise prohibited from exercising any of its rights under this Security Agreement or the Guaranty or in the event any

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[4483] Security Agreement (Sept. 9, 2008), at pp. 1-2 [JPM-2004 0005873].

[4484] Guaranty (Sept. 9, 2008), at pp. 1-2 [JPM-2004 00005813]. The Guaranty defines "Borrowers" as "the direct or indirect subsidiaries" of LBHI. *Id.* at p. 1.

[4485] Security Agreement (Sept. 9, 2008), at p. 5 [JPM-2004 0005873].

> DEFAULT has occurred and is continuing, in either case, prior to the end of the three day notice period and upon any such transfer in the security interest hereunder shall be released.[4486]

This meant that Lehman had to provide written notice three days in advance before it could attempt to require JPMorgan to transfer any security under the September Agreements.

(ii) There Was No Written Notice for Collateral Return

To invoke the right to access collateral under the September 2008 Security Agreement, Lehman would have needed, at a minimum, to provide JPMorgan with written notice for return of collateral.[4487] Lehman never provided any such written notice.

The Examiner is aware of a claim by Fuld that on a September 11 conference call between Fuld and Lowitt of Lehman and Black and Dimon of JPMorgan, there was some type of oral promise for the return of collateral. According to Fuld, Dimon promised that if Lehman would post $5 billion in additional collateral the next day,

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[4486] *Id*. at p. 3 (emphasis added).

[4487] The Examiner has considered whether providing notice might be regarded as futile. If a party understands that honoring a contractual notice requirement may be futile, there are at least some circumstances under which a party is relieved of that requirement. *24/7 Records, Inc. v. Sony Music Entm't Int'l*, 566 F. Supp. 2d 305, 313 (S.D.N.Y. 2008). That line of cases, however, requires that it be clear that the other party – in this case, JPMorgan – will not live up to its contractual obligations. The Examiner has not found any credible evidence to suggest that JPMorgan made clear that it would not have returned at least some collateral under any circumstances on three days' written notice. Indeed, there *is* evidence that JPMorgan returned some of Lehman's collateral. *See, e.g.*, e-mail from Edward J. Corral, JPMorgan, to Michael A. Mego, JPMorgan (September 12, 2008) [JPM-EXAMINER00005961] ("Let the CLO go."); Examiner's Interview of Edward J. Corral, Sept. 30, 2009, at p. 11.

JPMorgan would return that collateral at the end of that business day.[4488] Dimon denied knowledge of any such promise.[4489] The existence of such a promise is a disputed issue of fact, but an oral promise could not have modified the written notice requirement of the September 2008 Security Agreement. By their terms, the September Guaranty and Security Agreement provide that all modifications to their terms be in writing.[4490] Further, New York General Obligations Law § 15-301(1) reinforces these provisions, providing:

> A written agreement . . . which contains a provision to the effect that it cannot be changed orally, cannot be changed by an executory agreement unless such executory agreement is in writing and signed by the party against whom enforcement of the change is sought or by his agent.

Although there are some doctrinal exceptions to the statute – waiver, equitable estoppel and partial performance – none appears applicable here given that Lehman's actions (*i.e.*, pledging collateral) were consistent with the original agreements.[4491] Thus, a written modification would have been needed to satisfy the written notice requirement from the September Agreements.

[4488] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 14.

[4489] Examiner's Interview of Jamie L. Dimon, Sept. 29, 2009, at pp. 9-10.

[4490] Guaranty (Sept. 9, 2008), at p. 5 [JPM-2004 0005813] (Section 13 states: "No amendment or waiver of any provision of this Guaranty . . . shall be effective unless it is in writing and signed by the Bank, and then the waiver or consent shall be effective only in the specific instance and for the specific purpose for which given."); Security Agreement (Sept. 9, 2008), at p. 6 [JPM-2004 0005873] ("No provision hereof shall be modified or limited except by a written instrument expressly referred hereto and to the provision so modified or limited.").

[4491] *See* 22A N.Y. Jur. 2d *Contracts* § 486 (2009).

As noted above, the Examiner has not identified any such written request from Lehman to JPMorgan for the return of collateral. The Examiner specifically requested from JPMorgan, Alvarez & Marsal and the Creditors' Committee any evidence of any written requests, but none of those entities was aware of any written requests.[4492] Accordingly, and assuming the validity of the September Agreements, the Examiner concludes there is insufficient evidence to support a colorable claim that JPMorgan breached agreements with Lehman by refusing to return collateral to Lehman following the execution of the September Agreements.[4493]

(f) There Is Evidence to Support a Colorable, But Not Strong, Claim That JPMorgan Breached the Implied Covenant of Good Faith and Fair Dealing by Demanding Excessive Collateral in September 2008

The Examiner concludes that there is evidence to support a colorable claim that JPMorgan breached the implied covenant of good faith and fair dealing by making excessive collateral requests of Lehman during September 2008. The claim is not strong,

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[4492] There is some circumstantial evidence suggesting that at various times between September 11 and September 15, Lehman executives informally inquired about the return of collateral. *E.g.,* Examiner's Interview of Steven Berkenfeld, Oct. 5 & 7, 2009, at p. 21 (Berkenfeld stated that on a telephone call on the afternoon of September 14 he asked Dimon to return collateral); e-mail from Michael Gelband, Lehman, to Herbert H. (Bart) McDade III, Lehman (Sept. 12, 2008) [LBEX-AM 001337] (discussing the need to pressure JPMorgan for return of collateral). These requests are discussed in detail in Section III.A.5.b.1.m of this Report. The Examiner, however, has found no evidence that any of these informal requests were sent in written form as required by the September Agreements.

[4493] Notably, Lowitt told the Examiner that even if JPMorgan had agreed to return some collateral to Lehman, the larger issue for Lehman was that Lehman had lost enormous amounts of secured funding and the confidence of the market. Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at pp. 22-23.

however, because of evidence that the requests were reasonable and that Lehman waived any such claim by complying with the requests.

(i) Legal Standards Governing Implied Covenant of Good Faith and Fair Dealing

Under New York common law, implicit in every contract is the covenant of good faith and fair dealing.[4494] To succeed on a claim for breach of the covenant of good faith and fair dealing, a plaintiff must prove "1) fraud, 2) malice, 3) bad faith, 4) other intentional wrongdoing, or 5) reckless indifference to the rights of others such as gross negligence."[4495] Where a contract contemplates the exercise of discretion, the duty of good faith and fair dealing "includes a promise not to act arbitrarily or irrationally."[4496] However, a "party to a contract is allowed to act in its own self-interest consistent with its rights under the contract."[4497]

The plaintiff must show that the defendant's conduct infringed on the plaintiff's "actual rights or benefits embodied in the underlying contract,"[4498] and "[n]o obligation can be implied . . . which would be inconsistent with other terms of the contractual relationship."[4499] In addition, New York law "does not recognize a separate cause of

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[4494] *Cont'l Cas. Co. v. State of N.Y. Mortgage Agency*, No. 94 Civ. 8408, 1998 WL 513054, at *13 (S.D.N.Y. Aug. 18, 1998).

[4495] *Cont'l Cas.*, 1998 WL 513054, at *13 (internal citation and quotation mark omitted).

[4496] *Citibank v. United Subcontractors, Inc.*, 581 F. Supp. 2d 640, 645 (S.D.N.Y. 2008) (quoting *Dalton v. Educ. Testing Serv.*, 663 N.E.2d 289, 291 (N.Y. 1995)).

[4497] *Id*. at 646.

[4498] *Sch. Dist. of Erie v. J.P. Morgan Chase Bank*, Nos. 08 CV 07688, 08 CV 07982, 2009 WL 234128, at *5 (S.D.N.Y. Jan. 30, 2009).

[4499] *Murphy v. Am. Home Prods. Corp.*, 448 N.E.2d 86, 91 (N.Y. 1983).

action for breach of the implied covenant of good faith and fair dealing when a breach of contract claim, based on the same facts, is also pled."[4500] A claim for breach of the implied covenant "will be dismissed as redundant where the conduct allegedly violating the implied covenant is also the predicate for breach of covenant of an express provision of the underlying contract."[4501]

New York courts have allowed claims for breach of the duty of good faith and fair dealing to proceed where a plaintiff alleges that a bank has valued its secured position in bad faith. For example, in *CDO Plus Master Fund Ltd. v. Wachovia Bank, N.A.*,[4502] the court denied Wachovia's motion for judgment on the pleadings as to plaintiff's claim that Wachovia breached the implied covenant of good faith and fair dealing where the plaintiff alleged that Wachovia had acted "arbitrarily and irrationally" in its capacity as "Valuation Agent" under ISDA agreements between the parties.[4503] When the plaintiff challenged a collateral demand made by Wachovia,

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[4500] *CDO Plus Master Fund Ltd. v. Wachovia Bank, N.A.*, No. 07 Civ. 11078, 2009 U.S. Dist. LEXIS 59540, at *19 (S.D.N.Y. July 13, 2009) (quoting *Harris v. Provident Life & Accidental Ins. Co.*, 310 F.3d 73, 81 (2d Cir. 2002)).

[4501] *ICD Holdings S.A. v. Frankel*, 976 F. Supp. 234, 243-44 (S.D.N.Y. 1997) (quoting *Houbigant, Inc. v. ACB Mercantile, Inc. (In re Houbigant, Inc.)*, 914 F. Supp. 964, 989 (S.D.N.Y. 1995), *modified by* 914 F. Supp. 997 (S.D.N.Y. 1996)).

[4502] No. 07 Civ. 11078, 2009 U.S. Dist. LEXIS 59540 (S.D.N.Y. July 13, 2009).

[4503] *Id.* at *21-22; *see also Mallon Res. Corp. v. Midland Bank, PLC*, No. 96 Civ. 7458, 1997 U.S. Dist. LEXIS 10346, at *8 (S.D.N.Y. July 17, 1997) (denying motion to dismiss claim of breach of covenant of good faith and fair dealing where contract allowed defendant in its discretion to determine a "Borrowing Base" premised upon values assigned to plaintiff's assets, where plaintiff alleged that its business was successful and its reserves had substantially increased). Notably, however, the court held that the plaintiff failed to state a breach of contract claim based on Wachovia's collateral demands where the contract at issue "unambiguously provide[d] Wachovia with the right to make [collateral] demands" and

Wachovia, in its capacity as Valuation Agent, was required to recalculate its exposure.[4504] Wachovia confirmed the legitimacy of the collateral request and ultimately demanded that plaintiff post collateral in excess of the notional amount of the contract – a result that the plaintiff alleged was "absurd."[4505] The court held these allegations sufficient to state a claim for breach.[4506]

In addition, under N.Y. U.C.C. Law Section 1-203, JPMorgan had an obligation of good faith in its performance or enforcement of its various security agreements with Lehman.[4507] N.Y. U.C.C. Law Section 9-102, which applies to secured transactions, defines "[g]ood faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing."[4508] The second clause of this definition – "the observance of reasonable commercial standards of fair dealing" – establishes an objective standard for

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the plaintiff "complied with Wachovia's [collateral] demands on fourteen occasions without exercising its right . . . to challenge the . . . demands." *CDO Plus Master*, 2009 U.S. Dist. LEXIS 59540, at *15-17.

[4504] *CDO Plus Master*, 2009 U.S. Dist. LEXIS 59540, at *5-6.

[4505] *Id.* at *7, *21.

[4506] *Id.* at *22. The determination of good faith is generally a question of fact. *See Pernet v. Peabody Eng'g Corp.*, 248 N.Y.S.2d 132, 135 (App. Div. 1964).

[4507] N.Y. U.C.C. Section 1-208 also imposes an obligation to act in good faith in the request of additional collateral. The annotations to Section 1-208 refer to it "as an application of [Section] 1-203 which imposes a general obligation of good faith upon the parties in performing or enforcing obligations." N.Y. U.C.C. Law § 1-208 N.Y. annotations (McKinney's 2001).

[4508] N.Y. U.C.C. Law § 9-102(a)(43). This definition of "good faith" applies both under Section 1-203 and Section 1-208. The official comment to Revised Article 9 notes that Section 9-102's definition of "good faith" – which includes the objective consideration of "the observance of reasonable commercial standards of fair dealing" – applies "for purposes of the obligation of good faith imposed by Section 1-203." *Id.* § 9-102(a)(43) official cmt. 19. Section 1-208 cross-references Section 1-201, *id.* § 1-208 official cmt., which provides an alternate definition of "[g]ood faith" as "honesty in fact in the conduct or transaction concerned," *id.* § 1-201(19). This alternate definition of "good faith" provided in Section 1-201, however, is "[s]ubject to additional definitions contained in the subsequent Articles of this Act which are applicable to specific Articles or Parts thereof," including the definition of "good faith" provided in Section 9-102. *See id.* § 1-201. Thus, the definition of "good faith" provided in Section 9-102 would also control the obligations imposed by Section 1-208.

good faith, in addition to the requirement of "honesty in fact."[4509] Under the objective component of the standard, JPMorgan was required to observe reasonable commercial standards of fair dealing in the determination of its collateral demands from Lehman.

(ii) There Is Sufficient Evidence To Support a Colorable, But Not a Strong, Claim That JPMorgan Violated the Implied Covenant by Demanding Excessive Collateral

The September Guaranty provided that LBHI's "maximum liability under this Guaranty shall be THREE BILLION DOLLARS ($3,000,000,000) or such greater amount that *the Bank has requested from time to time as further security* in support of this Guaranty."[4510] The September Security Agreement, in turn, provided "that the Bank may from time to time request further security or payments on account of any of the Liabilities [including Liabilities as defined in the Guaranty]."[4511] As discussed in detail above,[4512] the definition of "Liabilities" in the Guaranty had been greatly expanded to

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[4509] *See Christie's Inc. v. Davis*, 247 F. Supp. 2d 414, 421 (S.D.N.Y. 2002) (applying Section 9-102 definition of "good faith" to reasonableness of presale valuations and noting that "the fact that of the 52 items of collateral that have been auctioned, only 9 sold for more than their high presale estimate, and most were well within the two estimates"); *see also Wawel Savings Bank v. Jersey Tractor Trailer Training, Inc. (In re Jersey Tractor Trailer Training, Inc.)*, 580 F.3d 147, 156 (3d Cir. 2009) (finding that identical definition of "good faith" under New Jersey U.C.C. provision governing secured transactions "has both a subjective prong – 'honesty in fact' – and an objective prong – observance of 'reasonable commercial standards of fair dealing'"); *Bank of Am., N.A. v. Prestige Imports,* 917 N.E.2d 207, 218 n.25 (Mass. App. Ct. 2009) (noting that Massachusetts' revision of U.C.C. definition of "good faith" to "honesty in fact and the observance of reasonable commercial standards of fair dealing" adds "an objective component to the previously subjective definition"); *Sunoco, Inc. (R & M) v. Honeywell Int'l Inc.*, No. 05CIV7984, 2006 WL 709202, at *6 (S.D.N.Y. Mar. 21, 2006) (observing that an almost-identical definition of "good faith" under the Pennsylvania Commercial Code "has a subjective and objective component").

[4510] Guaranty (Sept. 9, 2008), at p. 2 [JPM-2004 0005813] (emphasis added).

[4511] Security Agreement (Sept. 9, 2008), at p. 5 [JPM-2004 0084861].

[4512] *See supra* at Section III.A.5.b.2.e.i.

cover any type of Lehman obligation to JPMorgan and its affiliates.[4513] Thus, the September Agreements established that JPMorgan had the discretion to make additional collateral requests to cover any of its liabilities with Lehman, but the September Agreements did not expressly define how JPMorgan was to calculate its exposure. Under these circumstances, JPMorgan's discretion was limited by its common law duty to avoid acting in an arbitrary or irrational manner, and by its duty under the New York U.C.C. to exhibit honesty in fact while observing reasonable commercial standards of fair dealing.[4514]

It is standard in the industry to request and hold collateral with market value in excess of a loan amount.[4515] The Examiner is aware of no clear-cut definition, however, as to how much collateral cushion is "too much" – for example, at what point a bank's legitimate demands for self-protection in the face of uncertainties in exposure and valuation of existing collateral become arbitrary or irrational. A trier of fact would almost certainly require expert testimony as to objective standards of reasonable conduct in estimating exposure and assessing and valuing collateral.[4516]

[4513] Guaranty (Sept. 9, 2008), at p. 1 [JPM-2004 0005813].

[4514] *See supra* at Section III.A.5.b.2.f.i (discussing legal background).

[4515] *See* Current Issues: PDCF, at p. 2 (noting that clearing banks require collateral with a higher market value than the amount a lender can borrow).

[4516] In addition, the parties would likely seek to introduce studies or literature relevant to ascertaining typical industry practices as to capitalization, margin and collateral practices of clearing banks. *See, e.g.*, NewBank Working Group Report.

Based on testimony and evidence as to reasonable commercial practices in the industry, the trier of fact would then need to evaluate the reasonableness of JPMorgan's requests and whether JPMorgan had acted irrationally or arbitrarily – in addition to evaluating whether JPMorgan subjectively exhibited "honesty in fact."

There are sufficient competing facts for a trier of fact to resolve as to whether JPMorgan acted reasonably,[4517] and thus the Examiner concludes a colorable claim exists. Some of JPMorgan's own documents suggest that JPMorgan recognized it was overcollateralized during the days leading up to Lehman's bankruptcy. For example, JPMorgan's Ricardo Chiavenato prepared a series of analyses concerning JPMorgan's triparty-repo exposure that suggested that JPMorgan was sufficiently collateralized at least as of September 10, 2008.[4518] Starting on September 11, 2008, Craig Delany did the same.[4519] One version of Delany's analysis suggests that JPMorgan was overcollateralized by as much as $6.1 billion on September 12.[4520] These documents could be interpreted to suggest that JPMorgan understood it was more than adequately collateralized as to clearing risks.[4521]

[4517] The Examiner hereinafter uses the term "reasonably" as shorthand to encompass both the U.C.C. standard and the common law standard of good faith and fair dealing.

[4518] *See supra* at Section III.A.5.b.1.k.

[4519] *See supra* at Section III.A.5.b.1.l.

[4520] *See* JPMorgan, Spreadsheet, at p. 8 [JPM-2004 0029769].

[4521] In addition, an internal JPMorgan e-mail could be interpreted to suggest that JPMorgan believed it was overcollateralized as of September 15. *See* e-mail from Heidi Miller, JPMorgan, to Jamie Dimon, JPMorgan, *et al*. (Sept. 15, 2008) [JPM-2004 0006510] ("All we need to talk this morning about the calls Leh has been making about having us return a portion of our excess collateral to their holding co. We have

There is also substantial evidence to support a contention that JPMorgan's collateral requests were reasonable. First, both Chiavenato's and Delany's analyses accounted only for JPMorgan's triparty-repo exposure to Lehman. The September Agreements, however, expanded LBHI's obligations under the Guaranty and Security Agreement to all manner of liabilities between Lehman and JPMorgan. Thus the written analyses do not reflect JPMorgan's full range of exposures under the September Agreements.[4522] As discussed above, JPMorgan stated that it based the September 9 collateral request on its Investment Bank exposure – a request that Black characterized as "art, not science."[4523] Second, it was reasonable for JPMorgan to have taken into account Lehman's rapidly deteriorating financial condition and the risk of a Lehman failure. There is evidence, for example, suggesting that JPMorgan continued to accept novations from Lehman counterparties, and that novation requests were increasing over time.[4524] Ultimately, because the JPMorgan September 9 request was based on "art" and not science, a trier of fact will have to evaluate expert testimony and

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taken the position that their is no excess but they have not yet accepted that. We should make sure our statements are consistent since I am sure you will soon get called as well").

[4522] Several JPMorgan witnesses stated that JPMorgan could have justified a request for more collateral than JPMorgan ultimately demanded. *See supra* at Section III.A.5.b.1.g.

[4523] *See id.* Note, however, that Dellosso, in an internal e-mail, referred to the new collateral as covering intraday exposure. *See* e-mail from Donna Dellosso, JPMorgan, to Steven D. Black, JPMorgan, *et al.* (Sept. 10, 2008) [JPM-2004 0006377] ("[Lehman] will maintain collateral of $4bln to cover intra-day exposure."). JPMorgan's largest Investment Bank exposure to Lehman was in the form of derivative transactions. While Lehman and JPMorgan employed standard ISDA and credit support agreements to mitigate counterparty risk, each party still faced the risk that, in the event of a default, it would not be able to replace the defaulted trades at the previously understood market value. At the time of the September 9 collateral request, JPMorgan also had exposure due to its provision of a $2 billion credit line to LBIE. *See supra* at Section III.A.5.b.1.i.

[4524] *See supra* at Sections III.A.5.b.1.k & III.A.5.b.2.b.

determine whether the amount JPMorgan arrived at was consistent with reasonable commercial standards.

With respect to JPMorgan's September 11 collateral request, JPMorgan witnesses contend that the internal JPMorgan analyses discussed above, which imply overcollateralization, did not reflect JPMorgan's concerns with specific elements of the existing Lehman collateral. Chiavenato stated that his written analysis assumed the full face value of $3 billion for the "Fenway" commercial paper even though he knew that there was a problem with its valuation,[4525] and that his analysis did not account for dealer-pricing of collateral in the triparty shell.[4526] Delany similarly stressed that his analysis accepted all valuations of triparty-shell collateral in the BDAS system as accurate.[4527] In addition, as with the September 9 request, the reasonableness of the September 11 request must be analyzed in part based on Lehman's deteriorating position in the market.

[4525] As discussed above, Delany concluded that RACERS and Fenway were problematic because of their structure (commercial paper and short-term notes credit-enhanced by Lehman) and because of the illiquidity of the underlying assets. Delany concluded that RACERS and Fenway should be considered greatly devalued, far below their $8 billion assigned face value. *See supra* at Section III.A.5.b.1.l; *see also infra* Section III.A.5.c.1.c.ii (Citigroup witness characterized CLOs offered by Lehman to Citigroup – including Freedom, Spruce and Verano – as "bottom of the barrel" and "junk"). Because LBHI was the ultimate liquidity and credit provider for the Fenway securities, Fenway was effectively equivalent to Lehman short-term debt that would pay principal at maturity only if Lehman remained creditworthy. Stated differently, Fenway's value would drop precipitously upon a Lehman default, and it was not unreasonable for JPMorgan to have discounted its value as collateral.

[4526] *See supra* at Section III.A.5.b.1.k.

[4527] *See supra* at Section III.A.5.b.1.l.

Furthermore, there are disputed issues of fact concerning the impact of post-petition events, if any, on an analysis of the reasonableness of JPMorgan's collateral demands in the first instance.[4528] For example, according to JPMorgan, it has unpaid claims of $7.60 billion, against $7.14 billion of remaining cash and money market funds – suggesting it was undercollateralized, or at least that its collateral demands were reasonable.[4529] In addition, JPMorgan also holds "unliquidated securities collateral" separately pledged by LBHI, LCPI and LBI for which JPMorgan asserts the value is not currently determinable.[4530] The Examiner understands that the Estate contends the "unvalued collateral" is worth approximately $6 billion (and was worth that amount in September 2008), which would arguably imply that JPMorgan was more than $5 billion over-collateralized.[4531] Ultimately, however, the Examiner concludes that JPMorgan's assessment of its exposure on September 9 and September 11, and the factors and data JPMorgan considered at that time, are the most probative evidence of whether JPMorgan acted reasonably and honestly in making the September collateral requests.

[4528] The trier of fact will have to determine the probative value, if any, of evidence as to the effect of post-September 11 activity (such as liquidations and valuations) on the question whether the collateral requests were reasonable at the time they were made.

[4529] Duff & Phelps, Ex Post Evaluation and Claims of JPM Collateralization (Jan. 15, 2010), at p. 1. A trier of fact considering the probative value of these post-petition events would have to consider, among other things, the underlying validity of JPMorgan's post-petition claims (for example, whether JPMorgan is attempting to apply collateral to obligations that fall outside the scope of the September Guaranty), and the impact of intervening events after September 11 on the value of the collateral Lehman originally provided.

[4530] *Id.* at p. 1.

[4531] *Id.* at p. 2. In addition, JPMorgan continued to extend credit to Lehman the week of September 15, 2008, supported in part by collateral received from Lehman prior to September 15. Those events, including the involvement of the FRBNY, are discussed in Section III.A.6.

The different potential interpretations of this evidence and the necessity of establishing industry standards by expert testimony are sufficient to support the existence of a colorable claim as to the reasonableness of JPMorgan's September 2008 collateral requests.

(iii) A Trier of Fact Will Likely Have to Resolve a Waiver Defense

JPMorgan will likely raise a defense of waiver to any claim that JPMorgan breached its contractual obligations or duty of good faith and fair dealing in making the September 2008 collateral requests. Under New York law, "[i]t is well-established that where a party to an agreement has actual knowledge of another party's breach and continues to perform under and accepts the benefits of the contract, such continuing performance constitutes a waiver of the breach."[4532] JPMorgan will likely contend that Lehman not only acceded to the September requests by posting collateral, but that Lehman also enjoyed the benefits of its actions by continuing to receive discretionary credit from JPMorgan.

A recent New York decision, *VCG Special Opportunities Master Fund Ltd. v. Citibank, N.A. ("Citibank")*,[4533] applied the waiver doctrine to bar a claim of breach of the implied covenant of good faith and fair dealing. In that case, VCG entered into a credit

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[4532] *VCG Special Opportunities Master Fund Ltd. v. Citibank, N.A.*, 594 F. Supp. 2d 334, 342 (S.D.N.Y. 2008) (quoting *Nat'l Westminster Bank v. Ross, U.S.A.*, 130 B.R. 656, 675 (S.D.N.Y. 1991), *aff'd sub nom. Yaeger v. Nat'l Westminster*, 962 F.2d 1 (2d Cir. 1992)), *reconsideration denied,* No. 08-CV-01563, 2009 WL 311362 (S.D.N.Y. Jan. 29, 2009), *aff'd*, No. 08-5707-cv, 2009 WL 4576542 (2d Cir. Dec. 8, 2009).

[4533] 594 F. Supp. 2d 334.

default swap transaction with Citibank. Although the parties disagreed as to whether their contract allowed Citibank "to demand additional collateral (or 'variation margin') based upon a downward movement in the daily 'mark-to-market value' of the underlying reference obligation," Citibank demanded collateral from VCG four times over a span of weeks.[4534] While VCG delivered the collateral each time, VCG alleged that it questioned Citibank's evaluation of its credit risk under the transactions. VCG claimed that it delivered the sums out of fear that Citibank might use a refusal to deliver the collateral as a reason to declare a technical default under the agreements.[4535] The Court found VCG had waived its breach of contract claim, concluding that "[g]iven VCG's actual posting of the disputed credit support, and its receipt of Citibank's regular payments during this time, VCG cannot now claim that Citibank breached the CDS Contract by wrongly demanding additional collateral."[4536] The Court then applied the same reasoning to conclude that VCG had also waived its claim that Citibank breached the implied covenant of good faith and fair dealing.[4537]

JPMorgan could argue that Lehman similarly waived any breach of the implied covenant of good faith and fair dealing by posting collateral in response to JPMorgan's

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[4534] *Id.* at 338. The Court later stated that it disagreed with VCG's contract interpretation and noted that "[t]he Credit Support Annex allowed Citibank to request additional collateral from VCG." *Id.* at 342.

[4535] *Id.* at 338.

[4536] *Id.* at 342-43. The Court also noted that VCG was barred from challenging Citibank's request for additional collateral because the Credit Support Annex to the contracts in question had a Dispute Resolution provision with which VCG failed to comply. *See id.* at 343.

[4537] *Id.* at 344 ("With regard to VCG's allegation of a breach of the implied covenant on the basis of variation margin, . . . this claim is waived in light of VCG's continued posting of the demanded collateral and acceptance of the benefits of the CDS Contract.").

demands. The September Security Agreement and September Guaranty specifically allowed JPMorgan to make collateral requests to secure a broad range of obligations.[4538] Furthermore, like VCG's actions in *Citibank*, even though Lehman at times questioned JPMorgan's valuation of Lehman's collateral or the size of JPMorgan's requests,[4539] Lehman ultimately posted additional collateral in response to the September 9 and September 11 requests.

There is also evidence available to Lehman to contest a defense of waiver. Lehman did not provide the full $5 billion requested on September 9 by JPMorgan, suggesting that Lehman did not entirely cede to JPMorgan's demands.[4540] Also, there are reports that Lehman did resist the collateral requests, especially on September 11, when they were first communicated by JPMorgan.[4541] For example, there is evidence that Fleming and Tonucci communicated to Doctoroff on September 10 Lehman's view that JPMorgan's requests for collateral were "somewhat arbitrary" as was JPMorgan's valuation of collateral.[4542] The Estate could argue that such resistance was sufficient to

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[4538] *See* Security Agreement (Sept. 9, 2008), at p. 5 [JPM-2004 0084865]; Guaranty (Sept. 9, 2008), at p. 2 [JPM-2004 0005813].

[4539] *See supra* at Section III.A.5.b.1.

[4540] *See id., supra.* Lehman's objections to the full amount of the demand may not, however, excuse a waiver as to the amounts it did provide.

[4541] *See id., supra*.

[4542] *See* e-mail from Mark G. Doctoroff, JPMorgan, to Donna Dellosso, JPMorgan, *et al.* (Sept. 11, 2008) [JPM-2004 0061651] (reporting the impression of Fleming and Tonucci); *see also* e-mail from Donna Dellosso, JPMorgan, to Steven D. Black, JPMorgan, *et al*. (Sept. 10, 2008) [JPM-2004 0061485] (reporting that while Tonucci confirmed that Lehman "will maintain collateral of $4bln to cover intra-day exposure," Tonucci believed JPMorgan had "excess collateral in [Lehman's] UK and US boxes that in addition to the cash and money market funds likely exceeds our $4bln request").

constitute a notice to JPMorgan of its breach of the implied covenant of good faith and fair dealing.[4543] Finally, there are reports of requests from Lehman for return of its collateral, including evidence to support the contention that Lehman believed that the $5 billion posted in response to the September 11 request would be returned at the end of the day on September 12.[4544] This evidence could support the position that Lehman's posting of collateral was not a waiver because it was not "an intentional and voluntary relinquishment of a known right."[4545] Thus, there are credible disputed issues of material fact concerning whether JPMorgan would ultimately succeed on a defense of waiver.

The Examiner concludes that there is sufficient evidence to determine that a colorable claim exists for breach of the implied covenant of good faith and fair dealing, but that the claim is not strong because of substantial evidence that JPMorgan was neither arbitrary nor irrational in its requests for collateral pursuant to its broad discretion under the September Agreements, and because of evidence that Lehman

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[4543] "[A] party to an agreement who believes it has been breached may elect to continue to perform the agreement rather than terminate it, and later sue for breach; this is true, however, only where notice of the breach has been given to the other side." *Nat'l Westminster Bank, U.S.A. v. Ross*, 130 B.R. 656, 675 (S.D.N.Y. 1991), *aff'd sub nom. Yaeger v. Nat'l Westminster*, 962 F.2d 1 (2d Cir. 1992). *But cf. Citibank*, No. 08-CV-01563, 2009 WL 311362, at *2 (S.D.N.Y. Jan. 29, 2009) (denying motion for reconsideration; "VCG's hindsight explanations for why it failed to object to the collateral demands do not constitute notice of a breach to Citibank. Neither do VCG's attempts to introduce 'expert discovery' to demonstrate that ISDA documents have not caught up with the substance of the transaction at issue.").

[4544] *See supra* at III.A.5.b.1.

[4545] *Citibank*, 2009 WL 311362, at *2.

waived the right to assert such a claim by complying with the collateral requests without asserting a breach, and by accepting benefits from JPMorgan.

c) Lehman's Dealings With Citigroup

This Section analyzes Lehman's relationship with Citigroup, Inc., another of its clearing banks, and certain of its subsidiaries and affiliates ("Citi" or "Citibank"), focusing predominantly on the parties' interaction in 2008.

(1) Facts

(a) Citigroup Provided Continuous Linked Settlement Service and Other Clearing and Settlement Operations to Lehman

Citigroup provided a wide array of financial services to Lehman, including "the establishment and maintenance of cash deposit and custodial accounts, the provision of credit facilities, trade clearing and settlement services, agency and trust services, foreign exchange-related services, and securities lending."[4546]

(i) Background Information on the Continuous Linked Settlement Service Citi Provided to Lehman

Citibank, N.A. (London) was the Designated Settlement Member on the CLS system for Lehman's broker-dealer, LBI, and three other Lehman subsidiaries.[4547] The

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[4546] Statement of Citigroup, Inc. in Support of Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, at p. 2 (¶ 1), Docket No. 110, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008). In addition, Citi was counterparty to some Lehman entities in connection with "thousands of trading positions under numerous financial contracts such as interest-rate and foreign-exchange swap agreements, securities contracts, and repurchase agreements." *Id*.

[4547] Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, Ex. A, Docket No. 109, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008). The LBI-Citibank CLS relationship was established by a "CLS Settlement

CLS system is a trading platform, operated by a consortium of banks, for the clearance and settlement of foreign exchange ("FX") trades.[4548] Approximately 80 percent of Lehman's FX trades went through CLS.[4549]

In the CLS community, Lehman was a shareholder and "user member," while Citi was Lehman's "settlement member."[4550] As a "user member" of the CLS system, Lehman relied on Citi to execute FX trades in the CLS system by making payments to the CLS Bank[4551] at scheduled times throughout the day.[4552] Each member submitted trades on a gross basis, and the system then determined a payment schedule setting forth net amounts companies had to pay in at certain times and for various currencies.[4553] By executing Lehman's FX trades in the CLS system, Citi indicated its acceptance of those trades, extended intraday credit to the Lehman entity, and assumed

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Services Agreement for CLS User Members" dated December 19, 2003. *Id*. at p. 1. This CLS clearance agreement was amended and restated in a "Citibank CLS Settlement Services Amended and Restated Agreement for CLS User Members" dated October 28, 2004. *Id*. References to the "CLS Agreement" refer to the Agreement as amended and restated.

[4548] *See* CLS, About CLS, http://www.cls-group.com/About/Pages/default.aspx (last visited Dec. 23, 2009).

[4549] Examiner's Interview of Jonathan D. Williams, Aug. 5, 2009, at p. 6.

[4550] *Id*. at p. 5. A settlement member "has a single multi-currency account with CLS Bank" and may submit payment instructions relating to its own FX transactions in addition to FX transactions of its customers. *See* CLS, Our Community, http://www.cls-group.com/About/Community/Pages/default.aspx (last visited Dec. 30, 2009). A user member, on the other hand, does not have an account with the CLS Bank and must submit its payment instructions through its settlement member. *Id*. The settlement member must then authorize the user member's instruction, at which point, the settlement member becomes "responsible for all funding obligations" related to the user member's instructions. *Id*.

[4551] CLS Bank is owned by the foreign exchange community and operates the largest multi-currency cash settlement system. CLS, About CLS, http://www.cls-group.com/About/Pages/default.aspx (last visited Dec. 23, 2009).

[4552] Examiner's Interview of Jonathan D. Williams, Aug. 5, 2009, at p. 5.

[4553] *Id*.

a corresponding amount of intraday risk in connection with that credit.[4554] After Citi authorized Lehman's payment instructions, Citi was obligated to settle all of Lehman's currency payments to the CLS Bank.[4555]

The timing for payments to the CLS Bank was such that Citi's payments into the system on Lehman's behalf preceded currency funding and payment cutoff times, which meant that Citi often had to pay the CLS Bank monies Lehman owed before Lehman received funds from non-CLS settlement trades.[4556] For instance, Citi paid Japanese Yen to the CLS Bank for Lehman's obligations well before Citi received U.S. dollars into Lehman's accounts, thus leaving Citi at risk for the Japanese Yen amount if Lehman's U.S. dollar funds did not come in.[4557] Prior to 6:00 p.m. New York time each business day, Citi had the option of not settling the CLS transactions, but, after 6:00 p.m., Citi was "irrevocably committed to settle" the CLS transactions.[4558] Typically, Citi

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[4554] *Id.*; *see also* Lehman, Citibank Clearing and Intraday Credit (June 17, 2008), at p. 1 [LBHI_SEC07940_745595].

[4555] Lehman, Citibank Clearing and Intraday Credit (June 17, 2008), at p. 1 [LBHI_SEC07940_745595].

[4556] *Id*. at p. 2.

[4557] E-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup, *et al*. (June 17, 2008) [CITI-LBHI-EXAM 00073791]; *see also* e-mail from Julius Silbiger, Citigroup, to Thomas Obermaier, Citigroup, *et al*. (Sept. 9, 2008) [CITI-LBHI-EXAM 00065668] (explaining that Japanese Yen had been released late that day and all other Asian Currencies had been approved for release, creating a daylight overdraft limit overdraft of $1.4 billion which was scheduled to be repaid later in the day on September 10 when U.S. dollars came in).

[4558] Citigroup, Overview of GTS Clearing and Settlement Lines (Sept. 4, 2008), at p. 4 [CITI-LBHI-EXAM 00102127].

received an overview of the next day's anticipated CLS payment flows by 6:30 p.m. the previous evening.[4559]

As part of its FX business on the CLS system, Lehman consolidated its currency-specific "nostro" accounts with Citi.[4560] A nostro account is "an account one bank holds with a bank in a foreign country, usually in the currency of that foreign country."[4561] For instance, a Lehman Japanese Yen nostro account would exist at Citi in Tokyo because the payments and receipts occurred during Tokyo business hours.[4562] At the end of the day, the nostro accounts should have had a zero balance because the accounts were used to facilitate purchases and sales where Lehman would buy Japanese Yen from one entity and sell the Japanese Yen to another entity in the same day.[4563]

(ii) Other Clearing and Settlement Services That Citi Provided to Lehman

Citi provided other clearing and settlement services to Lehman in addition to CLS. Citi served as Lehman's primary cash clearer and a significant provider of custody and clearing services in emerging markets, as well as a provider of those services in the United States.[4564] Citi Direct Custody and Clearing facilitated

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[4559] E-mail from Janet Birney, Lehman, to Robert Eby, Lehman, *et al.* (Sept. 10, 2008) [LBEX-AM 008560].
[4560] Examiner's Interview of Jonathan D. Williams, Aug. 5, 2009, at p. 5.
[4561] *See* InvestorWords.com, Nostro Account, http://www.investorwords.com/3348/nostro_account.html (last visited Dec. 23, 2009).
[4562] Examiner's Interview of Jonathan D. Williams, Aug. 5, 2009, at p. 5.
[4563] *Id*.
[4564] Lehman, Citibank Clearing and Intraday Credit (June 17, 2008), at p. 1 [LBHI_SEC07940_745595].

international clearing and settlement of securities transactions.[4565] Occasionally, Citi had to extend intraday credit to pay out cash or transfer securities in connection with securities transactions on behalf of Lehman if insufficient funds or securities were available in Lehman's account at the time when payments were required.[4566]

As Lehman's cash clearer in emerging markets and in the United States, Citi provided uncommitted clearing lines, which meant the lines could be cancelled at Citi's discretion.[4567] Generally, Citi expected Lehman to cover the intraday credit extended by the day's end in New York.[4568]

As of May 31, 2008, Citi provided Lehman with substantial clearing lines to support the business Lehman transacted on Citi's Global Transaction Services Securities and Cash Clearing business.[4569] Among the 26 countries in which Citi extended a clearing line to Lehman were: the United Kingdom ($6.3 billion), the United States ($5.9 billion), Italy ($3.1 billion), Japan ($1.8 billion), Canada ($500 million) and Mexico ($500 million).[4570] As Lehman's Global Transaction Services clearing agent, Citi served as an

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[4565] Citigroup, Overview of GTS Clearing and Settlement Lines (Sept. 4, 2008), at p. 3 [CITI-LBHI-EXAM 00102127].

[4566] *Id*.

[4567] *Id*. at p. 5.

[4568] *See* e-mail from Julius Silbiger, Citigroup, to Thomas Obermaier, Citigroup, *et al*. (Sept. 9, 2008) [CITI-LBHI-EXAM 00065668] (concerning intraday credit limit overdraft created by processing payments of Japanese Yen on Lehman's behalf would be repaid by U.S. dollars later in the day on September 10).

[4569] Citigroup, Lehman Brother Holding Inc. (Exposure Summary) (as of May 31, 2008), at p. 1 [CITI-LBHI-EXAM 00110721].

[4570] *Id*.

intermediary between Lehman and its trade counterparties, acting as both buyer and seller for the securities trades.

(iii) Citi's Clearing and Settlement Exposure to Lehman, Generally

As of mid-June 2008, Lehman had approximately 487 bank accounts with Citi in the United States, Europe and Asia.[4571] By then, Citi had pared back to $3 billion the intraday-credit amounts provided in the aggregate for CLS and non-CLS eligible currencies, $3 billion for U.S. dollar clearing and $1.2 billion for Asian currencies.[4572] These aggregate intraday-credit allotments were divided among various Lehman facilities and subsidiaries.[4573] In order to exceed the set credit limits, an excess approval request had to be submitted to Citi Risk personnel in the New York office; local Citi personnel outside of New York did not have the authority to authorize a Lehman transaction to be paid if it exceeded the established credit limit.[4574]

[4571] Lehman, Citibank Clearing and Intraday Credit (June 17, 2008), at p. 1 [LBHI_SEC07940_745595].

[4572] *Id*.

[4573] *See* e-mail from Risk Systems Support Europe group, Citigroup, to CMB CRMS LatAm group, Citigroup (Sept. 9, 2008) [CITI-LBHI-EXAM 00007751] (Lehman Brothers Incorporated had a $10 million settlement risk limit for its Chile unit); e-mail from Risk Systems Support Europe group, Citigroup, to CMB CRMS Asia group, Citigroup (Sept. 9, 2008) [CITI-LBHI-EXAM 00006741] (Lehman Brothers Securities Taiwan had a direct risk limit of approximately $10 million through Citi).

[4574] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 7; *see also* e-mail from Thomas Fontana, Citigroup, to Anna Jankowiak, Citigroup, *et al.* (June 26, 2008) [CITI-LBHI-EXAM 00042270] (Fontana approved a $6.2 million excess for a Lehman Brothers RR3 transaction); e-mail from Melissa J. Torres, Citigroup, to Anna Jankowiak, Citigroup, *et al.* (July 2, 2008) [CITI-LBHI-EXAM 00042500] (Torres approved a $1.3 million excess for a Lehman Brothers RR3 transaction).

According to officials at Citi, Lehman rarely made it through a day in the spring of 2008 without being overdrawn at some point.[4575] According to Lehman, it exceeded its CLS intraday credit line because of an imbalance between CLS and non-CLS trades, which, once realized, Lehman was able to monitor and control better by having its FX desk trade in or out of CLS as necessary.[4576] Following discussions with Lehman in June 2008, Citi analyzed Lehman's usage of the daylight overdraft limit during the week of June 23 to June 27, 2008.[4577] Because Citi did not have the "technology to systemically track intraday exposure," Citi created a manual process through which local Citi staff physically noted Lehman's cash and securities overdraft positions on an hourly basis over those five days.[4578] The exercise was carried out in seven major markets that accounted for 94 percent of Lehman's clearing lines with Citi.[4579] However, the manual nature of the process made it prone to human error.[4580] Nevertheless, Citi came to the conclusion through this exercise that Lehman's *average* daily daylight overdraft limit usage for cash and securities clearing combined ranged from $1.457 billion to $2.53

[4575] E-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al.* (July 11, 2008) [CITI-LBHI-EXAM 00076243] (noting that that day was the first time in more than three months that Lehman was not overdrawn at all); *see also* e-mail from Katherine Lukas, Citigroup, to Seamus Kennedy, Citigroup, *et al.* (May 2, 2008) [CITI-LBHI-EXAM 00023281] (reporting Lehman used the full CLS clearing line of $3 billion and exceeded that limit on a regular basis).

[4576] Lehman, Citibank Clearing and Intraday Credit (June 17, 2008), at p. 3 [LBHI_SEC07940_745595].

[4577] Citigroup Global Transaction Services Risk Management, Lehman: Intraday (DOL) Usage Profile (July 2, 2008), at p. 2 [CITI-LBHI-EXAM 00107335].

[4578] *Id.*

[4579] *Id.*

[4580] *Id.*

billion, while Lehman's actual minimum usage of the daylight overdraft limit was $7.741 million and the actual maximum usage was $10.354 billion.[4581]

(iv) The Terms of Lehman's CLS Agreement with Citi

LBI and Citibank, N.A. (London) entered into a CLS Settlement Services Agreement for CLS User Members on December 19, 2003, and later agreed to the Citibank CLS Settlement Services Amended and Restated Agreement for CLS User Members ("Agreement" or "CLS Agreement") on October 28, 2004.[4582] For purposes of the issues analyzed by the Examiner, the October 28, 2004 version governs.[4583] The Agreement lists Lehman Brothers Commercial Corporation ("LBCC") as a "Permitted Affiliate," which meant that LBI could submit CLS transaction instructions on behalf of LBCC as well as itself.[4584] In addition to LBCC, Lehman Brothers Special Financing Inc. ("LBSF") and Lehman Brothers International (Europe) ("LBIE") were added as affiliates on November 8, 2007.[4585]

[4581] *Id*. at p. 6. Citi also measured the potential maximum usage for cash and securities clearing combined at $17.654 billion. *Id*.; *see also* e-mail from Vivek Tyagi, Citigroup, to Thomas Fontana, Citigroup, *et al*. (July 2, 2008) [CITI-LBHI-EXAM 00107333] (stating there "was a high degree of volatility over the week" that Citi performed this exercise).

[4582] Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, Ex. A at p. 1, Docket No. 109, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008).

[4583] *Id*. (specifying that the "Original Agreement is hereby amended and restated in its entirety").

[4584] *Id*. at pp. 1, 12-13.

[4585] *Id*.; Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, Ex. B at p. 1, Docket No. 109, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008). These four Lehman entities are the only entities that agreed to the terms of the CLS Agreement. Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, Ex. A at pp. 1, 12, Docket No. 109, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008); Motion of Debtors for Order, Pursuant

Under the CLS Agreement, LBI could submit transaction instructions for itself or the three Lehman "affiliates" either directly to the CLS Bank or through Citi.[4586] As Lehman's "Designated Settlement Member," Citi had to authorize the transaction instructions that LBI submitted directly to the CLS Bank, and the decision whether to provide such authorization was to "be made in Citibank's sole discretion."[4587] By authorizing a transaction in the CLS system, "Citibank necessarily assume[d] a credit exposure to CLS Bank" on Lehman's behalf.[4588] Further, the Agreement provides:

> Unless Citibank has expressly agreed in writing to a committed credit facility and received a commitment fee therefore, any extension of credit on behalf of the Customer or a Permitted Affiliate is within Citibank's *sole discretion* and may be changed or discontinued at any time without prior notice, notwithstanding any other provision of this agreement, provided, however, that Citibank may not without Customer's consent, cancel or rescind any instruction that Citibank has previously authorized.[4589]

While the Agreement provided that Lehman could terminate the Agreement at any time, the Agreement required that Citibank provide 90 days' written notice before it could terminate the "Agreement as a whole or with respect to any Permitted

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to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, Ex. B at p. 1, Docket No. 109, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008); *see also* Letter from Citibank, N.A., to Lehman Brothers Inc., *et al.*, re: CLS Settlement Services Agreement (Sept. 15, 2008), at p. 2 [LBEX-DOCID 462068] (terminating the CLS Agreement with LBI, LBCC, LBSF and LBIE on the afternoon of September 15).

[4586] Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, Ex. A at p. 2 (¶ 1), Docket No. 109, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008). The CLS Agreement also holds LBI responsible for any transaction submitted by an affiliate even if that affiliate is not a "Permitted Affiliate." *Id*.

[4587] *Id*.

[4588] *Id*. at p. 3.

[4589] *Id*. (emphasis added).

Affiliate."[4590] However, Citibank "reserve[d] the right to terminate this Agreement immediately, without notice" in other instances, including in the event of: (1) a Default;[4591] (2) a bankruptcy, reorganization or receivership against any of the Transaction Parties or parent corporation; or (3) "upon the occurrence of a material adverse change in the financial or other condition of a Transaction Party."[4592] Paragraph 8 of the Agreement specifies that the laws of England govern the Agreement.[4593]

(b) Lehman Provided a $2 Billion Cash Deposit with Citi on June 12, 2008 To Support its Clearing Needs

Following the near collapse of Bear Stearns in March 2008, Lehman's second quarter 2008 earnings preannouncement on June 9 of a $2.8 billion loss, and Lehman's announced changes in upper-management on June 12, Citibank requested a "comfort deposit" from Lehman to help cover Citi's risk exposure.[4594] Consequently, on June 12,

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[4590] *Id*. at p. 6 (¶ 6: Termination).

[4591] As defined in ¶ 6 of the CLS Agreement an event of Default with respect to a "Transaction Party shall exist immediately upon the occurrence of any of the following events with respect to that Transaction Party: (i) Transaction Party fails to make any payment to Citibank to fund a short balance of such Transaction Party in any currency by the applicable cut-off time; (ii) Transaction Party has breached any obligation hereunder to make any payment other than a payment covered by (i) by the applicable due date and fails to remedy such default within ten (10) days after Customer's receipt of notice from Citibank advising Transaction Party of such failure to pay; or (iii) Transaction Party has breached any material obligation hereunder not covered by (i) or (ii) and fails to remedy such default within thirty (30) days after Customer's receipt of notice from Citibank detailing the nature of the claimed breach." *Id*. A "Transaction Party" is defined as the "Customer or the Permitted Affiliate on whose behalf an instruction is submitted with respect to a transaction to which it is a counterparty." *Id*. at p.2 (¶ 1).

[4592] *Id*. at p. 6 (¶ 6).

[4593] *Id*. at p. 9 (¶ 8).

[4594] E-mail from Brian R. Leach, Citigroup, to Vikram S. Pandit, Citigroup, *et al.* (June 12, 2008) [CITI-LBHI-EXAM 00114115] (stating that Citi initially asked for $3 billion segregated but Lehman sent $2 billion in a call account).

Lehman posted a $2 billion deposit in an overnight call account with Citi.[4595] Citi and Lehman had discussions for the next several months regarding Lehman pledging securities to cover intraday risk, but a formal pledge agreement was never executed.[4596] Instead, on September 9, 2008, Lehman signed an amendment to its 2004 Guaranty Agreement,[4597] adding nine subsidiaries to its holding company guaranty and an additional subsidiary on September 11.[4598] Additionally, on September 12, Lehman and Citi amended their DSCA,[4599] which gave Citi stronger rights over the assets it held for Lehman.[4600]

[4595] E-mail from Daniel J. Fleming, Lehman, to Ian T. Lowitt, Lehman (June 12, 2008) [LBEX-AM 008608].

[4596] *See* e-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup (Sept. 10, 2008) [CITI-LBHI-EXAM 00075863] (discussing how Citi spent two months negotiating the collateral arrangement and should have had it completed long ago instead of the "fire drill" of getting the Guaranty Amendment on September 9).

[4597] Guaranty (Jan. 7, 2004) [LBEX-DOCID 1090071].

[4598] *See* Amendment 1 To Guaranty (Sept. 9, 2008) [LBEX-DOCID 090568] (executed version signed by Ian Lowitt and adding LBCC on September 11, 2008). Even though LBCC was added to the Guaranty Amendment on September 11, the executed document retains "September 9, 2008" as the amendment date specified in the text. As such, references in this Report to the "September 9 Guaranty Amendment" refer to the amendment as effective on the evening of September 11 with LBCC added.

[4599] The DCSA is alternatively titled the Direct Custody Agreement ("DCA") in the document signed on March 26, 1992, and referred to as the DCSA in the September 12, 2008 amendment. However, the DCA and DCSA are the same document, amended by the Deed addendum on September 12, 2008. For consistency, the Examiner refers to the 1992 version as the "DCSA," or "original DCSA," and the 2008 version as the "DCSA Amendment." *See* Direct Custodial Services Agreement Deed (Sept. 12, 2008) [LBEX-DOCID 4263617] (referring to the DCSA entered into by LBI, then known as Shearson Lehman Brothers Inc., and Citibank on March 26, 1992), *and* Direct Custody Agreement for Citibank, N.A., Subsidiaries and Affiliates and Shearson Lehman Brothers Inc. (Mar. 26, 1992) [LBEX-DOCID 1091570].

[4600] Direct Custodial Services Agreement Deed (Sept. 12, 2008), at p. 2 [LBEX-DOCID 4263617].

(i) The Market Environment and Other Circumstances Surrounding Citi's Request for the $2 Billion Cash Deposit on June 12

In March 2008, after the near collapse of Bear Stearns, counterparties and clearing banks turned their attention to those broker-dealers regarded as the next-most vulnerable. LBI, as the next-smallest, with its large leverage ratios and real estate-heavy balance sheet at the parent company level, was widely viewed as particularly vulnerable.[4601]

In addition, in a June 5, 2008 meeting with Citi, Lehman previewed its second quarter earnings announcement, disclosing an anticipated $2.6 billion loss.[4602] Subsequently, Lehman's then-CFO Callan formally delivered the earnings announcement on June 9 during a preannouncement call, where she reported an official loss amount of $2.8 billion.[4603] The market reacted negatively, and Lehman lost further credibility in the market when it also announced a $6 billion equity capital raise on June 9[4604] even though Callan had stated numerous times, including on February 6, 2008, that

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[4601] Jenny Anderson, *At Lehman, Allaying Fears About Being the Next to Fall*, N.Y. Times, Mar. 18, 2008.

[4602] Lehman, Q2 2008 Update (June 4, 2008), at p. 2 [CITI-LBHI-EXAM 00078768]; e-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (June 4, 2008) [CITI-LBHI-EXAM 00081461] (describing the agenda for the June 5 meeting as including a look at Lehman's second quarter results).

[4603] *Preliminary 2008 Lehman Brothers Holdings Inc. Earnings Conference Call - Final*, Fair Disclosure Wire, June 9, 2008.

[4604] *Id*. The $6 billion capital raise was comprised of $4 billion of common equity and $2 billion of mandatorily convertible preferred stock. *Id*.

Lehman had no interest in raising new common equity capital.[4605] Lehman announced on June 12 that Callan and Gregory had been dismissed from their positions, although Callan remained at Lehman in an investment-banking position[4606] until she resigned in mid-July 2008.[4607]

Thus, as a result of Lehman's rapidly declining stock price, and negative market reactions to Lehman's earnings preannouncement and changes in upper-management, Citi experienced a three-fold increase in novation requests on June 12[4608] for a total of approximately 26 novation requests to trade out of Lehman that week.[4609] Typically, when a novation would occur, Citi would step in to face Lehman in place of one of

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[4605] *Lehman Brothers Holdings Inc. at Credit Suisse Group Financial Services Forum - Final*, Fair Disclosure Wire, Feb. 6, 2008 ("We have no interest -- and someone may ask me this question at some point, in raising new common equity capital."); *see also* Citigroup, Initial Classification Memorandum (June 13, 2008), at p. 1 [CITI-LBHI-EXAM 00051049] (noting that Lehman's "management team's credibility however has come under fire with 3 additional capital raises since January after the company indicated it did not need any more after the first one" when Callan said in March 2008 that Lehman would not need to raise additional capital after raising $1.9 billion in February, but had since raised an additional $10 billion in fresh capital).

[4606] Alistair Barr, *et al.*, *Lehman CFO Callan, COO Gregory ousted from posts*, MarketWatch, June 12, 2008.

[4607] Jenny Anderson, *Demoted Lehman Officer Leaves for Credit Suisse*, N.Y. Times, July 16, 2008, *available at* http://www.nytimes.com/2008/07/16/business/16lehman.html (last visited Dec. 23, 2009).

[4608] Lehman, CITIGROUP Call Report (June 17, 2008), at p. 1 [LBEX-AM 008578] (summarizing remarks made by Citi CRO Brian Leach in a June 17, 2008 meeting with Lehman that "Citi began receiving three times the number of novation requests (on average 6) starting in Asia" on June 12) (attached to e-mail from Emil F. Cornejo, Lehman, to Julie M. Boyle, Lehman, *et al*. (June 20, 2008) [LBEX-AM 008577].

[4609] E-mail from Thomas Fontana, Citigroup, to Brian R. Leach, Citigroup, *et al*. (June 16, 2008) [CITI-LBHI-EXAM 00115773]. Fontana identified the counterparties who requested novations during the week of Monday June 9: "Putnam (15 trades), GSAM (4), BOA (2), KingStreet (2), Elliot (2) and Citadel (1)." *Id*. Additionally, Fontana stated that Bracebridge novated nine trades to Citi during the week of June 2, and other Lehman counterparties who sought novations out of Lehman in the preceding few weeks included MetWest, PIMCO and ING. *Id.*; *see also* e-mail from Paolo R. Tonucci, Lehman, to Ian T. Lowitt, Lehman, *et al.* (June 12, 2008) [LBEX-DOCID 458725] (Lehman was informed that Citi Asia refused to take a novation on an Indonesia credit default swap).

Lehman's counterparties who wanted out of the transaction.[4610] In the first half of 2008, Citi had accepted a total of approximately 1100 novation requests industry-wide, where the average notional value per trade was just under $10 million[4611] and the average monthly total was $3-4 billion.[4612] Approximately 90 percent of the novation requests Citi received involved credit default swaps.[4613] Citibank Global Financial Institutions Risk Management Risk Officer Thomas Fontana, in an internal June 12 Citi e-mail exchange, stated:

> Fuld oust[ed the] CFO and COO. . . . We have cut back clearing lines in Asia . . . . This is bad news. Market is saying Lehman can not make it alone. Loss of confidence here is huge at the moment. We are seeing novations and are passing on them![4614]

In a later e-mail in the same chain, Fontana wrote that Citi's "internal team has lost complete confidence [in Lehman]. No telling what will happen."[4615] Citi was loath to reject these counterparty requests, but desired additional security for the increased

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[4610] A novation is defined as "an agreement to change a contract by substituting a third party for one of the two original parties." *See* BNET Business Dictionary, Business Definition for: Novation, http://dictionary.bnet.com/definition/novation.html.

[4611] E-mail from Thomas Fontana, Citigroup, to Paolo R. Tonucci, Lehman, *et al.* (June 20, 2008) [LBEX-DOCID 038249]. The 1100 novations were not Lehman-specific. *See id*.

[4612] E-mail from Thomas Fontana, Citigroup, to Brian R. Leach, Citigroup, *et al*. (June 16, 2008) [CITI-LBHI-EXAM 00115773].

[4613] *Id*.

[4614] E-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al.* (June 12, 2008) [CITI-LBHI-EXAM 00072923].

[4615] *Id*.; Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 3 (explaining that only a few people on Fontana's internal team had lost confidence, not the entire Citi team).

risk exposure it faced in novating these trades.[4616] That day, Citi turned down "a number of trades with clients desiring to novate" over to them.[4617]

Later that day, Citi requested that Lehman deposit $3-5 billion to cover intraday exposures or end of day shortages.[4618] The documents suggest that Citi and Lehman negotiated the deposit amount: Fontana reported internally at Citi that Citi "made a request for $5B in a cash deposit,"[4619] Fleming informed Lowitt by e-mail that Citi was seeking a $3 billion cash deposit to cover intraday exposures,[4620] but, later that day,

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[4616] E-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al.* (June 12, 2008) [CITI-LBHI-EXAM 00106013] (Fontana wrote "[a]fter speaking with the CFO and Treasurer [of Lehman], we made a request for $5B in a cash deposit" and noted that Citi had turned down a number of trades with clients desiring to novate over to Citi); *see also* e-mail from Jasmin Herrera, Lehman, to Emil F. Cornejo, Lehman (June 16, 2008) [LBEX-AM 008659] (attached memorandum summarizes the cash deposit negotiations from Lehman's perspective); Jasmin Herrera, Lehman, Global Creditor Relations-Highlights Citigroup (June 16, 2008), at p. 1 [LBEX-AM 008660]). The memorandum states that, "[u]ntil June 12, 2008, Citi has consistently been Lehman's strongest provider of credit. However, due to a substantial increase in novation requests from counterparties, Citi requested that we collateralize $3-$5 B in intraday exposure. Lehman declined, but did agree to a $2B term deposit, callable daily." Jasmin Herrera, Lehman, Global Creditor Relations-Highlights Citigroup (June 16, 2008), at p. 1 [LBEX-AM 008660]; *see also* e-mail from Christopher M. Foskett, Citigroup, to John P. Havens, Citigroup, *et al.* (June 12, 2008) [CITI-LBHI-EXAM 00026400] (Foskett wrote that he had been on the phone that morning with Lowitt and Tonucci, and that he asked Lehman to put up a cash deposit "to keep our clearing capabilities at levels they require to efficiently operate").

[4617] E-mail from Brian R. Leach, Citigroup, to Vikram S. Pandit, Citigroup, *et al.* (June 12, 2008) [CITI-LBHI-EXAM 00114272]; e-mail from Thomas Fontana, Citigroup, to Brian R. Leach, Citigroup, *et al.* (June 12, 2008) [CITI-LBHI-EXAM 00114466].

[4618] E-mail from Brian R. Leach, Citigroup, to Vikram S. Pandit, Citigroup, *et al.* (June 12, 2008) [CITI-LBHI-EXAM 00114115] (stating that Citi initially asked for $3 billion segregated but Lehman sent $2 billion in a call account). *But see* e-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al.* (June 12, 2008) [CITI-LBHI-EXAM 00106013] (Fontana wrote that Lehman asked for $5 billion in a cash deposit); Jasmin Herrera, Lehman, Global Creditor Relations-Highlights Citigroup (June 16, 2008), at p. 1 [LBEX-AM 008660) (stating that Citi asked Lehman to collateralize $3-5 billion in intraday exposure).

[4619] E-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al.* (June 12, 2008) [CITI-LBHI-EXAM 00106013].

[4620] E-mail from Daniel J. Fleming, Lehman, to Ian T. Lowitt, Lehman (June 12, 2008) [LBEX-AM 008609].

LBHI agreed to deposit a $2 billion "comfort deposit" with Citibank.[4621] Some within Citi questioned whether this was the right thing to do,[4622] while others viewed Lehman's $2 billion cash deposit as necessary for Citi "to continue to do business with them--that's just for us to keep answering the phones if they call."[4623]

Citi had received a similar deposit from Bear Stearns during the summer of 2007.[4624] According to Michael Mauerstein, Citi's Managing Director of the Financial Institutions - Broker Dealers Group, Citi's motivation in seeking the "comfort deposit" from Lehman was grounded mainly in concerns about operational efficiency, but also due, to a lesser extent, to concerns about Lehman's stability.[4625] When Mauerstein met with Lehman's Emil Cornejo (Senior Vice President Treasury), Julie Boyle (Senior Vice President in Commercial Bank and Global Creditor Relations) and Janet Birney (Global Head of Network Management) on the evening of June 12, they informed Mauerstein that Citi was the only bank to "bother" them that day.[4626]

[4621] E-mail from Daniel J. Fleming, Lehman, to Ian T. Lowitt, Lehman (June 12, 2008) [LBEX-AM 008608].

[4622] E-mail from Vikram S. Pandit, Citigroup, to Lewis Kaden, Citigroup, *et al.* (June 12, 2008) [CITI-LBHI-EXAM 00114272].

[4623] E-mail from Stephen G. Malekian, Citigroup, to Sanjay V. Reddy, Citigroup, *et al*. (June 14, 2008) [CITI-LBHI-EXAM 00034822].

[4624] E-mail from Christopher M. Foskett, Citigroup, to John P. Havens, Citigroup, *et al.* (June 12, 2008) [CITI-LBHI-EXAM 00026400].

[4625] Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at pp. 2, 4.

[4626] E-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup (June 12, 2008) [CITI-LBHI-EXAM 00072943].

Initially, Citibank had asked for a pledge of cash or the right of setoff on collateral rather than just a cash deposit,[4627] but Lehman refused that request because Lehman did not want to reduce the size of its liquidity pool, as Tonucci and Cornejo were concerned about keeping the liquidity pool at a high reported level.[4628] In addition, Citi expressed its concern to Lehman that such a collateral pledge might trigger a requirement that Lehman report the transaction by filing an 8-K form with the SEC.[4629] Cornejo asked Citi to consider higher yielding alternatives to the overnight account into which Citi's Funds desk swept Lehman's deposit, as the sweep paid about 20 to 30 basis points below what Lehman earned on its money market funds.[4630] However, Lehman officials indicated numerous times that they would not encumber the deposit, even if such an encumbrance would earn them a higher interest rate on the deposit.[4631] Citi understood that Lehman wanted to keep the $2 billion deposit an

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[4627] Lehman, Citigroup Agenda (June 17, 2008), at p. 2 [LBEX-AM 008597].

[4628] Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 5.

[4629] E-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup, *et al.* (July 12, 2008) [CITI-LBHI-EXAM 00076243] (Mauerstein conveyed his opinion that Lehman would not agree to grant collateral at the Treasurer level because granting $2 billion in collateral "will likely be an 8-K event and therefore a CEO discussion"); e-mail from Emil F. Cornejo, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (July 13, 2008) [LBHI_SEC07940_528212] (Cornejo stated that Mauerstein "opined that a pledge of this size would probably be a reportable event"). An 8-K is "the 'current report' companies must file with the SEC to announce major events that shareholders should know about." *See* SEC, Form 8-K, *available at* http://www.sec.gov/answers/form8k.htm.

[4630] E-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup, *et al.* (June 17, 2008) [CITI-LBHI-EXAM 00047242].

[4631] E-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (June 12, 2008) [CITI-LBHI-EXAM 00073732] (reporting that Lehman indicated it will not encumber the deposit); e-mail from Christopher M. Foskett, Citigroup, to Thomas Fontana, Citigroup, *et al*. (July 14, 2008) [CITI-LBHI-EXAM 00076293] (recapping conversation where Lowitt conveyed concern about not wanting to tie up Lehman's liquidity unnecessarily); e-mail from Emil F. Cornejo, Lehman, to Joseph Igoe, Lehman (July 4,

overnight deposit "to have maximum liquidity,"[4632] and Lowitt explained to Christopher Foskett (Managing Director, Global Head of Citi's Financial Institutions Group) that Lehman was willing to work out a solution to Citi's intraday credit concerns, so long as the solution did not tie up Lehman's liquidity unnecessarily.[4633]

Throughout the summer, after Lehman posted the $2 billion cash deposit, Lehman proposed several alternatives to the cash deposit in an effort to, *inter alia*, protect the deposit from a Citi insolvency.[4634] Lehman considered the $2 billion cash deposit to be a direct exposure to Citi because Lehman's exposure was "rolling intraday and not one consistent exposure."[4635] According to Mauerstein, Tonucci proposed giving Citi a cash deposit each morning in anticipation of clearing and getting that deposit back each evening when Lehman closed flat, *i.e.*, without any overdrafts.[4636] Cornejo proposed not leaving a deposit with Citi, which would have caused Citi to reduce Lehman's daylight overdraft limits to zero, prompting Lehman to use its cash as

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2008) [LBEX-DOCID 1078431] (Cornejo explains that Lehman could make the cash deposit "a time deposit, but steve needs to keep the deposit liquid").

[4632] E-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup (July 10, 2008) [CITI-LBHI-EXAM 00076191].

[4633] E-mail from Christopher M. Foskett, Citigroup, to Thomas Fontana, Citigroup, *et al*. (July 14, 2008) [CITI-LBHI-EXAM 00076293] (summarizing conversation in which Lowitt conveyed concern about not wanting to tie up Lehman's liquidity unnecessarily).

[4634] E-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup, *et al.* (July 21, 2008) [CITI-LBHI-EXAM 00082127]. Specifically, Tonucci sought to ensure that any securities Lehman pledged would be remote from a Citibank insolvency. *Id*.

[4635] Katherine Lukas, Citigroup, Unpublished Notes (July 10, 2008), at p. 36 [CITI-LBHI-EXAM 00110294] (contemporaneous handwritten notes).

[4636] E-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup (July 14, 2008) [CITI-LBHI-EXAM 00018024] (conveying topics discussed during a conversation Mauerstein had with Tonucci).

working capital during the day in lieu of Citi extending intraday credit to Lehman.[4637] Yet another proposal from Tonucci was for Lehman to put up securities that would apply only to outstanding clearing exposure, with the understanding that the securities would only be "pledged" when Lehman actually had outstanding clearing exposure.[4638] None of these alternatives were ever implemented, nor does it appear any of these alternatives advanced beyond preliminary discussions.[4639]

(ii) The Parties Did Not Share the Same Understanding of the Terms of the $2 Billion Cash Deposit

Citi required the deposit in order to continue clearing and settling trades for Lehman; if Lehman failed to maintain the deposit at Citi, Lehman likely would have had to prefund its trading activity.[4640] In addition, Citi officials informed Lehman that Citi believed it had a general right of offset against the $2 billion deposit.[4641] Finally, Citi subjected the deposit to a number of internal controls designed to retain the funds at Citi.[4642] In contrast, Lehman officials maintained that the deposit was simply a sign of

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[4637] *Id*.

[4638] E-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup, *et al.* (July 21, 2008) [CITI-LBHI-EXAM 00082127]. According to Mauerstein, Tonucci also wanted further clarification that the securities pledged would be remote from a Citi insolvency (which was part of Lehman's concern about leaving the cash deposit with Citi), wanted clarification that the collateral amount would match the lower level of daylight overdraft limit Lehman was using at the time, and wanted to discuss this with the Federal Reserve. *Id*. Tonucci reportedly further commented that, should Lehman not feel protected, it would take its clearing business away from Citi. *Id*.

[4639] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 7.

[4640] *Id*. at p. 9.

[4641] Lehman, CITIGROUP Call Report (Aug. 7, 2008), at p. 1 [LBEX-DOCID 450310].

[4642] E-mail from Katherine Lukas, Citigroup, to Ranjit Chatterji, Citigroup, *et al.* (Aug. 27, 2008) [CITI-LBHI-EXAM 00020787]; Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 5.

Lehman's "good faith," and could have been retrieved by Lehman upon request.[4643] Lehman included the deposit in its reported liquidity pool.[4644]

a. What Lehman Understood the Terms of the Deposit To Be

In a June 12 e-mail to Lowitt and Tonucci, Fleming characterized the terms of the deposit as "[n]o lien or right of offset, a straight overnight fed funds deposit."[4645] The assumption that the deposit was freely returnable, and distinguishable from a "pledge" of collateral, was widely held within Lehman.[4646] In his interview with the Examiner, Tonucci stated that he made it abundantly clear to Citibank that the deposit should be returnable to Lehman daily, and that there were to be no restrictions on getting the deposit back.[4647] He also characterized the deposit as a "good faith deposit" to maintain Citibank's "good will."[4648] Lehman was "always beholden, to an extent, on the good will of its clearing banks," Tonucci explained, and Lehman gave the $2 billion deposit to Citi to maintain its positive relationship with that bank.[4649] By early August, Tonucci

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[4643] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 20; Examiner's Interview of Irina Veksler, Sept. 11, 2009, at p. 6.

[4644] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 21.

[4645] E-mail from Daniel J. Fleming, Lehman, to Ian T. Lowitt, Lehman, *et al*. (June 12, 2008) [LBEX-AM 008608].

[4646] Lehman, Citigroup Agenda (June 17, 2008), at p. 2 [LBEX-AM 008597]. Lehman's Agenda stated: "Lehman did not agree to pledge cash or give the right of set-off on collateral as Citi requested, but we reluctantly did agree to deposit $2B in a call account, callable daily." *Id*.

[4647] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 20; Examiner's Interview of Irina Veksler, Sept. 11, 2009, at p. 6 (expressing her understanding that Lehman could have the $2 billion cash deposit at Citi at any time).

[4648] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 20.

[4649] *Id*.

and Cornejo were aware that Citi believed it had the right under New York law to offset the cash deposit.[4650] Fleming stated that while Citi viewed the deposit as something that could be offset, Lehman viewed it as a trade where Lehman was earning a return on the deposit.[4651]

Tonucci further noted that Lehman could have operated with less intraday credit from Citi.[4652] In addition, Tonucci expressed confidence that Lehman could have continued to trade through Citi, albeit with a little more difficulty, even if Lehman had withdrawn the $2 billion cash deposit. Tonucci, however, acknowledged that the full impact of Lehman withdrawing its deposit was unknown because it was never attempted.[4653] Had Lehman withdrawn the $2 billion cash deposit prior to September 2008, Fleming acknowledged that this would likely have resulted in senior-level discussions at Citi, but he also expressed doubt that Citi would actually have returned the deposit if asked.[4654] However, Fleming stated that, in hindsight, Lehman likely could not have continued to clear through Citi had Lehman successfully withdrawn its cash deposit.[4655]

[4650] Lehman, CITIGROUP Call Report (Aug. 7, 2008), at p. 1 [LBEX-DOCID 450310]. Cornejo and Tonucci participated in the call for Lehman, while Foskett and Mauerstein participated for Citigroup. *Id*. According to Lehman's summary, Citi would not have the right to offset unpledged securities if Lehman replaced the $2 billion cash deposit with less liquid collateral. *Id*.

[4651] Examiner's Interview of Daniel J. Fleming, Sept. 24, 2009, at p. 8.

[4652] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 20.

[4653] *Id*.

[4654] Examiner's Interview of Daniel J. Fleming, Sept. 24, 2009, at p. 8.

[4655] *Id*.

b. What Citi Understood the Terms of the Deposit To Be

Interviews of witnesses from Citi confirmed that the deposit was structured as an unencumbered, overnight call deposit, returnable daily upon Lehman's request.[4656] However, Fontana, Mauerstein and Foskett each stated his belief that, either under New York state law or the Uniform Commercial Code, Citi had a right of setoff against the $2 billion, which gave the bank some measure of comfort.[4657]

However, Citi officials recognized that Lehman's comfort deposit was not as secure as the deposit posted with Citi by Bear Stearns in the summer of 2007.[4658] The deposit agreement Citi reached with Bear Stearns explicitly provided a right of offset, whereas there was no "clean right of offset" with respect to the Lehman deposit.[4659] Foskett explained that this concern about the lack of a clean right of offset to the deposit

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[4656] Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 2. Fontana stated that the $2 billion deposit was structured as a lien-free, overnight call deposit, returnable daily on Lehman's request. *Id*. Mauerstein stated that the deposit was structured as an unencumbered call deposit with Citi's Federal Funds desk, which was returnable on Lehman's request. Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 5; *see also* e-mail from Michael Mauerstein, Citigroup, to Katherine Lukas, Citigroup, *et al.* (Aug. 29, 2008) [CITI-LBHI-EXAM 00076678] (describing the deposit as "an overnight deposit that Lehman can ask to be returned at any time").

[4657] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 5 (Foskett explained that someone in Citi's legal department informed him that Citi had a general right of offset, the type that any bank generally has against a bank deposit); Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 5; Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 5; e-mail from Michael Mauerstein, Citigroup, to Katherine Lukas, Citigroup, *et al.* (Aug. 29, 2008) [CITI-LBHI-EXAM 00076678] (Mauerstein wrote that Citi personnel believed they had the right of offset under New York state law).

[4658] E-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (June 12, 2008) [CITI-LBHI-EXAM 00073732]; *see also* e-mail from Patrick Ryan, Citigroup, to Elena T. Matrullo, Citigroup (Mar. 14, 2008) [CITI-LBHI-EXAM 00113393] (the amount of the deposit Bear Stearns placed with Citi was $1.5 billion as of March 2008).

[4659] E-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (June 12, 2008) [CITI-LBHI-EXAM 00073732].

arose, in part, from the fact that the deposit supporting Citi's relationship with LBI did not come from LBI, but from LBHI.[4660] Additionally, unlike the Bear Stearns deposit, Lehman was not borrowing from Citi and had not executed a "promissory note with 'right of offset' language" with Citi as Bear Stearns had done.[4661] While Bear Stearns' deposit was pledged to Citi and Bear Stearns could only borrow against the deposit, there was no similar pledge with Lehman's deposit when the deposit was made.[4662] Citi's Global Head of Global Transaction Services viewed overnight accounts (such as Lehman's $2 billion cash deposit) that could be "yanked" at any time by the client as counting "for nothing as it relates to collateral / security interest."[4663]

Although the Lehman deposit with Citi was not formally pledged as collateral, there was an understanding within Citi as to the consequences to Lehman if Lehman were to withdraw the deposit.[4664] In response to an internal Citi e-mail from Mauerstein highlighting the distinction between treating the $2 billion amount as a "pledge" versus a "deposit," Citi's Managing Director of Global Transaction Services Cash Management stated, "Mike, I am aware and understand all of this – though their asking for the

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[4660] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 5.

[4661] E-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (June 12, 2008) [CITI-LBHI-EXAM 00073732].

[4662] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 4.

[4663] E-mail from Paul S. Galant, Citigroup, to Jerry Olivo, Citigroup, *et al.* (Aug. 29, 2008) [CITI-LBHI-EXAM 00076678].

[4664] *See* e-mail from Jerry Olivo, Citigroup, to Michael Mauerstein, Citigroup, *et al.* (Aug. 29, 2008) [CITI-LBHI-EXAM 00076678].

deposit back does have distinct impacts on clearing capacity."[4665] Fontana further explained that, had Lehman withdrawn the deposit, Citi would have reassessed whether it would have continued doing "business as usual" with Lehman, and that, in order for Citi to continue clearing and settling trades for Lehman, Lehman would have had to prefund its transactions through Citi.[4666] According to Fontana, that prefunding would have been a liquidity drain for Lehman.[4667] Mauerstein and Foskett each also opined that Citi would likely have reduced Lehman's intraday credit lines if Lehman had withdrawn the deposit.[4668] Moreover, Fontana and Foskett stated that Citi would have stopped providing credit lines to Lehman if Lehman had withdrawn its cash deposit and did not replace it by, for example, pledging collateral or prefunding.[4669]

Notably, Citi subjected the "comfort deposit" to a number of internal controls designed to keep the $2 billion within Citi.[4670] Shortly after Lehman provided the deposit, Fontana stated in an internal Citi e-mail exchange:

> My concerns are twofold: keeping the liquidity [of the deposit] within Citi and being able to control the release of the deposit. I don't want to learn the deposit was not renewed a week after Lehman has the funds. The standing order to Eddie [Hewett, Jr.] is as soon as he gets the call [from

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[4665] *Id.*

[4666] Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 5.

[4667] *Id.*

[4668] Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 9; Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 9.

[4669] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 9; Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 5.

[4670] *See* e-mail from Katherine Lukas, Citigroup, to Ranjit Chatterji, Citigroup, *et al.* (Aug. 27, 2008) [CITI-LBHI-EXAM 00020787].

> Lehman asking for release of the deposit] he is to call me to advise me of [Lehman's] intentions.[4671]

Citi's Risk Treasury desk was charged with notifying Fontana prior to the release of any portion of the deposit.[4672] Further, in discussions concerning the most applicable interest rate to provide Lehman on the $2 billion, and how to count the "comfort deposit" internally within Citi's systems, Citi's Managing Director of Global Transaction Services Cash Management characterized the deposit as "essentially captive funds."[4673]

In providing "background" to others at Citi on the nature of the "comfort deposit," one relationship manager at Citi described the deposit as:

> [A] $2BN Cash Deposit from [LBHI] placed with Eddie's Risk Treasury Desk. . . . This is an overnight investment that gets rolled on a daily basis. Once of the caveats from Risk was that Citi Risk would have control and final approval prior to releasing funds should Lehman look to pull the funds back. A process is in place for Tom Fontana to be notified for approval by the desk prior to a withdrawal being made.[4674]

In his interview with the Examiner, Fontana confirmed that an internal notification process, such as the one described above, governed the release of the deposit.[4675] Although Citi likely would have released the deposit if asked, before

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[4671] E-mail from Thomas Fontana, Citigroup, to Robert Blackburn, Citigroup, *et al.* (June 19, 2008) [CITI-LBHI-EXAM 00018405].

[4672] *Id*.

[4673] E-mail from Jerry Olivo, Citigroup, to Robert Blackburn, Citigroup, *et al*. (June 25, 2008) [CITI-LBHI-EXAM 00020787].

[4674] E-mail from Katherine Lukas, Citigroup, to Ranjit Chatterji, Citigroup, *et al.* (Aug. 27, 2008) [CITI-LBHI-EXAM 00020787].

[4675] Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 5.

releasing the deposit Citi would have decided internally if it would continue to conduct "business as usual" with Lehman.[4676] This internal procedure was "just to check" with people at Citi before the deposit was released.[4677]

Thus, while Lehman considered the deposit to be "lien-free" and offered merely as a "good faith" gesture to maintain a positive working relationship, Citi officials emphasized that Citi had a legal right of setoff against the deposit, and that withdrawing the deposit would have negative implications on Citi's willingness to clear for Lehman. Further, Citi subjected the deposit to an internal procedure, whereby release of the deposit was subject to its risk desk's notification and approval.[4678]

At least once during the summer of 2008, Lehman used $210 million of the $2 billion deposit to cover a Demand Deposit Account overdraft, and promised to replace the used funds the next business morning.[4679] Neither Fontana nor Foskett recalled another instance where Lehman asked for any portion of its cash deposit back.[4680]

[4676] *Id*.

[4677] Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 5.

[4678] Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 5; Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 5.

[4679] E-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup (June 30, 2008) [CITI-LBHI-EXAM 00074989]; *see also* e-mail from Thomas Fontana, Citigroup, to Brian R. Leach, Citigroup, *et al.* (July 1, 2008) [CITI-LBHI-EXAM 00111749] (reporting that Lehman had a fail from another bank on June 30, 2008, which would have resulted in a $268 million overdraft, but Citi "permitted the company to use part of its deposit to cover the OD [and this] avoided a potential asset which the OD would have created over month-end"); e-mail from Emil F. Cornejo, Lehman, to Joseph Igoe, Lehman (July 4, 2008) [LBEX-DOCID 1078431] (Cornejo explained that Lehman withdrew $210 million from the deposit at Citi to cover a fail in Lehman's account with Citi); Citigroup, Spreadsheet (as of Sept. 18, 2008) [CITI-LBHI-EXAM 00115772] (showing a $210 million withdrawal on June 30, 2008).

[4680] Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 5; Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 6.

c. The Exact Terms of the "Comfort Deposit" Are Unknown Because the Terms Were Not Reduced to Writing

The terms controlling Lehman's $2 billion "comfort deposit" were not reduced to writing.[4681] Foskett said that, after the near collapse of Bear Stearns, it became "standard" practice for clients to leave a deposit with Citi to facilitate clearing without the parties necessarily formalizing the arrangement in writing.[4682] Specifically, during the summer of 2008, at least one other large investment bank in addition to Lehman maintained a cash deposit at Citi for clearing purposes, and Citi was in talks with another investment bank to do the same until market conditions in September 2008 made that deposit unnecessary.[4683]

(iii) Citi Knew the "Comfort Deposit" was Included in Lehman's Liquidity Pool

Lehman included the $2 billion "comfort deposit" in its liquidity pool.[4684] Fontana understood that Lehman included the $2 billion deposit in its liquidity pool.[4685] In preparation for a June 17, 2008 meeting with Lehman, Mauerstein's list of "talking points" included conveying to Lehman that "Lehman has over $40 billion liquidity

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[4681] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 4; Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 5.

[4682] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 4.

[4683] *Id*.

[4684] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 21.

[4685] Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 6. Fontana was not aware, however, that Lehman's deposits or collateral pledges with other clearing banks were included in the liquidity pool. *Id*. When presented with this possibility by the Examiner, Fontana stated: "The whole thing [pool] could have been pledged out!" *Id*.

pool, and [Citi] felt that it would help us if Lehman kept some of that on deposit with us."[4686] Likewise, Foskett recalled that Lehman insisted the deposit be liquid so that Lehman could include the $2 billion in the liquidity pool in reports sent to analysts and regulators (and, presumably, filings with the SEC for public investors as well).[4687] From Mauerstein's perspective, Lehman's decision about what to report in its liquidity pool was a matter between Lehman and its regulators.[4688] Foskett, Mauerstein and Fontana each acknowledged that they did not consider the June 12 cash deposit officially encumbered.[4689]

(c) Collateral Pledge Discussions Between Lehman and Citi Began in June 2008 and Continued Until September 2008

(i) The Unexecuted Pledge Agreement: the Parties Agreed to Negotiate the Terms but Not Execute the Agreement Until It Was Needed

Several weeks after Lehman placed the $2 billion "comfort deposit" with Citi on June 12, 2008, Citi and Lehman began to discuss executing a collateral pledge agreement

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[4686] E-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup, *et al*. (June 17, 2008) [CITI-LBHI-EXAM 00073791]; *see also* e-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (July 2, 2008) [CITI-LBHI-EXAM 00073015] (Mauerstein wrote that "[w]e should remind prople in our organization that Lehman has $50 billion of holding company cash/liquidity (including the $2B with us) and access to the Fed discount window").

[4687] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 5.

[4688] Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 6.

[4689] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 5; Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 6; Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 5.

to replace the cash deposit.[4690] Citi and Lehman met in late June and agreed that Citi would collect data on daylight overdrafts, which Citi would then use to perform its risk analysis, and from that, the parties would be able to determine how much collateral Citi would request.[4691]

In mid-July, the parties planned to agree on the terms of the pledge agreement, but to leave it unexecuted with the idea that the parties could execute the agreement later if the market deteriorated further.[4692] The rationale was that, should market conditions deteriorate such that the agreement would become necessary from Citi's perspective, the firms' respective legal departments would have already reviewed the agreement and the companies could execute the agreement immediately.[4693] Some at Citi questioned the logic of this, and queried whether the parties would actually be willing to execute the agreement at a time when it was needed because market conditions or company circumstances would likely have changed significantly.[4694] Nevertheless, the parties proceeded with this arrangement and Mauerstein sent the first

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[4690] E-mail from Christopher M. Foskett, Citigroup, to Michael Mauerstein, Citigroup, *et al*. (July 2, 2008) [CITI-LBHI-EXAM 00073015] (discussing whether Citi should take some collateral from Lehman since Lehman offered).

[4691] E-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (July 2, 2008) [CITI-LBHI-EXAM 00073015].

[4692] E-mail from Emil F. Cornejo, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (July 13, 2008) [LBHI_SEC07940_528212].

[4693] Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 7; e-mail from Richard C.S. Evans, Citigroup, to Gregory Frenzel, Citigroup, *et al.* (July 16, 2008) [CITI-LBHI-EXAM 00082047] ("What we need is their agreement to agree the documentation now so that it can be signed at a moment's notice, and not require another 24-48 hours of legal review at a later stage when we don't have that time.").

[4694] *E.g.*, Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 8.

version of a draft pledge agreement to Cornejo on July 14, 2008,[4695] a second version on July 16, 2008,[4696] and a third version on July 28, 2008.[4697] As of July 18, 2008, a collateral account titled "Lehman Brothers Holdings Inc., Pledge to Citibank" had been reserved (but not yet opened).[4698]

Lehman wanted to move away from a cash deposit in July toward a "more cash capital friendly collateral deposit" of less liquid securities.[4699] Specifically, Tonucci was agreeable to replacing the cash deposit with securities,[4700] but in general Lehman was resistant to a pledge of any kind.[4701]

Some Citi officials questioned whether the comfort deposit would have been returned upon the execution of the pledge agreement. Citi's Chief Risk Officer in Global Transaction Services expressed his preference in July to hold the cash deposit for

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[4695] E-mail from Michael Mauerstein, Citigroup, to Emil F. Cornejo, Lehman, *et al*. (July 14, 2008) [LBEX-DOCID 1078879].

[4696] E-mail from Michael Mauerstein, Citigroup, to Emil F. Cornejo, Lehman (July 16, 2008) [LBEX-DOCID 1076467].

[4697] E-mail from Michael Mauerstein, Citigroup, to Emil F. Cornejo, Lehman (July 28, 2008) [LBEX-DOCID 1076205].

[4698] E-mail from Ken Porcaro, Citigroup, to Katherine Lukas, Citigroup (July 18, 2008) [CITI-LBHI-EXAM 00022307]; e-mail from Katherine Lukas, Citigroup, to Janet Birney, Lehman, *et al*. (Aug. 4, 2008) [LBEX-DOCID 459043] (informing Lehman that the collateral account had been reserved).

[4699] E-mail from Reto Faber, Citigroup, to Vivek Tyagi, Citigroup, *et al*. (July 15, 2008) [CITI-LBHI-EXAM 00022615].

[4700] E-mail from Thomas Fontana, Citigroup, to Michael Mauerstein, Citigroup, *et al.* (July 22, 2008) [CITI-LBHI-EXAM 00075055].

[4701] E-mail from Emil F. Cornejo, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (July 13, 2008) [LBHI_SEC07940_528212] (Cornejo told Mauerstein "that any pledge would not be acceptable to [L]ehman").

"10 years" before Citi had to give any back.[4702] When asked whether Citi would have returned the cash deposit to Lehman upon a pledge of securities, Foskett speculated that it would likely have depended on how the collateral was structured.[4703]

Finally, as set forth *supra*, Citi officials opined that a pledge of this size would likely be an 8-K reportable event for Lehman, which would require CEO approval.[4704] The pledge agreement negotiations continued into September, but an agreement was never finalized and executed.[4705]

(ii) Citi Had Difficulty Pricing the Collateral Offered by Lehman as a Substitute for the Cash Deposit

Part of the delay in agreeing to terms for the collateral pledge agreement stemmed from the difficulties Lehman and Citi encountered in July and August in negotiating what securities would be placed with Citi.[4706]

[4702] E-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup (July 2, 2008) [CITI-LBHI-EXAM 00081921)].

[4703] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 6.

[4704] E-mail from Emil F. Cornejo, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (July 13, 2008) [LBHI_SEC07940_528212]; e-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup, *et al.* (July 12, 2008) [CITI-LBHI-EXAM 00076243] ("Granting $2B collateral will likely be an 8-K event and therefore a CEO discussion."); e-mail from Richard C.S. Evans, Citigroup, to Gregory Frenzel, Citigroup, *et al.* (July 16, 2008) [CITI-LBHI-EXAM 00082047] (characterizing the execution of a pledge agreement as a regulatory disclosure for Lehman).

[4705] *See* e-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup (Sept. 10, 2008) [CITI-LBHI-EXAM 00075863] (discussing how Citi should have had the collateral arrangement completed long ago instead of the "fire drill" of getting the Guaranty Amendment on September 9).

[4706] *See, e.g.*, e-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup, *et al*. (Aug. 4, 2008) [CITI-LBHI-EXAM 00074286] (noting the absence of a ready market for the collateral and the difficulty of pricing the collateral because the referenced CLOs did not trade); e-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al.* (Aug. 12, 2008) [CITI-LBHI-EXAM 00077310] (questioning the reliability of Citi's Global Transaction Services collateral system to provide real prices which Citi could execute against); Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 7.

An overview of a contemplated transaction in April 2008 between Citi and Lehman is helpful for an understanding of the securities valuation issue. Prior to the collateral negotiations in connection with the pledge agreement, in April 2008, Citi's CEO Vikram Pandit and Lehman's CEO Richard Fuld discussed setting up a "commercial real estate" repo.[4707] While this proposed repo was not connected to the pledge negotiations of import to the instant analysis, valuation difficulties in both instances were similar because both instances involved illiquid assets.[4708] According to Foskett, the repo discussions in April and May 2008 broke down in part because Citi

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[4707] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 6; *see* e-mail from Nancy Kim, Citigroup, to Thomas Mellina, Citigroup, *et al.* (May 21, 2008) [CITI-LBHI-EXAM 00034330] (attaching CMAC Memo - BVP against Lehman's Asset Backed Notes); Citigroup, Lehman Brother Holding Inc (June 4, 2008), at p. 2 [CITI-LBHI-EXAM 00078763] (detailing Lehman's CEO contact of Citi's Pandit in spring 2008 concerning Citi providing some liquidity against certain Lehman commercial real estate assets). A Borrow versus Pledge transaction was proposed where Citi would have borrowed a security (a RACERS Trust Note that was backed by commercial real estate assets) from Lehman and pledged U.S. Agency Mortgages to Lehman as collateral for the borrowed security. Citigroup, Lehman Brother Holding Inc (June 4, 2008), at p. 2 [CITI-LBHI-EXAM 00078763]. Lehman then would have lent out the agency securities in return for cash. *Id*. The commercial real estate assets being considered were loans against Hilton properties. *Id*. Citi's Senior Risk Management was not comfortable with taking any additional exposure to Hilton properties and declined to approve the financing transaction. *Id*. This "would have been booked as direct exposure (not PSE) given that Citi's ability to liquidate the collateral under a Lehman bankruptcy remained questionable." *Id*.; *see also* e-mail from Thomas Fontana, Citigroup, to Patrick Ryan, Citigroup, *et al.* (Apr. 25, 2008) [CITI-LBHI-EXAM 00038195] (noting Pandit and Fuld having some discussion regarding commercial real estate financings); e-mail from Christopher M. Foskett, Citigroup, to Michael Mauerstein, Citigroup, *et al*. (Apr. 18, 2008) [CITI-LBHI-EXAM 00080817] (noting high level dialogue between Fuld and Pandit); e-mail from Thomas Mellina, Citigroup, to Thomas Fontana, Citigroup, *et al.* (May 30, 2008) [CITI-LBHI-EXAM 00081443] (summarizing how the deal fell through because Lehman was supposed to contribute a diverse pool of commercial real estate assets but, instead, contributed only loans against Hilton properties; also, the deal was supposed to be structured so that it would be safe from a bankruptcy stay, but this failed); e-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup (May 29, 2008) [CITI-LBHI-EXAM 00081410] (summarizing a conversation Mauerstein had with Cornejo that the deal falling through was not about Lehman risk and more because Citi's risk people expected the portfolio to contain a diverse set of commercial real estate assets but the deal presented was only against a single asset - Hilton).

[4708] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 8.

was prepared to give only 50 cents on the dollar for the collateral, whereas Lehman thought the assets were worth closer to 90 cents on the dollar.[4709]

With this recent significant discrepancy in valuation, some at Citi recognized that any collateral deposit negotiations were going to be difficult, particularly when Lehman offered more illiquid assets, this time in the form of CLOs and CDOs, in July in connection with the collateral pledge agreement negotiations.[4710] Citi communicated to Lehman that Citi was trying to be flexible in what collateral Citi would accept, and suggested it would not view favorably a proposition that included emerging market sovereign bonds.[4711] Citi expanded the collateral listed in the proposed pledge agreement to reflect that Citi would accept more than just government securities, which Citi had initially requested.[4712]

[4709] *Id.* at p. 6. One of the advantages of using this type of trade was that it disguised the source of the assets by sending it through a trust. *See* e-mail from Thomas Mellina, Citigroup, to Joseph Martinelli, Citigroup, *et al.* (May 16, 2008) [CITI-LBHI-EXAM 00082707]. Thomas Mellina commented that, "[w]hen the market becomes concerned about a given party, the market should not be willing to lend against assets issued by or guaranteed by that party," and the special structure of the repo would hide the issuer's identity for a while. *Id.*; *see also* e-mail from Thomas Mellina, Citigroup, to Thomas Fontana, Citigroup, *et al.* (July 23, 2008) [CITI-LBHI-EXAM 00115293] (showing that the repo discussions did not terminate entirely in May, but the parties had not made much progress by the end of July because Citi was still trying to create a financing structure that addressed all of Citi's concerns); e-mail from Stephen J. Bujno, Citigroup, to Kenneth Quay, Citigroup (Sept. 3, 2008) [CITI-LBHI-EXAM 00034297] (forwarding "Lehman CRE Repo" document).

[4710] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 8.

[4711] E-mail from Michael Mauerstein, Citigroup, to Emil F. Cornejo, Lehman (July 25, 2008) [LBEX-DOCID 1078883] (relaying a message from Fontana in response to Cornejo's query regarding what type of collateral Citi would consider taking, including Fontana's comment that the collateral had "to be relatively simple from a pricing perspective and we are quite limited in our [collateral management systems] abilities") (brackets in original).

[4712] E-mail from Michael Mauerstein, Citigroup, to Emil F. Cornejo, Lehman (July 28, 2008) [LBEX-DOCID 1076205] (Mauerstein commented that Citi's "inhouse attorney revised the Pledge Agreement to include securities other than US Govies").

In early August, Lehman offered Citi the Kingfisher, Freedom, Spruce and Verano CLOs – recently rated tranches of asset-backed securities that were backed by corporate loans and structured by Lehman – as collateral in connection with the pledge agreement.[4713] Cornejo was concerned about Citi's reaction to Lehman proposing these assets as collateral[4714] and, according to Mauerstein, Lehman was not surprised when Citi ultimately rejected the CLOs as collateral.[4715] Citi personnel characterized the CLOs offered by Lehman in connection with the pledge negotiations as "bottom of the barrel"[4716] and "junk."[4717]

Citi encountered several problems when trying to price this collateral due to Citi not having a robust platform for valuing the collateral,[4718] the absence of a ready market

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[4713] E-mail from Michael Mauerstein, Citigroup, to Yingli Xie, Citigroup, *et al.* (Aug. 4, 2008) [CITI-LBHI-EXAM 00082162]; *see also* e-mail from Michael Mauerstein, Citigroup, to Anthony Lieggi, Citigroup, *et al.* (Aug. 1, 2008) [CITI-LBHI-EXAM 00022065] (seeking information on Lehman's Kingfisher, Freedom and Spruce CLOs). The CLOs Lehman offered to Citigroup were pledged to JPMorgan in response to JPMorgan's margin requirements. *Compare* e-mail from John N. Palchynsky, Lehman, to Richard Policke, Lehman, *et al*. (July 2, 2008) [LBEX-DOCID 077515] (Kingfisher), e-mail from Craig L. Jones, Lehman, to John Feraca, Lehman, *et al*. (June 19, 2008) [LBEX-DOCID 55577] (Freedom and Spruce), *and* LB Excess Collateral Priced by GF (Aug. 8, 2008) [JPM-2004 0008074] (Verano), *with* e-mail from Michael Mauerstein, Citigroup, to Yingli Zie, Citigroup, *et al*. (Aug. 4, 2008) [CITI-LBHI-EXAM 00082162] (listing CUSIPs for Kingfisher, Freedom, Spruce and Verano). JPMorgan was also having difficulty pricing these securities.

[4714] E-mail from Emil F. Cornejo, Lehman, to Julie M. Boyle, Lehman (July 31, 2008) [LBEX-AM 008649].

[4715] Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 8.

[4716] *Id*.

[4717] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 6.

[4718] E-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al.* (Aug. 12, 2008) [CITI-LBHI-EXAM 00077310] (questioning the reliability of Citi's Global Transaction Services collateral system to provide real prices against which Citi could execute); Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 7. Citi's clearing risk division also did not have the ability to track a company's clearing usage in real time. E-mail from Thomas Fontana, Citigroup, to Brian R. Leach, Citigroup, *et al*. (July 1, 2008) [CITI-LBHI-EXAM 00111749]. Additionally, in April 2008, Lehman's CLS line was reduced from $3 billion to $1.8 billion, and Lehman's clearing lines were removed from the nostro accounts. E-

for the collateral and the nature of the collateral itself.[4719] The CLOs were held by Lehman and, according to Citi's secondary trading desk, the CLOs proposed by Lehman did not trade.[4720] If Citi wanted to sell them in the market under conditions that existed in August 2008, Citi estimated that perhaps five investors would show a price and that Citi would essentially have to do a road show.[4721] On a call with Citi's Foskett and Mauerstein, Tonucci described the CLOs in the initial collateral portfolio as trading "only occasionally."[4722]

In August 2008, Mauerstein told Cornejo that Citi would not consider taking any CLOs as collateral unless Citi was sure it could value them and was confident it could sell them for an amount that covered the advance rate.[4723] However, Citi believed it had

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mail from Katherine Lukas, Citigroup, to Seamus Kennedy, Citigroup, *et al*. (May 2, 2008) [CITI-LBHI-EXAM 00023281].

[4719] Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 7; *see also* e-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup, *et al.* (Aug. 4, 2008) [CITI-LBHI-EXAM 00074286].

[4720] E-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup, *et al.* (Aug. 4, 2008) [CITI-LBHI-EXAM 00074286].

[4721] *Id*.

[4722] Lehman, CITIGROUP Call Report (Aug. 7, 2008), at p. 1 [LBEX-DOCID 1035842]. Based on document research and witness testimony, the Examiner does not believe these Lehman CLOs ever traded. Lehman was occasionally able to repo them for short periods, but actual trades between arm's length counterparties that would permit even limited price discovery do not appear to have occurred. *See* e-mail from Marie Stewart, Lehman, to Jonathan Cohen, Lehman, *et al*. (May 8, 2008) [LBHI_SEC07940_1069905] ("Like Freedom CLO and Spruce CLO [SASCO transaction] is just creating securities to take to Fed window"); Lehman, Securitizing Leveraged Loans: Freedom, Spruce, Thalia CLOs, at p. 2 [LBEX-WGM 835699] ("Securities thereby created are not meant to be marketed" with unidentified person's handwriting in the margin emphasizing "No intention to market").

[4723] E-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup, *et al.* (Aug. 5, 2008) [CITI-LBHI-EXAM 00076589] (relaying a conversation Mauerstein had with Cornejo the previous day).

no basis for establishing any initial price for the CLOs.[4724] Citi's secondary trading desk had informed Mauerstein that there were no active secondary market prices for the CLOs Lehman offered as collateral, and Citi was not going to price them based solely on their ratings.[4725] Fontana found it surprising that, according to Lehman's valuation, a single-A rated CLO would be priced as high as 96 to 97 cents on the dollar.[4726] Overall, Citi seemed more concerned about whether there was a ready market for these CLOs, as opposed to Citi's ability (or inability, as it were) to assign an exact price to them – but Citi could not get sufficient information in either respect.[4727] Ultimately, Citi decided in mid-August that the CLOs Lehman offered were not going to "work" for the pledge agreement.[4728]

On August 11, Emil Cornejo provided another portfolio of securities that Lehman proposed Citi accept as collateral; according to Lehman, these securities were asset-backed across the spectrum with a notional value of $3.7 billion.[4729] Fontana still

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[4724] E-mail from Thomas Fontana, Citigroup, to Michael Mauerstein, Citigroup, *et al.* (Aug. 4, 2008) [CITI-LBHI-EXAM 00074286].

[4725] E-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup, *et al.* (Aug. 5, 2008) [CITI-LBHI-EXAM 00076589].

[4726] E-mail from Thomas Fontana, Citigroup, to Joseph A. Cuniglio, Citigroup, *et al.* (Aug. 1, 2008) [CITI-LBHI-EXAM 00022065].

[4727] E-mail from Michael Mauerstein, Citigroup, to Yingli Xie, Citigroup, *et al.* (Aug. 4, 2008) [CITI-LBHI-EXAM 00082162].

[4728] E-mail from Michael Mauerstein, Citigroup, to Katherine Lukas, Citigroup, *et al.* (Aug. 12, 2008) [CITI-LBHI-EXAM 00021175] (discussing pricing the proposed portfolio of asset-backed securities for the pledge agreement).

[4729] E-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup, *et al.* (Aug. 11, 2008) [CITI-LBHI-EXAM 00077310]; *see also* Lehman, CITIGROUP Call Report (Aug. 7, 2008), at p. 1 [LBEX-DOCID 450310] (describing the second portfolio of collateral as $3 billion "of investment grade private label ABS, CMOs").

doubted whether Citi's desk would be able to provide pricing information on many of these newly proposed assets, and noted that most of the securities had limited liquidity in the market at the time.[4730] By late August, some at Citi wanted an agreement in place as soon as possible detailing which securities Lehman would pledge as collateral in place of the cash deposit.[4731]

Contributing to the difficulty of finding collateral that was agreeable to both parties was the fact that Fleming told Citi that Lehman repoed out for cash all of the marketable securities in its liquidity pool.[4732] On July 31, 2008, Cornejo stated, "[a]pparently, the only way to find acceptable collateral for Citi, is to repo in collateral which then can be pledged."[4733] In contrast, if Citi had accepted the CLOs, Lehman would not have had to reverse repo in any securities.[4734] Thus, if Citi refused to accept the CLOs, and requested that Lehman pledge marketable securities to Citi in connection with the pledge agreement, Lehman would have had to "reverse-in securities to deliver to us, and absorb the funding cost (what they would avoid doing if they pledge CLOs)."[4735]

[4730] E-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al.* (Aug. 12, 2008) [CITI-LBHI-EXAM 00077310].

[4731] E-mail from Paul S. Galant, Citigroup, to Jerry Olivo, Citigroup, *et al.* (Aug. 29, 2008) [CITI-LBHI-EXAM 00076678].

[4732] E-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup, *et al.* (Aug. 5, 2008) [CITI-LBHI-EXAM 00076589] (recounting a conversation he had with Fleming the previous week).

[4733] E-mail from Emil F. Cornejo, Lehman, to Julie M. Boyle, Lehman (July 31, 2008) [LBEX-AM 008649].

[4734] E-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup, *et al.* (Aug. 5, 2008) [CITI-LBHI-EXAM 00076589].

[4735] *Id*.

(iii) The Guaranty Amendment Was Signed in a "Fire Drill" on September 9, 2008

The original Guaranty between Citi and Lehman, whereby LBHI guaranteed the credit obligations of certain subsidiaries, was signed on January 7, 2004, and listed seven Lehman entities as "Borrowers" which LBHI guaranteed.[4736] This was subsequently amended between September 9 and 11, 2008 by adding ten Lehman subsidiaries and extending the scope of the Guaranty.[4737]

In the January 7, 2004 Guaranty, the consideration provision stated that LBHI entered into the Guaranty "[f]or good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, and to induce Citigroup to extend and/or maintain credit to or for the account of [LBHI's] subsidiaries listed on Schedule A."[4738] Section 1 of the Guaranty provided that LBHI unconditionally guaranteed "the punctual payment when due . . . of all obligations . . . of each Borrower to Citigroup under any and all extensions of credit extended and/or maintained by Citigroup."[4739]

The September 9, 2008 "Amendment 1 to Guaranty" ("September 9 Guaranty Amendment") contained an identical consideration provision, as it provided that LBHI entered into the Amendment "[f]or good and valuable consideration, the receipt and

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[4736] Guaranty (Jan. 7, 2004), at pp. 1, 6 [LBEX-DOCID 1090071]. Schedule A lists the seven "Borrowers:" Lehman Brothers Holdings PLC, Lehman Brothers Securities Asia Limited, Lehman Brothers Special Financing Inc., Lehman Brothers Japan Inc., Lehman Brothers International (Europe), Lehman Brothers Commercial Corporation Asia Limited and Lehman Brothers Bankhaus AG. *Id*. at p. 6.

[4737] *See* Amendment 1 To Guaranty (Sept. 9, 2008) [LBEX-DOCID 090568] (executed version signed by Ian Lowitt on September 11, 2008).

[4738] Guaranty (Jan. 7, 2004), at p. 1 [LBEX-DOCID 1090071].

[4739] *Id*. (§ 1).

sufficiency of which are hereby acknowledged, and to induce Citigroup to extend and/or maintain credit to or for the account of [LBHI's] subsidiaries listed on Schedule A."[4740] The September 9 Guaranty Amendment altered Section 1 of the original Guaranty so that LBHI now unconditionally guaranteed "the punctual payment when due . . . of all obligations . . . of each Borrower (i) under any agreements with Citigroup or any Citigroup Entity pursuant to which any Citigroup Entity opens and maintain accounts for the custody of cash, securities, and/or other assets of such Borrower or provides custodial and related services for such Borrower . . . and (ii) to any Citigroup Entity under any and all extensions of credit . . . ."[4741]

Fontana characterized the September 9 Guaranty Amendment as adding "the clearing side which was not previously expressly covered in our existing guarantees" and confirmed that the $2 billion deposit was thereby "completely secure[d] for [Citi] and any exposures."[4742] Thus, the Amendment (1) increased the number of entities covered by LBHI's Guaranty by adding ten Lehman subsidiaries, including LBI, and (2) expanded the category of obligations covered by the Guaranty by including

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[4740] Amendment 1 To Guaranty (Sept. 9, 2008), at p. 1 [LBEX-DOCID 090568].

[4741] *Id*. (§ 1).

[4742] E-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup (Sept. 10, 2008) [CITI-LBHI-EXAM 00075863]. *But see* e-mail from Emil F. Cornejo, Lehman, to Huw Rees, Lehman, *et al*. (Sept. 13, 2008) [LBEX-DOCID 1078385] (Cornejo stated there is no agreement, and the deposit is still a callable one); e-mail from Emil F. Cornejo, Lehman, to Huw Rees, Lehman, *et al*. (Sept. 13, 2008) [LBEX-DOCID 1078385] (Cornejo stated that, because Citi had a right of offset under New York law, if there was a negative balance the cash would not be released).

obligations owed to Citigroup under any custodial agreement with Citi in addition to extensions of credit provided by Citi.[4743]

a. Events Prior to the Signing of the September 9 Guaranty Amendment from Citi's Perspective

By September 2008, Citi had become increasingly concerned about the lack of an ironclad claim to Lehman's $2 billion "comfort deposit," and had worked on the collateral pledge arrangement with Lehman for approximately two months.[4744] On September 9, the failure of the KDB deal was widely reported, Lehman accelerated its third quarter 2008 earnings announcement to September 10, and Lehman's stock price plummeted. These events led Citi to seek the September 9 Guaranty Amendment.[4745] Specifically, on the morning of September 9, the Head of Citi's Institutional Clients Group requested that the comfort deposit be officially taken into collateral.[4746] In response to this request, Citi sought an amendment to the 2004 Guaranty that would allow Citi to offset the $2 billion deposit against obligations that LBI and several other

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[4743] Amendment 1 To Guaranty (Sept. 9, 2008) [LBEX-DOCID 090568].

[4744] E-mail from Thomas Fontana, Citigroup, to Brian R. Leach, Citigroup, *et al.* (Sept. 9, 2008) [CITI-LBHI-EXAM 00077391] (discussing attempts to improve Citi's claim on the $2 billion deposit); *see also* e-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup (Sept. 10, 2008) [CITI-LBHI-EXAM 00075863] (stating that Citi should have had the collateral arrangement completed long ago instead of the "fire drill" of getting the Guaranty Amendment on September 9).

[4745] Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 8.

[4746] E-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (Sept. 9, 2008) [CITI-LBHI-EXAM 00076762].

Lehman entities owed to Citi.[4747] Additionally, on September 9, Citi reduced Lehman's clearing lines significantly, some to zero.[4748] Worldwide, Lehman's clearing lines at Citi that were not reduced to zero were reduced to the level of the deposit Lehman had posted with Citi, which remained at $2 billion.[4749]

Citi set a deadline of 6:00 p.m. Eastern time[4750] on September 9 by which Lehman had to execute the amendment.[4751] According to Foskett, Citi did not present the amendment on a "take-it-or-leave-it" basis,[4752] and Lehman said it had no problem with providing a guaranty for LBI.[4753] In fact, Foskett stated that Lehman quickly faxed the signed amendment back to Citi[4754] after Ian Lowitt signed it shortly before the 6:00 p.m. deadline.[4755]

After LBI was added to the Guaranty prior to the 6:00 p.m. deadline, the negotiations continued in an effort by Citi to get additional Lehman subsidiaries added,

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[4747] Amendment 1 To Guaranty (Sept. 9, 2008) [LBEX-DOCID 4263143] (adding LBI to the January 7, 2004 LBHI Guaranty and expanding the scope of the Guaranty to include Custody Agreements as well as Credit Agreements).

[4748] E-mail from Thomas Fontana, Citigroup, to Brian R. Leach, Citigroup, *et al.* (Sept. 9, 2008) [CITI-LBHI-EXAM 00076776].

[4749] E-mail from Gregory Frenzel, Citigroup, to John Dorans, Citigroup, *et al.* (Sept. 9, 2008) [CITI-LBHI-EXAM 00076798].

[4750] All time references in this section regarding the September 9 Guaranty Amendment refer to Eastern Time.

[4751] E-mail from Emil F. Cornejo, Lehman, to Ian T. Lowitt, Lehman, *et al*. (Sept. 9, 2008) [LBEX-AM 008564].

[4752] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 9.

[4753] E-mail from Christopher M. Foskett, Citigroup, to Thomas Fontana, Citigroup, *et al*. (Sept. 9, 2008) [CITI-LBHI-EXAM 00077391] (noting Citi sending over an amendment to the existing agreement to reflect Lehman's agreement to guarantee LBI).

[4754] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 9.

[4755] E-mail from Paolo R. Tonucci, Lehman, to Emil F. Cornejo, Lehman (Sept. 9, 2008) [LBEX-AM 008564].

specifically those in Asia.[4756] Indeed, Citi advised Lehman that Citi would not open for Lehman in Asia under the existing Guaranty.[4757] This meant that Citi would reduce Lehman's intraday credit lines to zero for the entities not covered by the Guaranty if Lehman did not sign the amendment in time; it did not mean that Citi would cease clearing for Lehman entirely.[4758] Citi likely would have continued clearing for Lehman even without a signed amendment, but Lehman would have had to prefund its trades.[4759] In order to prefund its trades, Lehman would have had to estimate its exposure and provide funds to cover that exposure, rather than relying on Citi to cover the exposure while being able to pay Citi back later in the day. Citi was concerned about its own business at this time and had to balance these issues carefully so that it did not expose itself to so much Lehman risk that Citi's business became endangered.[4760]

b. Events Prior to the Signing of the September 9 Guaranty Amendment from Lehman's Perspective

At 12:47 p.m. on September 9, Cornejo wrote to Tonucci and Boyle stating that he had just received a call from Foskett, during which Foskett told Cornejo that Citi was requesting a guaranty with LBI [in fact, an amendment of the existing 2004 LBHI-Citibank Guaranty] with the right to set off the $2 billion comfort deposit that had been

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[4756] E-mail from Thomas Fontana, Citigroup, to Emil F. Cornejo, Lehman, *et al*. (Sept. 9, 2008) [LBEX-DOCID 1079016].

[4757] *Id*.

[4758] Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 8.

[4759] Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 9.

[4760] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 8; *see also* Thomas Fontana, Citigroup, Unpublished Notes (Sept. 12, 2008), at p. 193 [CITI-LBHI-EXAM 00099649] (contemporaneous handwritten notes noting the "need to protect shareholders").

placed by Lehman in a call account with Citi on June 12.[4761] Cornejo wrote that this request was coming in response to Lehman's "stock price decline," and that Lehman had a $3.4 billion intraday overdraft with Citi when he spoke with Foskett.[4762] Cornejo was initially resistant to the idea and said he would get back to Foskett.[4763] Tonucci suggested Cornejo speak to Andrew Yeung, in-house counsel at Lehman, because Lehman "did something similar for JP[Morgan] so hopefully [it will not be] an issue to have legal review and agree."[4764]

Cornejo sent the draft agreement to James "Jim" Killerlane in Lehman's legal department for review.[4765] Killerlane expressed some concern about how the setoff provision in the original Guaranty would interact with Lehman's Custody Agreements.[4766] Despite this concern, Killerlane stated he would be comfortable with executing the amendment if Lowitt and Treasury personnel were comfortable with it.[4767] While Killerlane was expressing his concern about the proposed amendment, Craig Jones e-mailed Fleming, writing: "Citibank still has not released our $2bn. They say

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[4761] E-mail from Emil F. Cornejo, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (Sept. 9, 2008) [LBEX-AM 008563].
[4762] *Id*.
[4763] *Id*.
[4764] E-mail from Paolo R. Tonucci, Lehman, to Emil F. Cornejo, Lehman, *et al*. (Sept. 9, 2008) [LBEX-AM 008690].
[4765] E-mail from Emil F. Cornejo, Lehman, to James J. Killerlane, Lehman (Sept. 9, 2008) [LBEX-DOCID 1079080].
[4766] E-mail from James J. Killerlane, Lehman, to Emil F. Cornejo, Lehman (Sept. 9, 2008) [LBEX-AM 008571] (stating that he was "not sure if we can logistically [sign the amendment to the guaranty] with our Custody Agreements or if we are comfortable with this").
[4767] *Id*.

they are working on it. We have over funded the account"[4768] such that it appears Lehman believed it had more money in the account than was necessary to release the payment.

At 5:45 p.m., Cornejo forwarded Lowitt and Tonucci an execution draft of the Guaranty Amendment, stating in the e-mail: "Citi is holding payments unless we execute by 6pm tonight. Jim [Killerlane] has reviewed . . . . Ian, you are required to sign. . . . I will deliver to Citi tonight."[4769] In fact, at approximately 4:14 p.m. on the afternoon of September 9, Citi had ordered a $2.088 billion CLS payment to be held[4770] because Lehman's account balance was only $37 million with no daylight overdraft limit.[4771] When Lehman's account balance reached $2.085 billion, Fontana provided verbal approval shortly after 5:30 p.m. to release the CLS payment even though the account was $3 million short.[4772]

At approximately 5:56 p.m., Cornejo transmitted the executed document to Citi[4773] after Lowitt signed the September 9 Guaranty Amendment.[4774] In the first

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[4768] E-mail from Craig L. Jones, Lehman, to Daniel J. Fleming, Lehman (Sept. 9, 2008) [LBEX-AM 008562].

[4769] E-mail from Emil F. Cornejo, Lehman, to Ian T. Lowitt, Lehman, *et al*. (Sept. 9, 2008) [LBEX-AM 008571].

[4770] E-mail from William R. Maher, Citigroup, to Katie Evans, Citigroup, *et al.* (Sept. 9, 2008) [CITI-LBHI-EXAM 00032799].

[4771] E-mail from Katie Evans, Citigroup, to William R. Maher, Citigroup, *et al.* (Sept. 9, 2008) [CITI-LBHI-EXAM 00032799].

[4772] E-mail from Chris Deukmedjian, Citigroup, to Peter Dehaan, Citigroup, *et al.* (Sept. 9, 2008) [CITI-LBHI-EXAM 00032799].

[4773] E-mail from Emil F. Cornejo, Lehman, to Michael Mauerstein, Citigroup (Sept. 9, 2008) [LBEX-DOCID 4043703].

[4774] E-mail from Paolo R. Tonucci, Lehman, to Emil F. Cornejo, Lehman (Sept. 9, 2008) [LBEX-AM 008564].

executed version of the amendment, LBI was the only entity listed on "Schedule 1," which specifies the Lehman subsidiaries added to the parent Guaranty.[4775]

c. Negotiations Between Lehman and Citi Personnel Regarding Which Lehman Entities Were To Be Added to the Parent Guaranty by the September 9 Guaranty Amendment

At 12:54 p.m. on September 9, Mauerstein e-mailed the draft parent Guaranty Amendment to Cornejo, which proposed an additional 17 subsidiaries to the LBHI guaranty.[4776] Mauerstein told the Examiner that Citi had not sought a guaranty of LBI prior to September 9 because the U.S. broker-dealer was usually the most creditworthy Lehman entity.[4777] Nevertheless, because most of Citi's exposure was through LBI, Citi determined that, given market events, it needed its exposure to LBI covered.[4778] In the initial amendment draft, Citi's proposed list of 17 Lehman subsidiaries to be added to the parent guaranty included LBI.[4779]

[4775] Amendment 1 To Guaranty (Sept. 9, 2008) [LBEX-DOCID 4263143].

[4776] E-mail from Michael Mauerstein, Citigroup, to Emil F. Cornejo, Lehman (Sept. 9, 2008) [LBEX-DOCID 1079048].

[4777] Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 8.

[4778] *Id*.

[4779] Amendment 1 To Guaranty [Draft] (Sept. 9, 2008), at p. 3 [LBEX-DOCID 1032313] (this proposed draft was attached to Mauerstein's September 9, 2008 e-mail (LBEX-DOCID 1079048) at 12:54 p.m. to Cornejo). The subsidiaries that Citi proposed be added were: Caistor Trading BV, Lehman Brothers Australia Securities Pty Limited, Lehman Brothers Finance AG, Lehman Brothers Financial Products Incorporated, Lehman Brothers Incorporated, Lehman Brothers (Taiwan) Limited, Lehman Brothers Securities Private Limited, Libertus Jutaku Loan K.K., Neuberger Berman LLC, Lehman Brothers Commodity Services Incorporated, Lehman Brothers Equity Finance (Cayman) Limited, Lehman Brothers Finance Japan Incorporated, Lehman Brothers GCS Financing, Lehman Brothers Securities Taiwan Limited, Lehman Scottish Finance LP, Marcy Limited and Property Asset Management Inc. *Id*.

However, the signed amendment that was returned to Citi shortly before the 6:00 p.m. deadline only extended the Guaranty to LBI.[4780] When Citi received the September 9 Guaranty Amendment shortly before 6:00 p.m. on September 9 with only LBI added, Citi viewed the absence of Lehman's Asian subsidiaries as problematic for opening in Asia the next day.[4781] Lehman officials explained to Citi that it intended to provide guarantees for the Asian subsidiaries, but that Lehman needed to check with its overseas offices to ensure that no regulatory issues would prevent LBHI from doing so.[4782] Nevertheless, Citi still needed Lehman to add the subsidiaries initially listed on the amendment's schedule of parties, and stated it would withhold credit in Asia until Lehman did so.[4783]

Specifically, at 6:34 p.m., Fontana e-mailed Cornejo to request that Lehman guarantee all of the entities Citibank had included in its initial proposal, including "the international subs which are critical for us to clear for you in Asia."[4784] Cornejo

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[4780] E-mail from Emil F. Cornejo, Lehman, to Michael Mauerstein, Citigroup (Sept. 9, 2008) [LBEX-DOCID 4043703]; *see also* Amendment 1 To Guaranty (Sept. 9, 2008) [LBEX-DOCID 4263143] (first executed version remitted to Citigroup shortly before 6:00 p.m. on September 9, 2008 and adding only LBI as a guaranteed subsidiary).

[4781] E-mail from Thomas Fontana, Citigroup, to Gregory Frenzel, Citigroup (Sept. 9, 2008) [CITI-LBHI-EXAM 00108845]; e-mail from Christopher M. Foskett, Citigroup, to Thomas Fontana, Citigroup (Sept. 9, 2008) [CITI-LBHI-EXAM 00073290] (relaying Michael Mauerstein's statement that Lehman had guaranteed the U.S. broker-dealer).

[4782] E-mail from Emil F. Cornejo, Lehman, to Thomas Fontana, Citigroup (Sept. 9, 2008) [LBEX-DOCID 1079021].

[4783] E-mail from Thomas Fontana, Citigroup, to Emil F. Cornejo, Lehman, *et al*. (Sept. 9, 2008) [LBEX-DOCID 1079021] (specifically, Fontana wrote that Citi "will not open you in Asia with the agreement we have in place").

[4784] *Id*.

responded that Lehman intended to include those subsidiaries in the Guaranty, but needed more time to ensure there were no regulatory obstacles.[4785] Shortly after 7:00 p.m., Cornejo forwarded the September 9 Guaranty Amendment to others within Lehman to make sure there were no local legal or regulatory issues that prevented Lehman from adding any the remaining 16 subsidiaries that Citi had requested.[4786]

At 7:11 p.m., Fontana e-mailed Cornejo, "[w]e have a problem as we will not open you in Asia with the agreement we have in place. Call me."[4787] In an e-mail from Cornejo to Lehman personnel at 7:36 p.m., Cornejo wrote that "Citi wants LBHI to guaranty each of these legal entities. . . . I am not sure each of the entities is 100% owned by Lehman or that we have lines in Asia. Citi will reduce all limits to 0, unless we sign. . . . We signed off on [a] guaranty today in NY for LBI."[4788] Citi explained to the Examiner that Lehman either needed to agree to a parental guaranty for those Lehman entities or prefund its trades in order for Citi to clear for Lehman in Asia the next day.[4789]

[4785] E-mail from Emil F. Cornejo, Lehman, to Thomas Fontana, Citigroup (Sept. 9, 2008) [LBEX-DOCID 1079021].

[4786] E-mail from Emil F. Cornejo, Lehman, to Aireen Phang, Lehman, *et al.* (Sept. 9, 2008) [LBEX-DOCID 1079057].

[4787] E-mail from Thomas Fontana, Citigroup, to Emil F. Cornejo, Lehman, *et al*. (Sept. 9, 2008) [LBEX-DOCID 1079021].

[4788] E-mail from Emil F. Cornejo, Lehman, to Janet Birney, Lehman, *et al*. (Sept. 9, 2008) [LBEX-AM 008669].

[4789] Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 9 (Citi counsel Claudia Hammerman clarified this point to the Examiner).

During the evening of September 9, Lehman rejected eight of the original 17 entities that Citi had proposed including in the amended guaranty, and the final version that night contained nine Lehman subsidiaries that were ultimately added to the Guaranty.[4790] Specifically, Cornejo noted in an e-mail that evening that Lehman personnel had deleted five of the 17 additional subsidiaries Citi had proposed.[4791] Following that modification, Lehman removed three more entities because: (i) two of the subsidiaries had no accounts with Citi, and (ii) another subsidiary was "a division SARL."[4792] Lehman personnel also confirmed that one of the subsidiaries Cornejo had removed earlier was appropriately removed because it was a Special Purpose Vehicle.[4793] Thus, the Guaranty was amended on September 9 to add nine Lehman subsidiaries,[4794] while a tenth, LBCC, was added late on September 11, 2008[4795] after

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[4790] *See* e-mail from Emil F. Cornejo, Lehman, to Thomas Fontana, Citigroup, *et al*. (Sept. 10, 2008) [LBEX-DOCID 458344)]; Schedule 1 (To Amendment 1) (Sept. 9, 2008) [LBEX-DOCID 443684] (attached to Cornejo e-mail).

[4791] E-mail from Emil F. Cornejo, Lehman, to Janet Birney, Lehman (Sept. 9, 2008) [LBEX-DOCID 1075546]. (sent at 8:59 p.m. Eastern time). Cornejo noted that "[w]e have deleted the following names" but did not explain why the subsidiaries were deleted. *Id*. The deleted names were: Lehman Brothers Financial Products Incorporated, Property Asset Management Inc., Libertus Jutaku Loan K.K., Marcy Limited, and Caistor Trading BV. *Id*.

[4792] E-mail from Emily Critchett, Lehman, to Janet Birney, Lehman, *et al*. (Sept. 9, 2008) [LBEX-DOCID 1009802] (sent at 9:08 p.m. Eastern time). "SARL" is the abbreviation for "*société à responsibilité limitée*," and typically appears after the name of a French private limited company. Encyclopedia.com, SARL definition (last accessed Jan. 27, 2010).

[4793] E-mail from Emily Critchett, Lehman, to Janet Birney, Lehman, *et al*. (Sept. 9, 2008) [LBEX-DOCID 1009802] The subsidiary was Lehman Brothers Financial Products Incorporated. *Id*.

[4794] *See* Schedule 1 (To Amendment 1) (Sept. 9, 2008), at p. 1 [LBEX-DOCID 443684]. Those nine entities added on September 9, 2008 were: Lehman Brothers Australia Securities Pty Limited, Lehman Brothers Incorporated, Lehman Brothers (Taiwan) Limited, Lehman Brothers Securities Private Limited, Neuberger Berman LLC, Lehman Brothers Commodity Services Incorporated, Lehman Brothers Finance

Mauerstein told Cornejo that LBCC's CLO obligations would have to be prefunded that night if Lehman did not sign the Schedule to the Guaranty with LBCC included.[4796]

With the exception of the Lehman subsidiaries that were initially proposed, the terms of the executed Guaranty Amendment remained unchanged from what was sent via e-mail to Cornejo by Mauerstein at 12:54 p.m. on September 9.[4797] The documents do not show whether Lehman advised Citi as to the reasons for its removal of some of the proposed subsidiaries from the list, nor do they establish whether Citi resisted Lehman's removal of eight of the subsidiaries initially proposed by Citi.[4798]

Japan Incorporated, Lehman Brothers GCS Financing and Lehman Brothers Securities Taiwan Limited. *Id*.

[4795] E-mail from Rosa Garcia, Lehman, to Emil F. Cornejo, Lehman, *et al*. (Sept. 12, 2008) [LBEX-DOCID 065565] (noting that the attached signed Guaranty was sent to Mauerstein at Citi; this e-mail was sent at 8:55 p.m. Eastern time); s*ee also* Amendment 1 To Guaranty (Sept. 9, 2008) [LBEX-DOCID 090568] (executed version signed by Ian Lowitt on September 11, 2008).

[4796] E-mail from Michael Mauerstein, Citigroup, to Emil F. Cornejo, Lehman (Sept. 11, 2008) [LBEX-DOCID 1078857].

[4797] *Compare* Amendment 1 To Guaranty [Draft] (Sept. 9, 2008) [LBEX-DOCID 1032313] (draft version sent by Mauerstein to Cornejo at 12:54 p.m. on September 9, 2008), *with* Amendment 1 To Guaranty (Sept. 9, 2008) [LBEX-DOCID 4263143] (executed version from September 9 which added only LBI to the Guaranty), *and* Amendment 1 To Guaranty (Sept. 9, 2008) [LBEX-DOCID 090568] (final executed version signed by Ian Lowitt on September 11, 2008, listing 10 Lehman subsidiaries that were ultimately added to the parent Guaranty).

[4798] *See generally* e-mail from Paolo R. Tonucci, Lehman, to Emil F. Cornejo, Lehman, *et al*. (Sept. 9, 2008) [LBEX-AM 008690] (suggesting that, because Lehman had executed a similar guaranty with JPMorgan, this guaranty amendment would not, he hoped, be an issue for Lehman's legal department).

(iv) September 12, 2008: A Lehman Collateral Account at Citi was Activated After Two Months of Discussion, and Lehman Signed an Amendment to the Direct Custodial Services Agreement

A collateral account titled "Lehman Brothers Holdings Inc., Pledge to Citibank" at Citi was reserved by July 18,[4799] opened on September 11, and became active on September 12,[4800] but no collateral was ever transferred into it. The account was opened in conjunction with the proposed pledge of securities by LBHI because Lehman needed to have a "US securities custody account and cash account" at Citi.[4801]

Unlike JPMorgan, which discussed a guaranty amendment with Lehman on September 9 that was subsequently signed on September 10 and followed by a Security Agreement from Lehman on September 10,[4802] Citi did not obtain a Security Agreement. However, Citi did obtain an amendment on September 12, 2008 to its DCSA with Lehman.[4803] Specifically, on the afternoon of September 12, Citibank's Lukas and Lehman's Birney and Boyle signed the DCSA amendment which gave Citi stronger

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[4799] E-mail from Ken Porcaro, Citigroup, to Katherine Lukas, Citigroup (July 18, 2008) [CITI-LBHI-EXAM 00022307]; e-mail from Katherine Lukas, Citigroup, to Janet Birney, Lehman, *et al.* (Aug. 4, 2008) [LBEX-DOCID 459043] (informing Lehman that the collateral account had been reserved).

[4800] E-mail from Robson R. Morri, Citigroup, to Thomas Fontana, Citigroup, *et al.* (Sept. 11, 2008) [CITI-LBHI-EXAM 00012865].

[4801] E-mail from Deborah Mercer-Miller, Citigroup, to Craig S. Dudsak, Citigroup, *et al.* (Sept. 11, 2008) [CITI-LBHI-EXAM 00012697]. The collateral account number was 203489. E-mail from Deborah Mercer-Miller, Citigroup, to Rachel V. Cole, Citigroup, *et al.* (Sept. 11, 2008) [CITI-LBHI-EXAM 00012697]; e-mail from Robson R. Morri, Citigroup, to Thomas Fontana, Citigroup, *et al.* (Sept. 11, 2008) [CITI-LBHI-EXAM 00012865].

[4802] *See* Section III.A.5.b of this Report, which discusses the JPMorgan agreement amendments.

[4803] Direct Custodial Services Agreement Deed (Sept. 12, 2008) [LBEX-DOCID 4263617]; *see also* Direct Custodial Services Agreement Deed (Sept. 12, 2008) [CITI-LBHI-EXAM 00005903] (with Katherine Lukas' signature).

rights over the custody assets and included a carve-out for customer accounts that Lehman requested be added.[4804]

Lehman had initially approached Citi in February 2008 about updating the original DCSA.[4805] While the parties negotiated this, Citi sought to re-introduce lien and setoff language into the agreements (Fontana noted in July that most major broker-dealers had negotiated the lien language out of the DCSA).[4806]

In the original DCSA signed on March 26, 1992, LBI authorized Citi to establish Custody Accounts[4807] and Client Deposit Accounts[4808] in LBI's name.[4809] The original DCSA granted Citi "a general lien" on property so long as it was not held for the benefit

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[4804] Direct Custodial Services Agreement Deed (Sept. 12, 2008), at p. 1 (§ 1.3) [LBEX-DOCID 4263617]. The carve-out provision specifies that the "security interest and right of set-off provided in this Deed shall not apply to any account and cash or Securities held therein if the account is identified as for the benefit" of LBI's customers, except to the extent that the client assets are needed to be used to cover fees, administrative expenses and irrevocable transactions yet to settle. *Id*.; *see also* e-mail from Katherine Lukas, Citigroup, to Emily Critchett, Lehman, *et al*. (Sept. 12, 2008) [LBEX-DOCID 4026355] (noting that the updated Deed attached "includes the language relating to customer accounts under [section] 1.3"); e-mail from Katherine Lukas, Citigroup, to Tom Isaac, Citigroup, *et al.* (Sept. 12, 2008) [CITI-LBHI-EXAM 00011569] (explaining that the Deed includes a carve-out paragraph for customer accounts except Citi retains a lien over the client assets "for fees and admin expenses as well as being covered for those irrevocable transactions yet to be settled").

[4805] E-mail from Reto Faber, Citigroup, to Kathy El Ong, Citigroup, *et al.* (Aug. 1, 2008) [CITI-LBHI-EXAM 00022171]; *see also* e-mail from Emily Critchett, Lehman, to Katherine Lukas, Citigroup, *et al*. (Feb. 29, 2008) [LBEX-DOCID 1010232].

[4806] E-mail from Thomas Fontana, Citigroup, to Brian R. Leach, Citigroup (July 1, 2008) [CITI-LBHI-EXAM 00111749].

[4807] Direct Custody Agreement for Citibank, N.A., Subsidiaries and Affiliates and Shearson Lehman Brothers Inc. (Mar. 26, 1992), at p. 1 [LBEX-DOCID 1091570]. Custody Accounts were "for the deposit of any Securities, Precious Metals and other property (apart from cash) from time to time received by" Citi for the account of LBI. *Id*. at p. 4 (§ 2).

[4808] *Id*. Client Deposit Accounts were "for the deposit of funds in any currency from time to time" received by Citi for the account of LBI. *Id*.

[4809] *Id*.

of Lehman's customers.[4810] The general lien in the original DCSA extended to Property "held by [Citi] under this Agreement until the satisfaction of all liabilities and obligations of [LBI] (whether actual or contingent) owned to [Citi] hereunder, provided, that such lien shall secure only [LBI's] obligations to [Citi] for the safe custody and administration of the Property."[4811]

In Section 4.1 of the September 12 DCSA amendment, the lien was strengthened and expanded as Lehman granted Citi "a first fixed security interest . . . over all rights it has or may have now or in the future in respect of the Collateral" where Collateral was defined to include cash, securities or other assets held by Citi.[4812] Citi was only "obliged to release Collateral to [LBI] if there are no outstanding or contingent Secured Obligations."[4813] The Deed defines Secured Obligations as "(i) all obligations of the Client to reimburse the Custodian in respect of Irrevocable Commitments; and (ii) all other present and future obligations of the Client to repay the Custodian including, but not limited to, daylight and overnight overdraft lines and reversals of provisional

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[4810] *Id*. at p. 19 (§ 17).

[4811] *Id*. Section 1 contains the definitions, including defining "Property" as "any Securities, Precious Metals, cash or any other property held" by Citi under the terms of the Agreement. *Id*. at p. 4 (§ 1).

[4812] Direct Custodial Services Agreement Deed (Sept. 12, 2008), at p.2 (§ 4.1) [LBEX-DOCID 4263617]. The amendment defines Collateral in section 1.1 as "(i) cash held in any cash account with any Custodian; (ii) Securities or other assets held by any Custodian; and (iii) rights in respect of transactions in Securities in conjunction [with] services provided by any Custodian." *Id*. The "Custodian" is defined as "CITIBANK, N.A. on behalf of each branch or affiliate of the Bank from time to time selected and appointed by [LBI] as custodian or clearing agent." *Id*.

[4813] *Id*. at p. 2 (§ 4.2).

credits."[4814] Additionally, Section 5 of the DCSA amendment provides Citi with the right to set off any payment obligation owed by Lehman against any such obligation owed by Citi to Lehman, and specifies that Citi "may set off an amount estimated by it in good faith to be the amount of that obligation" if the obligation is unliquidated or unascertained.[4815]

(d) Lehman's Clearing Environment at Citi During the Week of September 8, 2008

(i) Citi Required Lehman To Operate Under Lower Daylight Overdraft Limits

During the collateral pledge negotiations in July 2008, some Citi personnel were baffled as to why Lehman needed such large daylight overdraft limits with Citi, as Citi understood Lehman to have almost $50 billion in its liquidity pool.[4816] Citi did not understand why Lehman could not put to use some of its liquidity, so that Citi could significantly reduce the daylight overdraft limits, as "this doesn't create any disclosure issues and [Lehman has] the liquidity."[4817] Moreover, in Citi's view, because Lehman

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[4814] *Id*. at p. 1 (§ 1.1).

[4815] *Id*. at p. 2 (§ 5).

[4816] E-mail from Gregory Frenzel, Citigroup, to Thomas Obermaier, Citigroup, *et al.* (July 16, 2008) [CITI-LBHI-EXAM 00082047] (concerning the Lehman Pledge Agreement, Frenzel suggested Citi insist on a larger pledge amount and set the intraday lines to that amount, or reduce Lehman's intraday lines to zero and let Lehman use its liquidity to prefund its transactions).

[4817] E-mail from John Dorans, Citigroup, to Brian R. Leach, Citigroup, *et al*. (July 16, 2008) [CITI-LBHI-EXAM 00108067].

represented that it had such a large liquidity pool, it would have been helpful to Citi if Lehman kept some of that deposit with Citi.[4818]

On Friday, September 5, 2008, Citi decided to downgrade its internal classification of Lehman's creditworthiness.[4819] Citi took this step because Lehman had "clearly defined problems,"[4820] whereas Lehman's prior creditworthiness classification at Citi only indicated "potential weakness."[4821] When Citi internally downgraded Lehman's creditworthiness on September 5, "the credit [system] automatically suspended all trading lines," which meant not that Citi cut the lines, but that Citi more carefully, manually monitored Lehman's trading activities.[4822] In addition to carefully monitoring Lehman's trading activities, Citi required internal approvals for any trades that were larger, longer in tenor, or riskier than usual.[4823] On September 10, Citi personnel mistakenly informed Lehman that Citi had cut the trading lines, which was

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[4818] E-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup, *et al*. (June 17, 2008) [CITI-LBHI-EXAM 00073791].

[4819] E-mail from Melissa J. Torres, Citigroup, to John J. Foley, Citigroup, *et al.* (Sept. 6, 2008) [CITI-LBHI-EXAM 00088683] (noting this change was made on Friday, September 5, 2008); *see also* e-mail from Gregory Frenzel, Citigroup, to NA IRM Weekly Updates group, Citigroup (Sept. 7, 2008) [CITI-LBHI-EXAM 00107376] (weekly update from September 5, 2008); e-mail from Michael Mauerstein, Citigroup, to Katherine Lukas, Citigroup, *et al.* (Sept. 8, 2008) [CITI-LBHI-EXAM 00051890] (noting that the classification "is strictly an internal Citi matter," Citi had not communicated anything to Lehman about the change in its internal classification of Lehman, nor had Citi changed its operations with Lehman due to the classification change).

[4820] Thomas Fontana, Citigroup, Unpublished Notes (Sept. 5, 2008), at p. 168 [CITI-LBHI-EXAM 00099649] (contemporaneous handwritten notes).

[4821] Thomas Fontana, Citigroup, Unpublished Notes (Sept. 12, 2008), at p. 191 [CITI-LBHI-EXAM 00099649] (contemporaneous handwritten notes).

[4822] E-mail from Kathy El Ong, Citigroup, to Ajaypal S. Banga, Citigroup, *et al.* (Sept. 11, 2008) [CITI-LBHI-EXAM 00012823].

[4823] *Id*.

not the case, and Citi thereafter reminded its employees to be extra vigilant so that misinformation would not be communicated to Lehman or to the marketplace.[4824]

On September 8, Lehman presented to Citi's Mauerstein, Fontana and Foskett its expected third quarter 2008 results and game plan for Lehman going forward.[4825] Citi's impression of the presentation was that the plan made sense, but that executing the plan was going to be key.[4826] Foskett commented that Lehman was "the most open amongst the brokers about [third quarter 2008] results and [its] plans to address the stress and strain of the current environment."[4827]

Mid-day on September 9, Citi's Silbiger requested that Lehman's daylight overdraft limit be reduced from $3 billion to zero while Citi, instead, used Lehman's $2 billion deposit (plus any overnight funds that Lehman had placed with Citi's treasury desk) to clear transactions for Lehman.[4828] Citi's Chief Risk Officer requested that Citi pare back the Global Transaction Services clearing lines "in order to monitor flows" while keeping FX trading available.[4829] Citi had frequently requested that Lehman leave a larger deposit, and had difficulty manually managing Lehman's clearing and

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[4824] *Id*.

[4825] E-mail from Christopher M. Foskett, Citigroup, to Ian T. Lowitt, Lehman (Sept. 8, 2008) [LBEX-DOCID 070422].

[4826] *Id*.

[4827] *Id*.

[4828] E-mail from Joseph Chesakis, Citigroup, to Katherine Lukas, Citigroup, *et al.* (Sept. 9, 2008) [CITI-LBHI-EXAM 00014706]. Citigroup's Responses to Examiner's First Set of Questions re Pre-Bankruptcy Setoff dated November 16, 2009 (Dec. 18, 2009), at p. 4 [hereinafter "Citigroup First Written Responses"].

[4829] E-mail from Paul Egan, Citigroup, to Ajaypal S. Banga, Citigroup, *et al.* (Sept. 10, 2008) [CITI-LBHI-EXAM 00075863].

settlement activities using just the $2 billion deposit after the lines had been reduced to zero.[4830] Despite the reduced daylight overdraft limit, Citi told its FX traders to continue trading with Lehman, so long as Citi's net exposure to Lehman did not exceed the $2 billion deposit.[4831]

In an interview with the Examiner, Foskett stated that, prior to Lehman Weekend, several smaller multi-national companies had to prefund their activity with Citi, suggesting that such prefunding was possible.[4832] Additionally, Foskett stated that over Lehman Weekend, two large companies had to prefund their transactions through Citi.[4833]

(ii) Lehman Deposited Amounts in Excess of the $2 Billion Deposit at Various Times in 2008 With Citi

At various times during the summer of 2008, Lehman deposited excess cash with Citi overnight, including: $343 million on June 13,[4834] $900 million on July 10,[4835] $1

[4830] E-mail from Thomas Fontana, Citigroup, to Michael Mauerstein, Citigroup, *et al*. (Sept. 9, 2008) [CITI-LBHI-EXAM 00065673].

[4831] E-mail from Christopher M. Foskett, Citigroup, to Paul Egan, Citigroup, *et al*. (Sept. 10, 2008) [CITI-LBHI-EXAM 00076841].

[4832] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 8. Two broker-dealers, each with approximately $1 billion in daily clearing exposure, pre-funded their cash clearing through Citi after the collapse of Bear Stearns. In addition, a larger broker-dealer may have also pre-funded after Citi limited its clearing exposure facing it. Citigroup First Written Responses, at p. 6.

[4833] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 8.

[4834] E-mail from Edward A. Hewett, Jr., Citigroup, to Scott Bere, Citigroup, *et al.* (June 13, 2008) [CITI-LBHI-EXAM 00115260].

[4835] E-mail from Edward A. Hewett, Jr., Citigroup, to Scott Bere, Citigroup, *et al.* (July 10, 2008) [CITI-LBHI-EXAM 00114179].

billion on July 11,[4836] $1.25 billion on July 14,[4837] $1.4 billion on July 15[4838] and $1.1 billion on August 6.[4839] Citi viewed these excess cash deposits as Lehman's attempts "to demonstrate to us that they [did] not have a liquidity issue."[4840] These funds would typically be returned to Lehman the following business day, along with interest earned on the deposit overnight.[4841] During the week of September 8, 2008, Lehman continued to deposit additional funds with Citi overnight: $680 million on the evening of September 9,[4842] $3.3 billion on September 10[4843] and $3.02 billion on September 11.[4844] On the morning of September 12, Lehman requested Citi return $1.8 billion, the last of the

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[4836] E-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup, *et al.* (July 12, 2008) [CITI-LBHI-EXAM 00076243].

[4837] E-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup (July 14, 2008) [CITI-LBHI-EXAM 00018024] (conveying topics discussed during a conversation Mauerstein had with Tonucci).

[4838] E-mail from Edward A. Hewett, Jr., Citigroup, to Scott Bere, Citigroup, *et al.* (July 15, 2008) [CITI-LBHI-EXAM 00115664].

[4839] E-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (Aug. 7, 2008) [CITI-LBHI-EXAM 00074313].

[4840] E-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al.* (July 11, 2008) [CITI-LBHI-EXAM 00082020]; e-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (Aug. 7, 2008) [CITI-LBHI-EXAM 00074313] (commenting that the $1.1 billion excess deposit on August 6, 2008, was "possibly a demonstration of 'liquidity'"); Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 7.

[4841] E-mail from Thomas Fontana, Citigroup, to Brian R. Leach, Citigroup, *et al.* (Sept. 10, 2008) [CITI-LBHI-EXAM 00054016] (noting that, while Lehman's deposit was $2.68 billion that morning, the $680 million in excess of the $2 billion cash deposit was to be returned that morning); Citigroup First Written Responses, at p. 4.

[4842] E-mail from Emil F. Cornejo, Lehman, to Michael Mauerstein, Citigroup (Sept. 10, 2008) [LBEX-DOCID 1078918]; *see also* Citigroup First Written Responses, at p. 4 (identifying the amount sold as $679 million).

[4843] E-mail from Thomas Fontana, Citigroup, to Brian R. Leach, Citigroup, *et al.* (Sept. 10, 2008) [CITI-LBHI-EXAM 00054016].

[4844] E-mail from Katherine Lukas, Citigroup, to Tom Isaac, Citigroup, *et al.* (Sept. 11, 2008) [CITI-LBHI-EXAM 00014488].

additional funds Lehman had placed with Citi's desk the previous night.[4845] Citi complied approximately three hours later at 12:52 p.m.[4846] Citi tried to hold on to the additional funds as long as it could on September 12 because Citi saw $4 billion of line utilization, "including FX settlements from Asia, trade settlements and clearing usage in Europe,"[4847] but Fontana later authorized the release of the funds in excess of the $2 billion cash deposit because "Lehman [was] in dire need" of the money.[4848] When trading ended on September 12, Lehman did not ask for its $2 billion deposit back.[4849]

(iii) Citi Endeavored To Help Lehman in September 2008, Prior to the Bankruptcy Filing

Citi endeavored to assist Lehman on numerous occasions in the days leading up to Lehman's bankruptcy filing. For example, on September 10, Citi approved a $500 million extension of credit in excess of the aggregate deposit held so that a CLS payment could be made.[4850] That brought all of Lehman's clearing lines up to capacity,

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[4845] *See* e-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup, *et al.* (Sept. 12, 2008) [CITI-LBHI-EXAM 00101294] (reporting that Fleming made the request prior to 10:00 a.m. that day).

[4846] E-mail from Katherine Lukas, Citigroup, to Chris Deukmedjian, Citigroup, *et al*. (Sept. 12, 2008) [CITI-LBHI-EXAM 00032758] (funds were released back to Lehman shortly before 1:00 p.m.).

[4847] E-mail from Thomas Fontana, Citigroup, to Thomas Schwartz, Citigroup, *et al*. (Sept. 12, 2008) [CITI-LBHI-EXAM 00048225].

[4848] E-mail from Thomas Fontana, Citigroup, to Richard C.S. Evans, Citigroup, *et al.* (Sept. 12, 2008) [CITI-LBHI-EXAM 00048225].

[4849] E-mail from Thomas Fontana, Citigroup, to Karen Kirchen, Citigroup (Sept. 12, 2008) [CITI-LBHI-EXAM 00054412]. *But see* e-mail from Daniel J. Fleming, Lehman, to David Forsyth, Lehman (Sept. 12, 2008) [LBEX-DOCID 083098] (Fleming confirmed that morning that he wanted to ask Citi for the money back, but it is not clear whether he was referring to the $2 billion cash deposit or the $3 billion in extra funds deposited with Citi the evening of September 11; also, there is no indication from this e-mail or others that Lehman renewed this request at the end of the day on September 12).

[4850] E-mail from Thomas Fontana, Citigroup, to Brian R. Leach, Citigroup, *et al.* (Sept. 10, 2008) [CITI-LBHI-EXAM 00108863].

and Citi advised Lehman that Lehman needed to get more money into its accounts before any further payments could be made.[4851] Additionally, late on September 14, Citi transferred $500 million from LBHI's account at Citi to LBI's account at Citi to fund Lehman's CLS obligations after Fleming made the request on the afternoon of September 14.[4852]

Citi sought other ways to help Lehman in September.[4853] For example, Citi was engaged by Hellman and Friedman regarding a potential acquisition of Neuberger Berman.[4854] Citi also approached Lehman in early September to see if Citi could assist with capital raises.[4855] Lehman also discussed spinning off most of its illiquid real estate assets into a separate publicly traded company, the "bad bank," to move those assets off

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[4851] *Id*.

[4852] E-mail from Daniel J. Fleming, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Sept. 14, 2008) [LBEX-DOCID 457630]; *see also* e-mail from Julius Silbiger, Citigroup, to Thomas Obermaier, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00104189] (stating that the $500 million had moved by 9:42 p.m. that evening); e-mail from Roger Barnes, Citigroup, to Naresh N. Kumar, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00104189] (explaining that Citichecking opened at 9 p.m. that evening so the transfer could be made then); e-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00101129] (approving the transfer); Lehman Brothers Inc. Account Report (Oct. 1, 2008), at p. 1033 [CITI-LBI 00024142] (account statement confirming that the transaction transferred $500 million from Lehman Brothers Holdings Main Open Account 4061-5202 to Lehman Brothers Inc. account 3054-4658).

[4853] E-mail from John P. Havens, Citigroup, to Herbert H. (Bart) McDade III, Lehman (Sept. 9, 2008) [LBEX-DOCID 4191451].

[4854] E-mail from Gary Shedlin, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (Sept. 9, 2008) [CITI-LBHI-EXAM 00075818].

[4855] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 9; e-mail from Christopher M. Foskett, Citigroup, to Gary Shedlin, Citigroup, *et al*. (Sept. 9, 2008) [CITI-LBHI-EXAM 00075818] (asking whether Shedlin and David Head "have any interest in getting involved to help Lehman" as it is "obvious they need capital"); e-mail from Christopher M. Foskett, Citigroup, to Peter Heidinger, Citigroup, *et al*. (Sept. 10, 2008) [CITI-LBHI-EXAM 00076841] (Citi in discussions with Lehman on a capital raise transaction).

Lehman's balance sheet.[4856] Under this plan, Lehman would provide a cash infusion, but then seek more funds from shareholders or other investors to enable the spin-off company to operate.[4857] Although Lehman did not ask Citi to fund the real estate assets in the "bad bank" part of the good bank/bad bank alternative,[4858] Citi dispatched personnel from its equity capital markets business to speak with Lehman about alternatives for raising money to support those assets.[4859] In addition, Citi was involved in discussions over Lehman Weekend with other banks (as part of a proposed loan facility for Lehman by a bank consortium) to fund the $33 billion in assets that Lehman contemplated spinning off into a "bad bank."[4860]

Throughout Lehman's difficulties, Citi seemed to maintain confidence in the firm almost until the petition date.[4861] On September 12, Foskett wrote that "[m]arket forces are irrational," and he and Fontana lamented how the market was treating Lehman.[4862] This exchange is similar to Citi's view of Lehman in June 2008 when, even though Citi personnel referred to a "loss of confidence" in Lehman on June 12, Foskett clarified that

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[4856] *See* Section III.A.3 of this Report, which discusses SpinCo.

[4857] *See id.*

[4858] *See id.*

[4859] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 9.

[4860] E-mail from Thomas Fontana, Citigroup, to William Mandaro, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00073424]. Citigroup First Written Responses, at p. 4.

[4861] *See* e-mail from Geoff Richards, Citigroup, to John Trohan, Citigroup, *et al.* (May 29, 2008) [CITI-LBHI-EXAM 00082821] (the "No Smoking Guns" research paper assessed Lehman's liquidity as good and thought concerns about another Bear Stearns-type funding problem were overblown); e-mail from John P. Havens, Citigroup, to Herbert H. (Bart) McDade III, Lehman (Sept. 9, 2008) [LBEX-DOCID 4191451] (Citi's team was very positive about Lehman's September 8, 2008 game plan presentation).

[4862] E-mail from Christopher M. Foskett, Citigroup, to Thomas Fontana, Citigroup (Sept. 12, 2008) [CITI-LBHI-EXAM 00073399].

the "loss of confidence" referred to a couple of people on Fontana's team, not a Citi-wide loss of confidence in Lehman.[4863]

(iv) Lehman's Accounts at Citi Closed on Friday September 12 With Funds in Excess of the $2 Billion Deposit

On September 12, Citi was aware of approximately $1.5 billion in anticipated payments that Citi would have had to make on Lehman's behalf on September 15.[4864] Thus, in preparation for trading on September 15, Citi held on to the full $2 billion deposit on September 12.[4865] According to contemporaneous Citi e-mails, in addition to the $2 billion deposit, Lehman ended Friday with approximately $970 million in additional funds in its accounts at Citi because Citi did not make four Lehman payments worth just over $2.4 billion.[4866] Two of the transactions failed because there

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[4863] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 3.

[4864] E-mail from Thomas Fontana, Citigroup, to Brian R. Leach, Citigroup, *et al.* (Sept. 12, 2008) [CITI-LBHI-EXAM 00054412].

[4865] *Id*.

[4866] E-mail from Julius Silbiger, Citigroup, to Naresh N. Kumar, Citigroup, *et al.* (Sept. 14, 2008) [CITI-LBHI-EXAM 00068053] (breaking down the failed transaction amounts as affecting LBHI ($616 million), LBI ($335 million) and LBSA ($19 million)); e-mail from Paul S. Galant, Citigroup, to John P. Havens, Citigroup (Sept. 12, 2008) [CITI-LBHI-EXAM 00114766] (listing the failed payments as "$883MM to Chase; $850MM to Chase; $670MM to Chase; and 224MM (USD eqv) C$ to RBC"); *but see* e-mail from Thomas Fontana, Citigroup, to Richard C.S. Evans, Citigroup (Sept. 13, 2008) [CITI-LBHI-EXAM 00052719] (stating the amount in excess of the deposit was $996 million). It appears that most of the money in the LBHI account was transferred on September 14 to LBI's account at Citi to support CLS service. *See* e-mail from Julius Silbiger, Citigroup, to Thomas Obermaier, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00104189] (stating that the $500 million had moved by 9:42 p.m. that evening); e-mail from Roger Barnes, Citigroup, to Naresh N. Kumar, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00104189] (explaining that Citichecking opened at 9 p.m. that evening so the transfer could be made then); e-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00101129] (approving the transfer); Lehman Brothers Inc. Account Report (Oct. 1, 2008), at p. 1033 [CITI-LBI 00024142] (account statement confirming that the transaction transferred $500 million from Lehman Brothers Holdings Main Open Account 4061-5202 to Lehman Brothers Inc. account 3054-4658).

was not enough cash to cover them, the third was returned by JPMorgan, and the fourth payment failed because Lehman did not fund its Canadian currency in time.[4867] According to an e-mail from Fontana, Lehman ran its balances at Citi too late on Friday, and Citi decided not to ask for an extension of the Fedwire service[4868] so that Citi could attempt to send those payments out.[4869] Similarly, Fleming wrote that day that Lehman did not have enough time that evening to transfer the funds.[4870] One Citi official's contemporaneous characterization of the day's activity was that it looked like Lehman was "clearing out the cash."[4871]

(e) Citi's Participation in "Lehman Weekend" Events

Over Lehman Weekend, Citi personnel worked with other banks to value Lehman's assets and participated in discussions with other banks about the possibility of creating a loan facility for Lehman to support the wind-down of certain Lehman assets.[4872]

[4867] E-mail from Paul S. Galant, Citigroup, to John P. Havens, Citigroup (Sept. 12, 2008) [CITI-LBHI-EXAM 00114766].

[4868] Fedwire services are owned and operated by the Federal Reserve Banks, and provide a secure method of transferring large-value, time-critical payments between participants. *See* Federal Reserve Bank, Fedwire Services Offerings, *available at* http://www.frbservices.org/fedwire/index.html (last accessed Jan. 21, 2010).

[4869] E-mail from Thomas Fontana, Citigroup, to Richard C.S. Evans, Citigroup (Sept. 13, 2008) [CITI-LBHI-EXAM 00052719].

[4870] E-mail from Daniel J. Fleming, Lehman, to Ian T. Lowitt, Lehman (Sept. 12, 2008) [LBEX-DOCID 070225] (explaining that Lehman ran out of time that evening to make certain payments because "by the time Citi confirmed our position it was after 6:30 which is the last time banks can transfer funds through the fed").

[4871] E-mail from John P. Havens, Citigroup, to Vikram S. Pandit, Citigroup (Sept. 12, 2008) [CITI-LBHI-EXAM 00114766].

[4872] Citigroup First Written Responses, at p. 4.

With regard to the latter, the Examiner's investigation revealed that Citi personnel were involved in discussions regarding the creation of a loan facility by a consortium of banks that would assist in an orderly wind-down of assets that were excluded from a sale, but these discussions ended when the proposed purchaser withdrew.[4873] In addition, discussion about creating a $100 billion equity repo backstop facility to fund collateral that could not be pledged at the PDCF was mooted by the FRBNY's announcement that it was expanding the types of collateral it would accept at the TSLF and PDCF windows.[4874]

In addition, Citi was one of several banks involved with valuing Lehman's real estate portfolios to gain a better understanding of Lehman's hidden contingencies and unfunded obligations.[4875] According to FRBNY e-mails, through this valuation analysis, the banks reported to the FRBNY that they assigned a value to Lehman's CRE of $17-20 billion in contrast to the $41 billion value Lehman had assigned.[4876] In addition,

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[4873] *Id*.

[4874] Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 9; Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 9; e-mail from Christopher M. Foskett, Citigroup, to Albert May, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00075998]; Citigroup First Written Responses, at p. 4.

[4875] E-mail from Sarah Bell, FRBNY, to Meg McConnell, FRBNY, *et al.* (Sept. 14, 2008) [FRBNY to Exam. 014832]; *see also* e-mail from Kenneth Cohen, Lehman, to Kevin Genirs, Lehman, *et al.* (Sept. 13, 2008) [LBEX-DOCID 1900538] (stating that Credit Suisse, Goldman Sachs and Citi would have access shortly to information on the estimated $41 billion global commercial real estate balance sheet, and noting that this would not include cash flows).

[4876] E-mail from Sarah Bell, FRBNY, to Meg McConnell, FRBNY, *et al.* (Sept. 14, 2008) [FRBNY to Exam. 014832]; *see also* e-mail from Brian R. Leach, Citigroup, to Vikram S. Pandit, Citigroup, *et al.* (June 12, 2008) [CITI-LBHI-EXAM 00114272] (expressing doubt that Lehman's balance sheet could be liquidated within 10 percent of its marks and commenting that it would likely be worse than that unless the government stepped in).

regarding Lehman's residential real estate, the banks reported an assigned value (exclusive of derivatives) of $9 billion, compared to Lehman's assigned value of $17.2 billion.[4877] However, according to e-mails produced by the FRBNY, the banks, including Citi, did not think they had either sufficient time or information to value Lehman's assets thoroughly.[4878] Indeed, some within Citi specifically recognized that "time is not on anyone's side,"[4879] especially given Lehman's complex balance sheet.[4880]

On the afternoon of Sunday September 14, Lehman informed Citi that it would be filing for bankruptcy.[4881]

(f) Citi's Actions Toward Lehman After Lehman Filed for Bankruptcy Protection

(i) Citi Continued to Provide CLS Services for Lehman, But Not in an Entirely Uninterrupted Manner

On September 15, 2008, Citi sent a letter to Lehman's CLS user members – LBI, LBCC, LBSF and LBIE – advising them that, "effective immediately, we are terminating

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[4877] E-mail from Sarah Bell, FRBNY, to Meg McConnell, FRBNY, *et al.* (Sept. 14, 2008) [FRBNY to Exam. 014832].

[4878] *Id*.

[4879] E-mail from Thomas Obermaier, Citigroup, to Paul S. Galant, Citigroup (Sept. 12, 2008) [CITI-LBHI-EXAM 00101309].

[4880] Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at pp. 9-10; *see also* e-mail from Christopher M. Foskett, Citigroup, to David J. Spinks, Citigroup (Sept. 14, 2008) [CITI-LBHI-EXAM 00074716] (responding to Spinks' comment that Spinks hoped Henry Paulson and the Federal Reserve knew what they were doing by not putting together a deal to save Lehman, Foskett stated "FSA put the squash on the Barclays deal").

[4881] *See* e-mail from Christopher M. Foskett, Citigroup, to FIG Executive Committee, Citigroup (Sept. 14, 2008) [CITI-LBHI-EXAM 00074716] ("Lehman will be filing for bankruptcy. There is no deal to save them.").

the CLS Settlement Services Amended and Restated Agreement."[4882] Later that same day, Lowitt signed an agreement requiring that Lehman deposit $1 billion in a deposit account at Citi in exchange for Citi agreeing to maintain CLS services for LBI and LBCC on September 16.[4883] Consequently, LBI established a $1 billion time deposit at Citi on the afternoon of September 15 to induce Citi to continue to effect CLS payments for LBI and LBCC.[4884] In recognition of this, Citi sent another letter suspending the September 15 termination notice for one day, which meant that Lehman was "authorized to submit orders through the CLS system using Citibank's account" on September 16.[4885] Some within Lehman viewed Citi's change in position on the evening of September 15 as the result of pressure from officials at the Federal Reserve and SEC.[4886]

During the evening of September 17, Citi again terminated the CLS Agreement with LBI, which, by that point, was the only Lehman subsidiary still authorized by Citi

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[4882] Letter from Citibank, N.A., to Lehman Brothers Inc., *et al.*, re: CLS Settlement Services Agreement (Sept. 15, 2008) [LBEX-DOCID 462068].

[4883] E-mail from Julie Barboza, Lehman, to Latoya Horton, Citigroup (Sept. 15, 2008) [LBEX-DOCID 4043766]; Letter Agreement from Citibank, N.A., to Lehman Brothers Inc. and Lehman Brothers Commercial Corporation, re: CLS Agreement (Sept. 15, 2008) [LBEX-DOCID 4043766x4264053]; *see also* e-mail from Jonathan D. Williams, Lehman, to Rob Close, CLS Bank, *et al.* (Sept. 15, 2008) [LBEX-DOCID 457922] (rescinding trades in CLS for LBIE and LBSF because LBIE was in receivership in the U.K. and LBSF was a U.S. non-regulated entity with very few FX trades).

[4884] Letter Agreement from Citibank, N.A., to Lehman Brothers Inc. and Lehman Brothers Commercial Corporation, re: CLS Agreement (Sept. 15, 2008) [LBEX-DOCID 4264053]; *see also* Letter Agreement from Citibank, N.A., to Lehman Brothers Inc., re: CLS Agreement (Sept. 16, 2008) [CITI-LBI 00024114] (referencing the September 15, 2008 Letter Agreement).

[4885] Letter from Citibank, N.A., to Lehman Brothers Inc., *et al.*, re: CLS Settlement Service Agreement and our letter dated 15th September (the Letter) (Sept. 15, 2008), at p. 1 [LBEX-DOCID 462068].

[4886] E-mail from Gregory Eickbush, Lehman, to Alastair Blackwell, Lehman, *et al*. (Sept. 15, 2008) [LBEX-DOCID 026761] ("FED and SEC told Citi to turn CLS back on for us. All fine for a few days.").

to submit orders to the CLS system.[4887] This termination lasted only approximately three hours because Barclays signed a pledge agreement with Citi on the evening of September 17 in the amount of $700 million so that Citi would clear for value for LBI on September 18.[4888] After receiving the $700 million pledge from Barclays at LBI's request, Citi withdrew its termination of the CLS Agreement.[4889] Citi thereafter cleared for Lehman through the CLS system through Friday September 19.[4890]

Citi felt comfortable continuing to serve as Lehman's CLS agent the week LBHI filed for bankruptcy protection because Barclays had stepped into the shoes of LBI, and because Citi still held the $2 billion comfort deposit.[4891] In the end, Citi served as Lehman's settlement member in CLS through Friday, September 19, by which time the

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[4887] Letter from Citibank, N.A., to Lehman Brothers Inc., re: CLS Settlement Services Agreement (Sept. 17, 2008) [LBEX-DOCID 462072]; *see also* Letter Agreement from Citibank, N.A., to Lehman Brothers Inc., re: CLS Agreement (Sept. 16, 2008) [CITI-LBI 00024114] (listing only LBI as authorized to submit orders to the CLS system on September 17, 2008).

[4888] E-mail from Katherine Lukas, Citigroup, to Daniel J. Fleming, Lehman, *et al.* (Sept. 17, 2008) [LBEX-DOCID 457387)] (with letter attached concerning Citi "withdrawing the termination of the CLS Agreement" as to LBI); *see also* e-mail from John P. Emert, Citigroup, to Stephen W. Stites, Paul Weiss, *et al.* (Sept. 17, 2008) [BCI-EX-00077688] (the proposed pledge agreement for Barclays to sign is referenced as attached to the e-mail). For the entire pledge agreement, *see* Pledge Agreement (Sept. 17, 2008) [BCI-EX 00077694] (unexecuted version), and Signature Page (Sept. 17, 2008) [BCI-EX 00077639] (signature page of the pledge agreement contains Gerard LaRocca's signature, Managing Director at Barclays, but the Citibank signature block is blank).

[4889] Letter from Citibank, N.A., to Lehman Brothers Inc., re: CLS Settlement Services Agreement (Sept. 17, 2008) [LBEX-DOCID 457387x462072]. Citi ultimately returned the $700 million to Barclays pursuant to the terms of the November 13, 2008 Supplement to Pledge Agreement. *See* Supplement to Pledge Agreement (Nov. 13, 2008) [CITI-LBI 000541].

[4890] Examiner's Interview of Jonathan D. Williams, Aug. 5, 2009, at p. 6 (Citi's clearing for Lehman included Wednesday September 17, which was the International Monetary Market's quarterly settlement date for CME currency futures and which Williams explained was significant because a "huge volume" of trades settled that day through CLS); e-mail from Jonathan D. Williams, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Sept. 16, 2008) [LBEX-DOCID 457949] (commenting that having CLS service on September 17 was extremely important because it was the IMM settlement date).

[4891] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 10.

settlement activity was significantly less than it had been at the beginning of the week.[4892] Citi stopped advancing funds and terminated the CLS agreement when Citi's exposure reached approximately $16 billion.[4893] Citi notified Lehman for the last time on September 19 that, effective September 22, Citi was terminating the CLS Services Agreement.[4894]

(ii) Prior to Lehman's Bankruptcy Filing, Citi Set Off a Portion of the Cash Deposit

Late on Sunday night, September 14, 2008, Citi's John Dorans wrote in an e-mail that Citi had "set-off certain funds and the balance of the money on deposit we will be holding as cash collateral subject to determining what we are ow[ed] by Lehman."[4895] The amount of the setoff was $512 million,[4896] which was ordered to be placed in a

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[4892] Examiner's Interview of Jonathan D. Williams, Aug. 5, 2009, at p. 6.

[4893] Thomas Fontana, Citigroup, Unpublished Notes (Sept. 17-18, 2008), at pp. 236, 241 [CITI-LBHI-EXAM 00099649] (contemporaneous handwritten notes suggesting CLS was short $15 billion on September 17, 2008, and short $16 billion when the New York markets opened on September 18, 2008).

[4894] Letter from Tom Isaac, Citigroup, to Lehman Brothers Inc., re: CLS Settlement Services Agreement (Sept. 19, 2008) [CITI-LBI 00024117].

[4895] E-mail from John Dorans, Citigroup, to James A. Forese, Citigroup, *et al.* (Sept. 14, 2008) [CITI-LBHI-EXAM 00105795].

[4896] Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, at p. 3 n.1, Docket No. 109, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008). Citigroup First Written Responses, at p. 1; Thomas Fontana, Citigroup, Unpublished Notes (Sept. 14-15, 2008), at pp. 202, 211, 219, 223 [CITI-LBHI-EXAM 00099649] (contemporaneous handwritten notes showing a breakdown of the $512 million setoff as $275 million for Lehman Brothers Commercial Corporation Asia Ltd. facility, $164 million for overdrafts and placements, $50 million for letters of credit and $23 million for miscellaneous mark-to-market. The $164 million amount was further broken down into $56 million for Lehman Brothers Finance AG Zurich Placement, $43 million for LBHI NY, $17.3 million for LBHI U.K. and $48.3 million for Lehman Brothers Securities Asia Ltd.).

segregated account in Citibank North America's name,[4897] but, according to Citi's counsel, was reversed (by $275 million) on September 16.[4898] The balance of the setoff was reversed ($237 million) on December 18, 2008, when Citi transferred those funds back into LBHI's cash deposit account 3077-8171.[4899] LBHI still maintains a $2 billion deposit with Citibank, against which Citibank "asserts rights of netting, offset, recoupment, or other claims of right."[4900]

(2) Analysis of Potential Colorable Claims

The Examiner's investigation has not revealed evidence supporting the existence of any colorable claims against Citi.

(a) Validity of the September 9 Guaranty Amendment

(i) Economic Duress

Because the September 9 Guaranty Amendment was proposed and executed in the same day, and because Citi officials stated on September 9 that they would not open

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[4897] E-mail from Thomas Fontana, Citigroup, to Edward A. Hewett, Jr., Citigroup (Sept. 14, 2008) [CITI-LBHI-EXAM 00068353].

[4898] Citigroup First Written Responses, at p. 7.

[4899] Account 3077-8171 Statement (Jan. 2, 2009), at p. 1 [CITI-LBHI 0005070].

[4900] Notice of Presentment of Stipulation and Order Authorizing (1) Transfer of Certain Prepetition Deposits, and (2) Preservation of Citibank's Setoff Rights, if any, in Respect of Amounts Transferred, Annex at p. 2, Docket No. 3272, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Apr. 3, 2009) (stating that LBHI maintains a $2 billion deposit with Citibank); Stipulation and Order Authorizing (1) Transfer of Certain Prepetition Deposits, and (2) Preservation of Citibank's Setoff Rights, if any, in Respect of Amounts Transferred, at p. 2 (¶ B), Docket No. 3372, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Apr. 15, 2009) (order signed by Judge James M. Peck); *see also* Statement of Citigroup Inc. in Support of Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, at p. 2 (¶ 2), Docket No. 110, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008) (showing that, as of September 18, 2008, the amount in LBHI's cash deposit account at Citi excluding any potential amount that had been set off, was $1.763 billion.).

for Lehman in Asia the next day without an amended agreement, this Section analyzes whether the September 9 Guaranty Amendment is invalid due to economic duress.

a. Legal Framework

Section 4 of the September 9 Guaranty Amendment provides that the Amendment is to be "governed by and construed in accordance with the laws of the State of New York."[4901]

As discussed *supra* in the analysis of potential colorable claims against JPMorgan, at Section III.A.5.b.2.a, under New York law "[a] contract may be voided and a party may recover damages 'when it establishes that it was compelled to agree to the contract terms because of a wrongful threat by the other party which precluded the exercise of its free will.'"[4902] The elements of economic duress are: "(1) a threat, (2) which was unlawfully made, and (3) caused involuntary acceptance of contract terms, (4) because the circumstances permitted no other alternative."[4903]

[4901] Amendment 1 To Guaranty (Sept. 9, 2008), at p. 2 [LBEX-DOCID 090568] (executed version signed by Ian Lowitt and adding LBCC on September 11, 2008).

[4902] *Madey v. Carman*, 858 N.Y.S.2d 784, 786 (App. Div. 2008) (*quoting 805 Third Ave. Co. v. M.W. Realty Assocs.*, 448 N.E.2d 445, 447 (N.Y. 1983)).

[4903] *Kamerman v. Steinberg*, 891 F.2d 424, 431 (2d Cir. 1989) (*quoting Gulf & W. Corp. v. Craftique Prods., Inc.*, 523 F. Supp. 603, 610 (S.D.N.Y. 1981)).

b. The Evidence Does Not Support the Existence of a Colorable Claim Against Citi for Economic Duress

Citi imposed a tight, same-day deadline on Lehman on September 9, providing Lehman with less than six hours to review the September 9 Guaranty Amendment.[4904] Internal Lehman e-mails suggest Citi was holding up payments until the amendment was signed and, specifically, that Citi was not releasing a $2 billion CLS payment.[4905] Moreover, while negotiating the inclusion of Lehman's Asian subsidiaries in the later-added parties to the September 9 Guaranty Amendment, Citibank informed Lehman that it would "not open [Lehman] in Asia with the agreement we have in place."[4906] Citi personnel stated to the Examiner that this meant Citibank would not clear trades for Lehman entities unless LBHI guaranteed the entities or they prefunded the trades.[4907]

The e-mails between Cornejo and Killerlane suggest that Lehman may have had very little time to verify whether Lehman could sign the amendment without infringing on their Custody Agreements. Specifically, Killerlane was unsure about how the setoff provision in the original Guaranty would interact with Lehman's Custody

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[4904] E-mail from Emil F. Cornejo, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (Sept. 9, 2008) [LBEX-AM 008563] (Foskett called Cornejo just prior to 1:00 p.m. requesting a guaranty with LBI); e-mail from Emil F. Cornejo, Lehman, to Ian T. Lowitt, Lehman, *et al*. (Sept. 9, 2008) [LBEX-AM 008564] (explaining that Citi wanted the guaranty executed by 6:00 p.m. that evening).

[4905] E-mail from Emil F. Cornejo, Lehman, to Ian T. Lowitt, Lehman, *et al*. (Sept. 9, 2008) [LBEX-AM 008571]; e-mail from Craig L. Jones, Lehman, to Daniel J. Fleming, Lehman (Sept. 9, 2008) [LBEX-AM 008562].

[4906] E-mail from Thomas Fontana, Citigroup, to Emil F. Cornejo, Lehman, *et al*. (Sept. 9, 2008) [LBEX-DOCID 1079016].

[4907] Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 8; Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 9.

Agreements.[4908] Nor did Killerlane seem comfortable with the September 9 Guaranty Amendment, but stated he would not demur, so long as Lowitt and Treasury at Lehman were comfortable with it.[4909]

Citi e-mails suggest that Lehman had little to no objection to signing the amendment to the Guaranty,[4910] and that Cornejo's only hesitation was that Lehman needed to verify that providing a guaranty for Asian entities would not create any regulatory issues.[4911] Based on documentary evidence, there was no disagreement over any of the substantive terms of the amendment, and there is no evidence contradicting Foskett's statement that Citi did not present the amendment to Lehman on a "take-it-or-leave-it" basis.[4912]

Moreover, Citi's initial proposal early in the afternoon of September 9 included 17 Lehman entities. Lehman, however, accepted these entities piecemeal, first agreeing prior to 6:00 p.m. to amend the Guaranty to include only LBI, and subsequently adding eight more Lehman entities on September 9, followed by one more subsidiary on September 11. Thus, Lehman agreed to add only one of the 17 proposed entities before the 6:00 p.m. deadline on September 9 before finally accepting eight additional entities

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[4908] E-mail from James J. Killerlane, Lehman, to Emil F. Cornejo, Lehman (Sept. 9, 2008) [LBEX-AM 008571] (stating that he was "not sure if we can logistically [sign the amendment to the guaranty] with our Custody Agreements or if we are comfortable with this").

[4909] *Id*.

[4910] E-mail from Christopher M. Foskett, Citigroup, to Thomas Fontana, Citigroup, *et al*. (Sept. 9, 2008) [CITI-LBHI-EXAM 00077391].

[4911] E-mail from Emil F. Cornejo, Lehman, to Thomas Fontana, Citigroup (Sept. 9, 2008) [LBEX-DOCID 1079021].

[4912] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 9.

later that evening, and adding LBCC on September 11. Even though some of Lehman's refusals were based on the fact that three of the proposed subsidiaries had no accounts with Citi or were Special Purpose Vehicles, Lehman's ability to resist Citi's demands at least to some degree indicates Lehman's acceptance of the terms was not involuntary.

To the extent that the reference to Citi's "holding payments" until execution of the Amendment[4913] refers to holding clearing advances under the CLS Agreement, the advance of those funds was left to Citi's "sole discretion," and was a practice that could be ended "without prior notice."[4914] Thus, any statement by Citi that it would or would not do something that was within Citi's "sole discretion" would not be unlawful or improper. The same is true if Fontana's threat not to "open [Lehman] in Asia"[4915] was made and understood to be a threat not to advance credit to Lehman rather than a complete refusal to clear. Citi personnel have confirmed to the Examiner that Fontana's statement that it would not open for Lehman in Asia without the signed amendment simply meant that Lehman would have had to prefund its trades in the region if the subsidiaries in Asia were not added to the holding company guaranty.[4916] This reading is further supported by Fontana's approval to release CLS payments Citi was holding

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[4913] *See* e-mail from Emil F. Cornejo, Lehman, to Ian T. Lowitt, Lehman, *et al*. (Sept. 9, 2008) [LBEX-AM 008564].

[4914] Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, Ex. A at p. 3 (§ 1), Docket No. 109, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008).

[4915] E-mail from Thomas Fontana, Citigroup, to Emil F. Cornejo, Lehman, *et al*. (Sept. 9, 2008) [LBEX-DOCID 1079021].

[4916] Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 8; Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 9.

on September 9; Citi waited until Lehman had prefunded the payment by providing $2.085 billion of the $2.088 billion necessary to cover the payment.[4917] The documents suggest that Citi was holding that payment, not because Citi refused to clear trades for Lehman in order to induce Lehman to sign the September 9 Guaranty Amendment, but because Citi had reduced Lehman's daylight overdraft limit to zero and Lehman's account did not have sufficient funds to cover the payment.

Additionally, the 6:00 p.m. deadline imposed by Citi on September 9 must be viewed in the context of the rest of the news of that day, including the KDB deal falling through, the advancement of Lehman's third quarter 2008 earnings announcement to September 10 and Lehman's stock price continuing to plummet. The 6:00 p.m. deadline was important for Citi because Citi was "irrevocably committed to settle" Lehman's CLS transactions after that time.[4918] In this setting, imposing a sub-six hour deadline for executing the amendment was not an unreasonable effort by Citi to protect its own business interests. As Foskett explained to the Examiner, Citi was very concerned about its business at this time and had to balance its actions carefully regarding Lehman to avoid harming itself.[4919]

[4917] E-mail from Thomas Fontana, Citigroup, to Chris Deukmedjian, Citigroup, *et al.* (Sept. 9, 2008) [CITI-LBHI-EXAM 00032799].

[4918] Citigroup, Overview of GTS Clearing and Settlement Lines (Sept. 4, 2008), at p. 4 [CITI-LBHI-EXAM 00102127].

[4919] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 8; *see also* Thomas Fontana, Citigroup, Unpublished Notes (Sept. 12, 2008), at p. 193 [CITI-LBHI-EXAM 00099649] (contemporaneous handwritten notes noting the "need to protect shareholders").

Alternatively, Lehman may have ratified the September 9 Guaranty Amendment through acquiescing to its terms. Many Lehman entities, including those operating on the CLS system, continued to accept clearing advances from Citi after the execution of the Amendment. Far from repudiating the September 9 Guaranty Amendment, Lehman sought to confirm the status of Citibank clearing advances in the Bankruptcy Court after the holding company filed its petition.[4920] There is also no evidence that the period of duress continued through that time, nor is there evidence that Lehman desired to repudiate the Amendment at any point.

The Examiner concludes that the evidence does not support the existence of a colorable claim that the September 9 Guaranty Amendment is invalid due to economic duress.

(ii) The Failure of Consideration

The September 9 Guaranty Amendment greatly expanded Citi's protection while, on the surface, did not provide Lehman with any clearing or custody services beyond what Citi had previously been providing. Based on these facts, this Section analyzes whether the September 9 Guaranty Amendment fails for lack of consideration.[4921]

[4920] *See* Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, Docket No. 109, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008).

[4921] See Section III.B.3 for a discussion of claims to avoid the September 9 Guaranty Amendment under applicable fraudulent transfer principles where "the consideration needed to support a simple contract"

a. Legal Framework

Consideration is "either a benefit to the promisor or a detriment to the promisee."[4922] A recitation of consideration in a contract is an admission of fact that can be disputed or explained with parol evidence.[4923] Notably, "a promise by one party to do that which he is already under a legal obligation to perform is insufficient as a consideration to support a contract."[4924] "Failure of consideration gives the disappointed party the right to rescind the contract."[4925] By New York statute, however, a contract modification "shall not be invalid because of the absence of consideration, provided that the [modification] agreement . . . shall be in writing and signed by the party against whom it is sought to enforce the . . . modification . . . or by his agent."[4926]

b. The Evidence Does Not Support the Existence of a Colorable Claim Against Citi for Failure of Consideration

Even though both the original 2004 Guaranty and the September 9 Guaranty Amendment contain the same boilerplate recitation of consideration, and even though Citi did not offer to increase the credit lines extended to Lehman in any way, the

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is not sufficient to establish reasonably equivalent value. *Rubin v. Mfrs. Hanover Trust Co.*, 661 F.2d 979, 991 (2d Cir. 1981).

[4922] *Holt v. Feigenbaum*, 419 N.E.2d 332, 336 (N.Y. 1981).

[4923] *See Diamond v. Scudder*, 45 A.D.3d 630, 632 (App. Div. 2007).

[4924] *Carpenter v. Taylor*, 58 N.E. 53, 55 (N.Y. 1900); *see also Roth v. Isomed, Inc.*, 746 F. Supp. 316, 319 (S.D.N.Y. 1990); *see also supra* Section III.A.5.b.2.b for further discussion of legal principles relating to consideration.

[4925] *Fugelsang v. Fugelsang*, 131 A.D.2d 810, 812 (App. Div. 1987).

[4926] N.Y. Gen. Oblig. Law § 5-1103 (McKinney 2009); *see also Deutsche Bank Secs. Inc. v. Rhodes*, 578 F. Supp. 2d 652, 660 (S.D.N.Y. 2008).

September 9 Guaranty Amendment is a modification of the January 7, 2004 Guaranty. Paragraph 1 of the September 9 Guaranty Amendment explicitly states that "[s]ection 1 of the Guaranty is amended by replacing the first sentence thereof in its entirety with the following."[4927] As such, under New York law, because the September 9 Guaranty Amendment is in writing and signed by Lowitt, additional consideration is not required and the Amendment is valid. The September 9 Guaranty Amendment gave Citi a guaranty for the repayment of credit obligations of various additional Lehman subsidiaries in order to induce Citi to extend or continue extending credit to those subsidiaries.

Under the CLS Agreement, the authorization of any transaction through the CLS system was left to Citi's "sole discretion," and any extension of credit could be changed or terminated without prior notice.[4928] Therefore, there was consideration for the Amendment insofar as the September 9 Guaranty Amendment induced Citi to provide or continue providing credit to Lehman subsidiaries, and insofar as Citi did not have an obligation to continue extending credit under the CLS Agreement – or, for that matter, any other credit agreement known to the Examiner. Considering the difficult economic

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[4927] Amendment 1 To Guaranty (Sept. 9, 2008) [LBEX-DOCID 090568] (executed version signed by Ian Lowitt and adding LBCC on September 11, 2008).

[4928] Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, Ex. A at p. 3 (¶ 1), Docket No. 109, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008).

situation Lehman found itself in on September 9, it does not seem unreasonable for Citi to have sought additional security from Lehman via the Guaranty Amendment.

Moreover, the documents suggest that Citi intended to continue to extend clearing advances to Lehman after the execution of the September 9 Guaranty Amendment. During negotiations over the September 9 Guaranty Amendment, Citibank refused to extend intraday credit to Lehman entities that were not guaranteed by LBHI, requiring them to prefund their trades. After Lehman executed the September 9 Guaranty Amendment, Citibank set Lehman's credit lines for clearing at the level of the deposit amount of $2 billion with the expectation that Citi personnel would manually approve extensions of credit above the deposit amount. Thus, there was consideration for the September 9 Guaranty Amendment because it induced Citi to continue providing intraday credit to Lehman.

The Examiner has thus concluded that the evidence does not support the existence of a colorable claim that the September 9 Guaranty Amendment is invalid due to lack of consideration.

(b) Breach of the Duty of Good Faith and Fair Dealing in Connection With the CLS Services Agreement

The CLS Agreement specifies that the laws of England govern the rights and obligations between Citibank and Lehman. Generally, New York courts honor parties'

choice of law provisions.[4929] As discussed in more detail in the HSBC Section below at Section III.A.5.d, English contract law does not recognize a generally applicable principle of good faith and fair dealing, and English courts will allow a commercial lender to exercise contractual, discretionary powers in what the lender genuinely believes to be its best commercial interest.

(i) The Evidence Does Not Support the Existence of a Colorable Claim Against Citi for Breach of the Duty of Good Faith and Fair Dealing in Connection With the CLS Services Agreement

Only four Lehman subsidiaries were authorized to submit transaction instructions to the CLS Bank through LBI: LBI, LBCC, LBSF and LBIE.[4930] If an instruction were submitted to the CLS Bank directly, Citi still had to authorize the transaction and did not have any responsibility for any such transaction that it had not yet authorized.[4931] On September 9, Citi significantly reduced the amount of credit it

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[4929] *Boss v. Am. Express Fin. Advisors, Inc.*, 791 N.Y.S.2d 12, 14 (App. Div. 2005).

[4930] Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, Ex. A at pp. 1, 12, Docket No. 109, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008) (LBI and LBCC); Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, Ex. B at p. 1, Docket No. 109, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008) (listing LBSF and LBIE as Affiliates); *see also* Letter from Citibank, N.A., to Lehman Brothers Inc., *et al.*, re: CLS Settlement Services Agreement (Sept. 15, 2008), at p. 2 [LBEX-DOCID 462068] (terminating the CLS Agreement with LBI, LBCC, LBSF, and LBIE on the afternoon of September 15).

[4931] Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, Ex. A at p. 2 (¶ 1), Docket No. 109, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008).

extended to Lehman for its CLS transactions, and Citi found it difficult to manage manually using only the $2 billion deposit.[4932]

As discussed *infra*, English law will likely recognize that any extension of credit provided by Citi to Lehman was within Citi's *sole discretion* unless Citi had expressly agreed in writing to provide a committed credit facility and had received a commitment fee. The Examiner did not discover anything to suggest that Citi had any such express agreement or was obligated to provide a certain level of CLS clearing service. Citi was obligated to make a CLS payment *only after* Citi had authorized the transaction, and that authorization was given in Citi's sole discretion. Given the increased risk Citibank faced vis-à-vis Lehman in September 2008, it is unlikely a court would find that Citi acted unreasonably, irrationally, arbitrarily, or in bad faith in exercising, or threatening to exercise, its contractual right to cease extending clearing advances, and cease serving as Lehman's settlement member.

Moreover, the terms of the CLS Agreement between Lehman and Citibank left the extension of credit to Citibank's "sole discretion," and provided Citibank with the right to "discontinue[]" such advances "at any time, without prior notice" so long as Citi had not already authorized the transaction instruction.[4933] The CLS Agreement also

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[4932] E-mail from Thomas Fontana, Citigroup, to Michael Mauerstein, Citigroup, *et al*. (Sept. 9, 2008) [CITI-LBHI-EXAM 00065673].

[4933] Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, Ex. A at p. 3 (¶ 1), Docket No. 109, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008).

granted Citi the right to terminate the agreement immediately and without notice if any one of a number of events occurred, including: a bankruptcy of a Lehman party, a material adverse change in the financial condition of a party, or the inability of a party to pay debts as they came due.[4934] Under the legal framework above, it is unlikely a court would use the implied covenant to contradict an express term of the Agreement - namely that it was within Citi's "sole discretion" to stop advancing funds "without notice."

The Examiner has thus concluded that the evidence does not support the existence of a colorable claim for breach of the covenant of good faith and fair dealing in connection with the CLS Agreement.

d) Lehman's Dealings With HSBC

HSBC was a clearing bank, source of intraday credit for settling trades and counterparty to Lehman for a variety of treasury products.[4935] Approximately one month prior to the petition date, HSBC informed Lehman that HSBC would be completely, albeit gradually, exiting their relationship.[4936] During the last week of August and the first week of September, HSBC demanded the equivalent of approximately $945 million and received the equivalent of approximately $947 to 992

[4934] *Id*. at p. 6 (¶ 6).

[4935] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 3.

[4936] Nicholas J. Taylor, HSBC, Briefing Note — Project Milan (Aug. 18, 2008), at pp. 1-2 [HBUS 90]; Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 6; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 4.

million cash collateral in order to continue providing clearing and settlement services to Lehman.[4937] (HSBC returned approximately $282 million of these funds on September 11).[4938]

HSBC also demanded that Lehman execute the U.K. and Hong Kong Cash Deeds to secure the collateral.[4939] Lehman successfully negotiated with HSBC to narrow the proposed right of setoff and expand its own access to the cash secured by the cash

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[4937] E-mail from Guy Bridge, HSBC, to Carlo Pellerani, Lehman, *et al.* (Aug. 27, 2008) [HBUS 3] (demanding combined deposits of $945 million in London and Hong Kong); e-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Aug. 28, 2008) [HBUS 9250] (reporting receipt of GBP 435 million, or approximately $800 million); e-mail from Martina C. W. Kung, HSBC, to Patricia Gomes, HSBC, *et al.* (Sept. 1, 2008) [HBUS 397] (reporting pending deposit of HKD 1.4 billion, or approximately $180 million); Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 5. *But see* e-mail from Stirling Fielding, Lehman, to Carlo Pellerani, Lehman, *et al.* (Sept. 1, 2008) [LBEX-AM 008963] (recording instant message conference stating that the Hong Kong deposit is equivalent to $192 million with unspecified credit due to Lehman); Memorandum from Ken Coleman, HSBC counsel, to Examiner, re: Transfers in Connection With the Hong Kong Cash Deed (Oct. 23, 2009), at p. 1 (representing that HSBC's Hong Kong affiliate received the equivalent of approximately $148 million). As discussed below, the Examiner's financial advisors were unable to identify a Hong Kong transfer with certainty. Pellerani and Lowitt discussed the possibility of offering securities instead of cash, although Lowitt expressed concern that such an offer might "set off alarm bells." E-mail from Carlo Pellerani, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Sept. 11, 2008) [LBEX-AM 008934]. The plan to use securities as collateral instead of cash never progressed beyond the proposal stage. Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 9. On September 11, HSBC returned to Lehman approximately EUR 200 million, or approximately $280 million, of the cash collateral. *See* Section III.A.5.d.4, *infra*.

[4938] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 7. According to Lehman's Daily Funding Call Update e-mail for September 11: "Trsy have reduced cash deposit with HSBC to GBP200m to release liquidity in the firm." E-mail from Maria Barrio, Lehman, to Neil Ullman, Lehman, *et al*. (Sept. 11, 2008) [LBEX-DOCID 1898196]. The Examiner's financial advisors' analysis of Lehman's transactions during this period shows that this report was erroneous, and that Lehman received EUR 200 million on September 11. Duff & Phelps, Preliminary Findings re: HSBC Deposits (Dec. 2, 2009), at p. 1.

[4939] E-mail from Guy Bridge, HSBC, to Carlo Pellerani, Lehman, *et al.* (Aug. 27, 2008) [HBUS 3]; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at pp. 5-6; Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at pp. 6-7 (discussing plan to require collateral).

deeds.[4940] Lehman executed two cash deeds to cover the U.K. deposit (collectively, the "U.K. Cash Deeds") on September 9,[4941] and the Hong Kong Cash Deed on September 12.[4942] Because Lehman executed the Hong Kong Cash Deed too late in the day for HSBC to transfer the cash collateral to a secured account covered by the deed, and because of a September 15 public holiday in Hong Kong, HSBC was unable to transfer the funds into such an account until September 16,[4943] and the funds were subsequently returned to a Lehman cash account.[4944] On September 9, 2009, HSBC and LBHI entered into a stipulation allowing HSBC to offset GBP 100,062,061.97 (approximately $164.6 million) in debts and interest covered under the U.K. Cash Deeds.[4945]

(1) Overview of HSBC's Relationship With Lehman

HSBC's relationship with Lehman covered four broad functions: 1) facing Lehman as a counterparty in derivatives trades and other transactions; 2) acting as a trustee for Lehman's special purpose vehicles in the Cayman Islands; 3) performing

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[4940] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 6; *see* e-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Sept. 3, 2008) [HBUS 570] (discussing Lehman's refusal to sign the Cash Deeds without changes to the terms).

[4941] E-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al*. (Sept. 9, 2008) [HBUS 1179]; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 6.

[4942] E-mail from Patricia Gomes, HSBC, to Agnes Y. L. Lau, HSBC, *et al.* (Sept. 12, 2008) [HBUS 1760].

[4943] *See id.*

[4944] Memorandum from Ken Coleman, HSBC counsel, to Examiner, re: Transfers in Connection With the Hong Kong Cash Deed (Oct. 23, 2009), at p. 1.

[4945] Stipulation, Agreement and Order, Pursuant to Sections 362 and 553 of the Bankruptcy Code, Modifying the Automatic Stay for the Limited Purpose of Permitting HSBC Bank plc to Effect Setoff and Resolution of Certain Banking Arrangements Between Lehman Brothers Holdings Inc. and HSBC Bank plc, at p. 2, Docket No. 5089, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 9, 2009). The stipulation also allowed a setoff of GBP 605,000 for a misdirected payment and committed to return EUR 70,000,000 to Lehman at a later date. *Id.* at pp. 2-3.

clearing and settlement services for Lehman's sterling-denominated securities trades in the CREST system; and 4) providing credit support to LBHI and its subsidiaries through a variety of credit products.[4946] For purposes of this Report, functions three and four — HSBC's exposure to Lehman through credit products, including credit advanced as part of clearing and settlement services for CREST — are the most significant aspects of the HSBC-Lehman relationship.

(a) HSBC Provided CREST Clearing and Settlement Services to Lehman

The CREST system is a clearing and settlement system for certain securities.[4947] CREST settles securities trades denominated in U.S. dollars, Euros and Pounds Sterling.[4948] Sterling-denominated trades are the most relevant to this Report.

In the CREST system, a CREST member bank, such as LBIE, appoints one of the 14 approved commercial banks, such as HSBC, to act as its CREST settlement bank.[4949] The CREST settlement bank then "stands in" for the CREST member bank to execute trades through CREST's central computer system.[4950]

[4946] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 3 (describing the first three functions); Examiner's Interview of Ken Coleman, David Esseks, and Angela Somers, July 22, 2009, at p. 2 (describing the first three functions); Lehman Global Annual Review (May 12, 2008), at pp. 1-2 [HBUS 10275] (describing exposure to Lehman arising from other credit products).

[4947] Angela Somers, HSBC counsel, CREST System Overview (July 22, 2009), at p. 1.

[4948] *Id.* at p. 2.

[4949] *Id.*; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 3.

[4950] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 3; Angela Somers, HSBC counsel, CREST System Overview (July 22, 2009), at pp. 1-2 (describing in more detail the process of settlement banks acting for member banks).

Sterling-denominated trades are settled in real-time.[4951] Throughout the day, CREST members direct their CREST settlement banks to execute trades.[4952] The CREST settlement banks then send messages with the trade information to the CREST central computer system.[4953] The CREST central computer checks the transferee member's CREST account to determine whether it holds sufficient funds and the transferor member's CREST account to determine whether it holds the relevant securities.[4954] If both conditions are satisfied, the CREST central computer system settles the transaction in its records and generates a message notifying the parties that the transaction has been completed.[4955]

Unlike other settlement systems such as Euroclear or DTC, the CREST system is neither a custodian nor depository of the securities being traded.[4956] Once the CREST central computer system settles a trade, the settlement bank (here, HSBC) — not the member bank (here, Lehman) — is directly liable for payment of the transaction.[4957] Rather than require member banks to prefund every transaction with their settlement banks, settlement banks often extend intraday credit to facilitate trades.[4958] In the

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[4951] Angela Somers, HSBC counsel, CREST System Overview (July 22, 2009), at p. 2.
[4952] *Id.* at p. 1; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 3.
[4953] Angela Somers, HSBC counsel, CREST System Overview (July 22, 2009), at p. 2.
[4954] *Id.*
[4955] *Id.*
[4956] *Id.*
[4957] *Id.* at pp. 1-2.
[4958] *Id.*; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 3; Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 7.

CREST system, this credit is called the "debit cap."[4959] The member bank and settlement bank typically settle their account at the end of each day.[4960]

A settlement bank may reduce the debit cap to zero at any time, although the settlement bank would be obligated to clear trades that had been approved through CREST before the reduction, and the CREST member would still be able to *sell* securities with a debit cap of zero.[4961] However, HSBC personnel opined that it would be impractical to the point of impossible to trade securities through CREST without intraday credit.[4962] According to Nicholas J. Taylor, Chief Operating Officer of HSBC's Global Financial Institutions Group and head of HSBC's Financial Institutions Group for the Americas, relying on prefunding instead of intraday credit is not feasible because of the difficulty of accurately modeling a member bank's CREST trades each day.[4963] Inaccurate modeling could cause a member bank to post inadequate funds to cover its trades, which would cause failed trades and send negative signals to the market about the financial health of the member bank.[4964]

[4959] Angela Somers, HSBC counsel, CREST System Overview (July 22, 2009), at p. 2.
[4960] *Id.*; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 3; Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 7 (discussing impracticality of prefunding trades compared to relying on intraday credit).
[4961] Angela Somers, HSBC counsel, CREST System Overview (July 22, 2009), at p. 2.
[4962] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 5; Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 7.
[4963] Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 7; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 5.
[4964] Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 7.

(b) Overview of the Operative Agreements

The CREST relationship between HSBC and LBIE was governed by a Facility Letter, which makes the CREST settlement facility available to LBIE;[4965] a Security Deed, which grants HSBC a security interest in LBIE's property held in connection with or derived from the CREST facility;[4966] and a list of Terms and Conditions, which are incorporated into the Facility Letter and specify the parties' rights and obligations.[4967] At the time of the petition, the CREST relationship between Lehman and HSBC was governed by a facility letter HSBC sent to Lehman on July 31, 2008, which Lehman accepted on August 19, 2008.[4968] This agreement supersedes the terms Lehman approved when it expanded its CREST activity with HSBC on May 5, 2007, but does not change the parties' relationship in a way that would be material to the bankruptcy proceedings.[4969]

[4965] *See* CREST Facility Letter between LBIE and HSBC (Aug. 19, 2008) [HBEU 138].

[4966] *See* Security Deed Creating Charges over CREST Stock (Gilts and Equities) and Receivables to Secure the Liabilities of a CREST Member or Sponsored Member (Apr. 24, 2002) [HBEU 72].

[4967] *See* Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (Aug. 19, 2008) [HBEU 102].

[4968] *See* CREST Facility Letter between LBIE and HSBC (Aug. 19, 2008), at p. 4 [HBEU 138].

[4969] *See* Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (May 5, 2007) [HBEU 142]; Letter from HSBC to LBI(E), re: CREST Settlement Bank Facility Made Available in Multicurrency on a Secured Basis (Apr. 3, 2007) [HBEU 174]; CREST Facility Letter between LBIE and HSBC (May 5, 2007) [HBEU 174] (adding additional participant IDs for LBI(E) under existing Terms and Conditions); Jenner & Block, Memorandum re: Representations by HSBC counsel (Jan. 11, 2010), at pp. 2-3. The Terms and Conditions attached to the May 5, 2007 Letter grant HSBC absolute discretion to terminate, without notice. *See* Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (May 5, 2007), at § 16.1 [HBEU 142]. This clause is materially identical to the termination clause in the August 19, 2008 Terms and Conditions. *See* Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (Aug. 19, 2008), at § 16.1 [HBEU 102].

Further, Section 16.1 of the Terms and Conditions of the CREST facility allows HSBC to

> terminate its responsibilities as Settlement Bank for the Customer under this Agreement either generally or in relation to one or more Designated Currencies [EUR, USD and GBP] at any time and at its absolute discretion, without notice, provided that [HSBC] shall, where it considers it practicable and appropriate, give not less than 30 days' notice to the Customer and Euroclear U.K. & Ireland Limited but shall not in any event have any liability to the Customer if it fails to do so.[4970]

LBIE also acknowledged that HSBC does not owe a duty of care to monitor or enforce compliance with CREST requirements and procedures.[4971] LBIE further agreed to various indemnifications of HSBC[4972] and exemptions of HSBC from liability.[4973] The parties additionally agreed that the terms of the exclusions and limitations of liability contained in the agreement are fair and reasonable,[4974] and that any single waiver, forbearance or failure to exercise rights under the contract in one instance would not operate as waiver or forbearance in any other instance or prevent a party from exercising its rights under the agreement.[4975] Finally, the agreement grants HSBC an irrevocable right to apply, without notice, any debts arising under the CREST agreement against any credit balance LBIE held with HSBC.[4976]

[4970] Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (Aug. 19, 2008), at § 16.1 [HBEU 102].
[4971] *Id.* at § 9.7.
[4972] *Id* at § 7.
[4973] *Id.* at §§ 3.4-3.5, 9.
[4974] *Id.* at § 9.11.
[4975] *Id.* at § 18.
[4976] *Id.* at § 19.

As Lehman's CREST settlement bank, HSBC routinely extended between $100 million and $1 billion in intraday credit for CREST transactions, and Lehman typically repaid the balance at the end of the day.[4977] Lehman was one of HSBC's 25 largest clients for sterling clearing and settlement services.[4978] HSBC was Lehman's only bank for clearing and settling sterling-denominated securities trades.[4979]

(2) The Examiner's Investigation of Particular Transactions

The most significant issues arising from the HSBC-Lehman relationship stem from HSBC's demand that Lehman post collateral and execute cash deeds in exchange for continued CREST clearing and settlement services. Accordingly, that demand and the related transactions are the focus of this Section of the Report.

The Examiner has also identified other transactions that do not directly affect the CREST relationship but nevertheless warrant additional explanation because of their size, timing, or divergence from the usual course of dealing between HSBC and Lehman. They are:

(a) HSBC Cancelled a $1 Billion Intraday Credit Facility

The single largest component of HSBC's exposure to Lehman through credit products and services other than CREST was a $1 billion intraday credit facility. HSBC had provided Lehman with a $1 billion intraday credit facility for the limited purpose

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[4977] Examiner's Interview of Ken Coleman, David Esseks, and Angela Somers, July 22, 2009, at p. 2.
[4978] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 3.
[4979] *Id.*

of financing the intraday liquidity risk Lehman incurred when marketing its clients' issuances of new equity.[4980]

Paul Lopez, HSBC's Global Relationship Manager for Financial Institutions, stated that Lehman had not used the facility since approximately 2003.[4981] Sometime between May and July 2008, Lehman proposed repurposing the facility as a general intraday liquidity facility to cover shortfalls in triparty repos with JPMorgan.[4982] Lopez stated that he decided not to proceed with repurposing the facility because Lehman's deteriorating financial condition made it too difficult to justify taking on an unsecured exposure to cover risks JPMorgan would not accept.[4983] HSBC cancelled the unused credit facility in July 2008 as a risk reduction measure during "Project Opaque," discussed *infra*.[4984] However, the decision to cancel the facility may have preceded the decision to withdraw from Lehman.[4985]

(b) Lehman Maintained a $1 Billion Segregated Deposit with HSBC

Documents produced by HSBC (through its American subsidiary, HSBC Bank USA, N.A. ("HBUS")) indicate that in June 2008, personnel at HSBC were concerned

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[4980] Examiner's Interview of Paul M. Lopez, Oct. 19, 2009, at pp. 3-4 (referring to corroborating statements by both Lopez and Taylor to the Examiner).

[4981] *Id*.

[4982] *Id.*

[4983] *Id.*

[4984] Memorandum from Nicholas J. Taylor, HSBC, to Global Financial Institutions Group, HSBC, re: Project Opaque [Draft] (July 28, 2008), at p. 4 [HBUS 16204] (describing cancellation of day loan facility as "already in train"). See Section III.A.5.d.3.a, below, for further discussion of Project Opaque.

[4985] Examiner's Interview of Paul M. Lopez, Oct. 19, 2009, at p. 3 (expressing uncertainty about when the facility was cancelled but opining that the cancellation preceded the decision to withdraw from Lehman).

that Lehman would withdraw a $1 billion deposit that was technically unencumbered but nevertheless governed by an "understanding" that Lehman would not make withdrawals.[4986] Lopez confirmed that LBI kept this deposit with HSBC to satisfy the net capitalization requirements of broker-dealers under Rule 15c3, promulgated under the Securities Exchange Act of 1934.[4987] Lopez explained that HSBC was concerned that Lehman's clients would make simultaneous withdrawals from their accounts at Lehman and prompt Lehman to withdraw funds from the segregated deposit at HSBC to meet the demand.[4988] Lopez stated that the deposit was unencumbered and that HSBC had expressly waived its right of setoff.[4989] Lopez stated that the deposit was available to Lehman on demand, but that Lehman was required to provide notice to HSBC before making a withdrawal.[4990] Lopez also explained that sometime post-petition in September 2008, Lehman directed HSBC to deliver the deposit to Barclays

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[4986] *E.g.*, e-mail from Paul M. Lopez, HSBC, to Karen von Ruffer, Lehman (June 5, 2008) [HBUS 12633] (describing the deposit and understanding).

[4987] Examiner's Interview of Paul M. Lopez, Oct. 19, 2009, at p. 4. Rule 15c3 establishes the minimum net capital broker-dealers must keep on hand in order to participate in various market activities, including holding funds and securities on behalf of customers. *See* 17 C.F.R. § 240.15c3-1; *see also* Memorandum from Robert Azerad, Lehman, to Investor Relations Department, Lehman, re: 2008 Q2 Liquidity Position (June 7, 2008), at p. 3 [LBEX-DOCID 008829] (discussing customer free credit balances in LBI that "are segregated from the Firm's liquidity per Rule 15c3"), attached to e-mail from Robert Azerad, Lehman, to John Feraca, Lehman, *et al.* (June 7, 2008) [LBEX-DOCID 68690].

[4988] Examiner's Interview of Paul M. Lopez, Oct. 19, 2009, at p. 4.

[4989] *Id.*

[4990] *Id.* (Lopez could not recall precisely how much notice was required).

and that HSBC complied with the request.[4991] According to Lehman's internal memoranda, LBHI did not include this deposit as part of its liquidity pool.[4992]

(c) Lehman Deposited $750 Million with HSBC on June 24

On June 24, Lehman personnel notified Lopez that Lehman was placing deposits with HSBC totaling $750 million.[4993] Lopez did not recall the specific deposits except insofar as he recalled that they were part of the ordinary course of business between Lehman and HSBC.[4994] Lopez opined that the deposits represented Lehman selling $750 million to HSBC's money desk, and that the deposits would have likely been returned to Lehman the next day.[4995] Lopez stated that these sorts of transactions usually passed without comment, and this transaction was unusual only in that it was brought to his attention.[4996] Lopez opined that Lehman was publicizing the deposits up to his level in order to show the strength of its liquidity pool and to build its relationship with HSBC by placing some of that liquidity with HSBC.[4997]

[4991] *Id.* at pp. 4-5.

[4992] Memorandum from Robert Azerad, Lehman, to Investor Relations Department, Lehman, re: 2008 Q2 Liquidity Position (June 7, 2008), at p. 3 [LBEX-DOCID 008829] (stating that customer free credit balances in LBI "are segregated from the Firm's liquidity per Rule 15c3"), attached to e-mail from Robert Azerad, Lehman, to John Feraca, Lehman, *et al.*, (June 7, 2009) [LBEX-DOCID 68690].

[4993] E-mail from Karen von Ruffer, Lehman, to Paul M. Lopez, HSBC (June 24, 2008) [HBUS 14054].

[4994] Examiner's Interview of Paul M. Lopez, Oct. 19, 2009, at p. 5.

[4995] *Id.*

[4996] *Id.*

[4997] *Id.*

(d) Lehman Committed $25 Million on August 15 to HSBC's Syndicated Lending Facility

After HSBC advised Lehman of its intent to withdraw and after HSBC requested that Lehman provide approximately $1 billion in cash collateral, Lehman requested to be released from a $25 million commitment to a syndicated credit revolver for HSBC.[4998] Lehman Brothers Commercial Bank had committed to this facility on August 15, 2008.[4999] HSBC personnel believed Lehman was participating in the facility to secure HSBC's continued support.[5000] HSBC personnel used Lehman's need for continued credit support as leverage to encourage Lehman's participation.[5001] In a June 15, 2008 e-mail to Lopez and other HSBC personnel, Taylor reports that he recently had a "long call" with Pellerani: "[In] the context of reciprocity and our continuing support during this period, I suggested they participated in HSBC Finance's current syndicated. He was positive about this and requested full details."[5002] At the time, Pellerani viewed this as an opportunity to "cement the relationship" by gaining the gratitude of HSBC management rather than an opportunity to secure a binding promise that HSBC would

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[4998] E-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Aug. 27, 2008) [HBUS 129].

[4999] Side Letter from HSBC to LBCB (Aug. 15, 2008) [LBEX-DOCID 089911] (signed by HSBC); Side Letter from HSBC to LBCB (Aug. 15, 2008) [LBEX-DOCID 089916] (signed by LBCB).

[5000] E-mail from Nicholas J. Taylor, HSBC, to Mark Stadler, HSBC, *et al.* (June 15, 2008) [HBUS 9925]; e-mail from Guy Bridge, HSBC, to Craig T. Thiele, HSBC, *et al.* (June 17, 2008) [HBUS 10046] ("They are under no illusion it could be extremely helpful to show their support . . . ").

[5001] E-mail from Nicholas J. Taylor, HSBC, to Mark Stadler, HSBC, *et al.* (June 15, 2008) [HBUS 9925].

[5002] *Id*.

continue providing credit support for CREST services or otherwise.[5003] The actual agreement governing the syndicated revolver contains a merger clause and does not promise continued credit support.[5004] For its part, the CREST agreement requires that any changes be made in writing.[5005]

Documents from HBUS reflect that HSBC personnel initially supported releasing Lehman from the agreement.[5006] Taylor told the Examiner that the agent bank (Citibank, N.A.)[5007] refused the request because of the precedent that cancelling Lehman's commitment would establish for the other banks participating in the revolver, and because cancelling the commitment risked sending negative market signals that could further erode Lehman's market position.[5008] For his part, Pellerani believed that HSBC did not expect Lehman to meet the commitment once HSBC had demanded collateral.[5009]

[5003] *See* e-mail from Carlo Pellerani, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Aug. 27, 2008) [LBEX-AM 008936] (stating that participation would "cement the relationship" and was "extremely appreciated at the most senior levels" of HSBC, but making no mention of promises to do or refrain from doing anything).

[5004] *See* Three-Year Revolving Credit Agreement (July 11, 2008), at § 19.07 [LBEX-DOCID 1029995]; *see also* Side Letter from HSBC to LBCB (Aug. 15, 2008) [LBEX-DOCID 089911] (signed by HSBC); Side Letter from HSBC to LBCB (Aug. 15, 2008) [LBEX-DOCID 089916] (signed by LBCB).

[5005] Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (Aug. 19, 2008), at § 17.1 [HBEU 102].

[5006] E-mail from Nicholas J. Taylor, HSBC, to Guy Bridge, HSBC, *et al.* (Aug. 27, 2008) [HBUS 129] (agreeing that HSBC should allow Lehman to exit the facility).

[5007] Three-Year Revolving Credit Agreement (July 11, 2008) [LBEX-DOCID 1029995].

[5008] Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 8.

[5009] Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at pp. 7-8.

HSBC ultimately rescinded its support for Lehman's request to withdraw. In a September 9, 2008 e-mail to Taylor regarding Lehman's request to cancel the commitment, HSBC's senior vice president of Money and Capital Markets wrote: "As we have discussed, we do not plan to consent to this termination request because of the negative signal and precedent it would send to our other banks in the deal."[5010] However, HSBC never drew on the $25 million commitment.[5011]

(e) Lehman Pledged $6 Million to HSBC as Collateral for Letters of Credit

On August 11, 2008, Lehman pledged $6 million to HSBC as collateral for a letter of credit.[5012] HSBC had already issued two unsecured letters of credit of $3.6 million and $750,000 to Lehman on or around June 27 and July 1, respectively.[5013] All three letters were issued pursuant to a June 24, 2008 Master Letter of Credit Agreement that allows HSBC to set off any of Lehman's deposits held at HSBC against any debts incurred under the master letter of credit.[5014] HSBC entered a claim for $116,083 for fees, interest, expenses and funds drawn against the letters of credit by the beneficiaries.[5015]

[5010] E-mail from Craig T. Thiele, HSBC, to Nicholas J. Taylor, HSBC, *et al*. (Sept. 9, 2008) [HBUS 5707].

[5011] Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at pp. 7-8. Taylor stated that Lehman did not otherwise transfer the funds to HSBC. Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 8.

[5012] Annex A to Proof of Claim of HSBC Bank USA, N.A., Claim No. 18857, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2009).

[5013] Annex B to Proof of Claim of HSBC Bank USA, N.A., Ex. 2, Claim No. 18857, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2009).

[5014] *Id*. (¶ 21).

[5015] Annex A to Proof of Claim of HSBC Bank USA, N.A., Claim No. 18857, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2009).

HSBC also asserted a contingent claim for future draws against the letters of credit by the beneficiaries.[5016]

(f) Other Significant Exposures

HSBC's remaining exposure to Lehman arises from $2,562,770.97 in payments erroneously directed to Lehman for delivery to London Diversified Fund Limited on September 29, 2008,[5017] and claims of at least $345,276,915.79 related to various securities transactions.[5018]

[5016] *Id.*

[5017] Annex A to Proof of Claim of HSBC Bank USA, N.A., Claim No. 18084, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2009).

[5018] *See* Ken Coleman, HSBC counsel, Spreadsheet of Claims by HSBC and Related Entities (Jan. 5, 2010). The claims break down as follows: HSBC Bank plc asserts a $2,910,446 claim against LBHI under an ISDA and guaranty, and a $64,337,830.50 claim against LBHI and LBSF under an ISDA and guaranty; HSBC Bank USA asserts a $6,320,245.45 claim against LBHI under an ISDA and guaranty, and a $50,420,868.24 claim against LBHI and LBSF under an ISDA and guaranty; HSBC Financial Products (France) SNC asserts a $4,652,646.23 claim against LBHI under an ISDA and guaranty, and a $311,526.01 claim under an OSLA and guaranty; HSBC Hang Seng asserts a $298,154.89 claim against LBHI under an ISDA and guaranty; HSBC Private Bank (Suisse) SA asserts a $477,970 claim against LBHI for a failed trade, a $724,723.40 claim against LBHI for another failed trade, and a $124,123.38 claim against LBHI under an ISDA and guaranty; HSBC France asserts a $79,998,295.50 claim against LBHI and LBSF under an ISDA and guaranty; HSBC Ltd. (Hong Kong) asserts a $28,479,863.12 claim against LBHI under an OSLA and guaranty, a $3,421,677.57 claim against LBHI and LBSF under an ISDA and guaranty, and a $10,095,478.51 claim under an ISDA and guaranty; Halbis US Credit Alpha Master Fund Ltd. asserts a $1,228,570.59 claim against LBHI and LBSF under an ISDA and guaranty; Halbis France asserts a $2,334,155 claim, a $1,313,837 claim, and a $1,605,357 claim against LBHI for various program securities; HSBC Assurance Vie (France) asserts an $85,206,000 claim for various program securities; HSBC PB France asserts a $568,815.30 claim against LBHI for various program securities on behalf of a client; HSBC plc asserts a $368,706 claim and a $49,925.63 claim against LBHI for various program securities, and a $27,700.47 for various program securities and a guaranty. At the time of drafting, HSBC plc had not yet determined the precise amount of its remaining claims against LBHI, which are therefore excluded from this total. *Id.* Although this debt has not been set off against the funds held pursuant to the U.K. Cash Deeds, HSBC reserved the right to make such setoffs in its stipulation with LBHI, and LBHI has agreed to "work in a commercially reasonable manner to address the issues surrounding" HSBC's claims not disposed of by the stipulation. Stipulation, Agreement and Order, Pursuant to Sections 362 and 553 of the Bankruptcy Code, Modifying the Automatic Stay for the Limited Purpose of Permitting HSBC Bank plc to Effect Setoff and Resolution of Certain Banking Arrangements Between Lehman Brothers Holdings

(3) HSBC Required Lehman to Provide Approximately $1 Billion in Collateral While Quietly Ending Their Relationship

(a) HSBC Determined to End Its Relationship with Lehman

Taylor stated that in mid-2006, HSBC began an in-depth examination of its exposure to the financial sector.[5019] According to Taylor, HSBC decided to conduct the examination because HSBC was concerned that Lehman and other financial institutions had not adequately disclosed their exposures to risks from subprime mortgages.[5020]

In fact, Lehman's public disclosures concerning its subprime mortgage exposure from this period relied on a definition of "subprime" that excluded Alt-A and so-called Alt-B mortgages even as the performance of those products increasingly resembled that of subprime.[5021] Moreover, Lehman continued to increase its exposure by pursuing a countercyclical business strategy in which it continued to originate subprime mortgages until August 2007, and Alt-A and Alt-B mortgages until January 2008.[5022]

Inc. and HSBC Bank plc, Docket No. 5089, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 9, 2009).

[5019] Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 4; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 4 (describing the same process).

[5020] Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 4.

[5021] *See* Letter from Christopher M. O'Meara, Lehman, to Jeffrey Gordon, SEC (Aug. 16, 2007), at p. 2 [LBEX-DOCID 2703435]. In response to questions from the SEC about the extent of Lehman's subprime exposure, O'Meara explained that Lehman's definition considered a borrower with a FICO score below 620 as a key feature of a subprime loan. *Id.* However, the Interagency Guidance for Subprime Lending Programs considered a borrower with a FICO score below 660 to be characteristic of a subprime loan. FDIC Press Release, "Expanded Guidance for Subprime Lending Programs" (Jan. 31, 2001), at p. 2.

[5022] Examiner's Interview of Lana Franks Harber, Sept. 23, 2009, at p. 1.

As a result of HSBC's evaluation of its exposure to the financial sector, in 2007, HSBC reduced the amount of uncommitted credit available to the investment banks.[5023] According to Taylor, other banks did the same.[5024] Taylor noted that, despite this reduction, the stress tests conducted by the investment banks during this period relied on assumptions that the credit was still available.[5025] Taylor said that the cash capital model of calculating liquidity was "discredited" by 2008 precisely because it relied on these overly optimistic assumptions about the availability of credit and unsupported assumptions about the value of certain asset-backed securities.[5026]

HSBC's concerns increased after the near collapse of Bear Stearns in March 2008, and HSBC viewed Lehman as the weakest remaining broker-dealer.[5027] In July 2008, HSBC increased its efforts to reduce its exposure to Lehman by further reducing the limits of various lines of credit it had extended to Lehman.[5028] HSBC initially focused its efforts on lines of credit that Lehman seldom used so that the reductions would not

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[5023] Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 4.

[5024] *Id.*

[5025] *Id.*

[5026] *Id.* at p. 5.

[5027] *Id.*; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 4.

[5028] Memorandum from Nicholas J. Taylor, HSBC, to Global Financial Institutions Group, HSBC [Draft] (July 28, 2008), at pp. 1-2 [HBUS 16204]; Memorandum from HSBC Financial Institutions Group, re Project Milan (Aug. 2008), at pp. 1-2 [HBUS 17459]. As part of this decision, HSBC also declined to renew Lehman's letters of credit after maturity. Memorandum from Nicholas J. Taylor, HSBC, to Global Financial Institutions Group, HSBC [Draft] (July 28, 2008), at p. 2 [HBUS 16204].

alert Lehman or other market participants to HSBC's actions.[5029] HSBC referred to its plan to mitigate exposure to the financial sector as "Project Opaque" but renamed the plan "Project Milan," which focused on Lehman specifically.[5030]

As part of Projects Opaque and Milan, HSBC asked Lehman to execute credit support annexes ("CSAs") to existing swap and derivative trading agreements ("ISDAs") that were not already accompanied by CSAs.[5031] Counsel for HSBC has represented that, as of the petition date, HSBC was a net provider of collateral to LBHI under the CSAs.[5032] The Examiner's investigation has not uncovered any evidence that HSBC withheld collateral from Lehman through the CSAs.

On August 18, 2008, Taylor informed Tonucci that HSBC intended to end its business relationship with Lehman entirely through an "orderly withdrawal."[5033] Lehman and HSBC personnel met over August 21 and 22 and discussed ways for HSBC

[5029] Financial Institutions Group, HSBC, Lehman Exposure Summary (July 2008), at p. 1 [HBUS 15615] (describing the avoidance of actions that would be transparent to the market or to Lehman under "Objectives").

[5030] Memorandum from Nicholas J. Taylor, HSBC, to Global Financial Institutions Group, HSBC [Draft] (July 28, 2008), at p. 2 [HBUS 16204] (referring to Project Opaque); Memorandum from HSBC Financial Institutions Group, re Project Milan (Aug. 2008), at p. 1 [HBUS 17459]; Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 5.

[5031] E-mail from Martin J. Holcombe, HSBC, to Sidhu Gurshinder, HSBC, *et al*. (July 9, 2008) [HBUS 14796] (forwarding e-mail chain discussing HSBC project to execute CSAs for all eligible swap and derivative trading agreements, focusing on top 25 clients and attaching files related to agreements with Lehman). When one party holds assets in excess of the value owed under the ISDA, the CSA gives the other party a security interest in the excess assets until they are returned. *See generally, e.g.*, ISDA Credit Support Annex to the Schedule to the Master Agreement dated October 5, 2000 between Lehman Brothers Finance S.A. and HSBC Bank USA (2000), at ¶¶ 3, 13 [HBUS 2135].

[5032] Memorandum from Ken Coleman, HSBC counsel, to Examiner, re: Transfers in Connection With the Hong Kong Cash Deed (Oct. 23, 2009), at p. 1.

[5033] Nicholas J. Taylor, HSBC, Briefing Note — Project Milan (Aug. 18, 2008), at pp. 1-2 [HBUS 90].

to continue reducing its exposure to Lehman without impacting Lehman's business and without alerting the market.[5034]

(b) HSBC Demanded Collateral for Intraday Credit

On August 27, 2008, Guy Bridge, a director in HSBC's Financial Institutions Group in London, informed Pellerani that HSBC required Lehman to deposit the equivalent of $800 million into an account in the U.K. and $145 million into an account in Hong Kong by August 29.[5035] Bridge told Pellerani that HSBC would require Lehman to execute cash deeds to secure the deposits.[5036] Bridge explained to Pellerani in an e-mail that "[t]his is required to ensure we can continue to provide the support for your clearing/settlement business as principal Bankers in these regions."[5037] Both HSBC and Lehman understood Bridge's letter to mean that HSBC would cease clearing and settling trades in CREST for Lehman if Lehman did not provide the collateral.[5038]

[5034] E-mail from Guy Bridge, HSBC, to Carlo Pellerani, Lehman (Aug. 23, 2008) [LBEX-AM 008910].

[5035] E-mail from Guy Bridge, HSBC, to Carlo Pellerani, Lehman, *et al.* (Aug. 27, 2008) [HBUS 3]; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 5.

[5036] E-mail from Carlo Pellerani, Lehman, to Guy Bridge, HSBC, *et al.* (Aug. 27, 2008) [HBUS 3]; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at pp. 5-6.

[5037] E-mail from Guy Bridge, HSBC, to Carlo Pellerani, Lehman, *et al.* (Aug. 27, 2008) [HBUS 3].

[5038] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 5; Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at p. 7; *see* e-mail from Huw Rees, Lehman, to Andrew Yeung, Lehman, *et al*. (Aug. 28, 2008) [LBEX-AM 008941] ("[T]here is a possibility that, without an agreement, our UK clearing operations will be impacted."); e-mail from Carlo Pellerani, Lehman, to Paolo R. Tonucci, Lehman (Aug. 27, 2008) [LBEX-AM 008916] ("[W]e need to give them ~$1b of deposit by Friday with a legal right to set-off, non negotiable, or they will not settle for us."); e-mail from Paolo R. Tonucci, Lehman, to Ian T. Lowitt, Lehman (Aug. 27, 2008) [LBEX-AM 008918] ("[T]hey want us to deposit cash by Friday if they are to continue clearing for us.").

HSBC intended the U.K. deposit to cover its exposure to Lehman arising from CREST clearing and settlement activities.[5039] HSBC intended the Hong Kong deposit to cover HSBC's exposure arising from various credit lines extended to Lehman subsidiaries in Asia-Pacific markets.[5040] HSBC requested collateral to cover these exposures in the short term instead of reducing Lehman's credit lines because Lehman would have had difficulty replacing HSBC's services in either area.[5041]

Not granting HSBC's demand would have been "terminal" for Lehman.[5042] Bridge told the Examiner that replacing HSBC's CREST services would have been impossible in the short term and "very difficult" in the medium term.[5043] Taylor stated to the Examiner that Lehman would also have had difficulty replacing HSBC's credit services in the Asia-Pacific region.[5044] Lehman agreed to make the deposits and review a draft deed.[5045] HSBC agreed to assist Lehman in finding ways to reduce the size of the required deposit by reducing Lehman's use of intraday credit.[5046]

[5039] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at pp. 5-6; Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at pp. 6-7; Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at p. 7.

[5040] E-mail from Guy Bridge, HSBC, to Carlo Pellerani, Lehman, *et al.* (Aug. 27, 2008) [HBUS 3] (demanding combined deposits of $945 million in London and Hong Kong to cover clearing and settlement activities in those regions).

[5041] Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at pp. 6-7.

[5042] Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at p. 7 ("Basically they were not going to allow us to do business. . . . They put a gun to our head.").

[5043] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 2.

[5044] Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at pp. 6-7 (referring to agreement to accept collateral for clearing and settlement services that would be difficult to replace).

[5045] E-mail from Carlo Pellerani, Lehman, to Guy Bridge, HSBC, *et al.* (Aug. 27, 2008) [HBUS 3].

[5046] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at pp. 3-4; e-mail from Carlo Pellerani, Lehman, to Guy Bridge, HSBC, *et al.* (Aug. 27, 2008) [HBUS 3] (requesting assistance identifying ways to reduce the

Pellerani told Taylor he would alert government regulators – the Federal Reserve, the Financial Services Authority, or both – of HSBC's demand.[5047] Bridge told Taylor via e-mail that the Federal Reserve was already aware of HSBC's "intended course."[5048] Bridge told the Examiner that he had not spoken with anyone at the Federal Reserve, but that he believed that either Taylor or another HSBC employee in New York had done so.[5049] Taylor informed the Examiner that he did not speak with anyone at the Federal Reserve, nor was he aware of anyone at HSBC who did.[5050] Taylor said that he assumed the Federal Reserve was aware of HSBC's cash collateral demand and plans to withdraw through its observation team embedded at Lehman.[5051] Pellerani did not recall directly informing the FSA of HSBC's demand, but said that the FSA had been informed either through daily discussions with on-site evaluators or daily written updates sent to the FSA.[5052]

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required deposit); e-mail from Guy Bridge, HSBC, to Carlo Pellerani, Lehman (Aug. 23, 2008) [LBEX-AM 008910] (suggesting coordination between HSBC and Lehman).

[5047] E-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Aug. 28, 2008) [HBUS 1900]; e-mail from Carlo Pellerani, Lehman, to Paolo R. Tonucci, Lehman (Aug. 27, 2008) [LBEX-AM 008916].

[5048] E-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Aug. 28, 2008) [HBUS 1900].

[5049] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at pp. 5-6.

[5050] Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 7.

[5051] *Id.*

[5052] Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at p. 7.

(c) HSBC Agreed To Accommodate Lehman at Quarter End

Lehman deposited the equivalent of approximately $800 million with HSBC in the U.K. on the morning of August 28.[5053] That same day, following conversations between Lowitt and HSBC's Chief Risk Officer, HSBC allowed Lehman to retrieve the deposit in order to hold it over the Labor Day weekend "to help with [Lehman's] quarter end BS targets."[5054]

Taylor stated that HSBC's purpose in returning the deposit was to assist with Lehman's cash management at the end of the quarter.[5055] According to Taylor, cash management issues are magnified at the end of each month, and even more so at the end of each quarter.[5056] As a consequence, Taylor did not think that there was anything wrong with a temporary return of the approximately $800 million deposit to assist Lehman at quarter end.[5057] Nevertheless, Taylor remarked that, in light of Lehman's

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[5053] E-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Aug. 28, 2008) [HBUS 9250]. The transfer may not have been completed before HSBC notified Lehman that it would allow Lehman to hold the deposit until after the end of the quarter. Lehman's bank records list an "attempted" transfer of GBP 435 million (approximately $800 million) on August 28 from LBIE to an HSBC account held by the London branch of LBHI, LBHI(U.K.). Duff & Phelps, Preliminary Findings re: HSBC Cash Transfer (Nov. 4, 2009), at p. 1. There are no wire data or bank confirmations associated with this entry. *Id.*

[5054] E-mail from Carlo Pellerani, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Aug. 28, 2008) [LBEX-AM 008853]; *see* e-mail from Ian T. Lowitt, Lehman, to Jeremy Isaacs, Lehman (Aug. 28, 2008) [LBEX-AM 008940] (referring to conversation with HSBC's CRO and HSBC's accommodation and its concern about Lehman over the quarter-end).

[5055] Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at pp. 8-9.

[5056] *Id.*

[5057] *Id.*

reported liquidity pool, he was surprised Lehman requested that HSBC temporarily return the funds.[5058]

(d) Lehman Deposited the Cash Collateral With HSBC

E-mails from HSBC report that Lehman again deposited the equivalent of approximately $800 million with HSBC on September 1 for value on September 2, bringing the total U.K. deposit back up to the equivalent of approximately $800 million.[5059] On September 2, Lehman deposited the equivalent of approximately $180 million in a Hong Kong account.[5060]

Bridge also sent Huw Rees, Head of European Creditor Relations at Lehman, a draft cash deed on the morning of August 28.[5061] Rees then sent the draft deed to Lehman in-house counsel, Andrew Yeung, for review.[5062]

[5058] *Id.* at p. 9.

[5059] E-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Sept. 1, 2008) [HBUS 401]. Lehman's bank records show an "attempted" transfer on September 1. Duff & Phelps, Preliminary Findings re: HSBC Cash Transfer (Nov. 4, 2009), at p. 1. There are no wire data or bank confirmations associated with this record. *Id.* Lehman's bank records show an actual transfer of GBP 435 million, equivalent to approximately $800 million, from LBIE into LBHI(U.K.)'s HSBC account on September 2. *Id.*

[5060] E-mail from Patricia Gomes, HSBC, to Guy Bridge, HSBC, *et al.* (Sept. 1, 2008) [HBUS 397] (stating that the Hong Kong deposit is equivalent to $180 million). *But see* e-mail from Stirling Fielding, Lehman, to Carlo Pellerani, Lehman, *et al.* (Sept. 1, 2008) [LBEX-AM 008963] (recording instant message conference stating that the Hong Kong deposit is equivalent to $192 million with unspecified credit due to Lehman). The Examiner's investigation has not revealed any other references to a Hong Kong deposit equivalent to $192 million. The Examiner's financial advisors identified a September 1 transfer equivalent to $192 million from a Lehman Brothers Asia Holdings money market account, but were not able to determine if all of these funds were used for a deposit. Duff & Phelps, Preliminary Findings re: HSBC Deposits (Dec. 2, 2009), at p. 2.

[5061] E-mail from Guy Bridge, HSBC, to Huw Rees, Lehman, *et al.* (Aug. 28, 2008) [LBEX-AM 008941].

[5062] *Id.*

On September 3, Pellerani informed Bridge that Lehman would not sign the deed without narrowing the scope of the right of setoff, and then began negotiating its terms.[5063] Lehman sought to narrow the debts that could be set off with the collateral and to broaden the circumstances under which it would have access to the funds.[5064]

(e) Lehman Negotiated New Terms and Executed the Cash Deeds

(i) Lehman Secured Concessions in the U.K. Cash Deeds

Lehman executed the U.K. Cash Deeds on September 9 to cover the U.K. deposit of the equivalent of approximately $800 million.[5065] As described below, HSBC returned the equivalent of approximately $282 million of these funds on September 11.[5066]

One deed is between HSBC Bank plc and LBIE.[5067] The second U.K. deed is between HSBC Bank plc and LBHI(U.K.).[5068] Lehman signed both deeds on September 9.[5069] HSBC split the LBHI(U.K.) deed into separate deeds to be joined by a cross-guaranty because HSBC believed administrative hurdles would delay execution of any

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[5063] E-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Sept. 3, 2008) [HBUS 570].

[5064] *Id.* Pellerani quickly distanced himself from negotiations with HSBC to the extent possible because he had become so "animated" over HSBC's collateral demand. Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at p. 7. The actual negotiations were handled by Rees, who was supervised by Pellerani. *Id.*

[5065] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 6.

[5066] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 7.

[5067] Cash Deed between HSBC and LBIE (Sept. 9, 2008) [HBUS 1180].

[5068] Cash Deed between HSBC and LBHI(U.K.) (Sept. 9, 2008) [HBUS 1190].

[5069] E-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Sept. 9, 2008) [HBUS 1179]; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 6.

deed that covered LBHI(U.K.), and HSBC wanted to gain as much security as soon as possible.[5070]

In both of the U.K. Cash Deeds, Lehman successfully negotiated for a more limited definition of debt for setoff purposes and greater access to the cash collateral covered by the deeds.[5071] The original draft cash deed defines "debt" eligible for setoff under the deed as "all money and liabilities whatever, whenever, and however incurred whether now or in the future due or becoming due from you to [HSBC]."[5072] The executed U.K. Cash Deeds limit the definition of debt to money owed on specified accounts held by LBIE, LBHI(U.K.) and Lehman Brothers Ltd.[5073] and to Lehman's debts for sterling clearing and settlement services.[5074]

The original draft cash deed would have allowed Lehman to access the deposit only when HSBC determined that there was no outstanding debt (broadly defined).[5075] The executed U.K. Cash Deeds require that HSBC exercise good faith in determining whether the deposit was adequate to cover the outstanding debt (more narrowly defined).[5076] However, Lehman's access to the deposit was still subject to HSBC's

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[5070] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 6.

[5071] *Id*.

[5072] Cash Deed between HSBC and LBIE [Draft] (Aug. 28, 2008), at § 1(c) [LBEX-DOCID 4468302].

[5073] Cash Deed between HSBC and LBHI(U.K.) (Sept. 9, 2008), at § 1 [HBUS 1190].

[5074] Cash Deed between HSBC and LBIE (Sept. 9, 2008), at §§ 1(e)(1)(c), 2 [HBUS 1180]; Cash Deed between HSBC and LBHI(U.K.) (Sept. 9, 2008), at § 1(e)(1)(c) [HBUS 1190].

[5075] Cash Deed between HSBC and LBIE [Draft] (Aug. 28, 2008), at § 4 [LBEX-DOCID 4468302].

[5076] Cash Deed between HSBC and LBIE (Sept. 9, 2008), at §§ 3-4 [HBUS 1180]; Cash Deed between HSBC and LBHI(U.K.) (Sept. 9, 2008), at §§ 5-6 [HBUS 1190].

approval, and the deposit was still subject to any right of setoff HSBC would have against an unsecured deposit.[5077]

Finally, the U.K. Cash Deeds specify that they are governed by English law.[5078]

(ii) Lehman Executed the Hong Kong Cash Deed Late on September 12

Lehman continued negotiating the terms of the Hong Kong Cash Deed until Friday, September 12.[5079] The parties to the executed deed are Lehman Brothers Asia Holdings ("LBAH") and HSBC Ltd.[5080] Like the U.K. Cash Deeds, the executed Hong Kong Cash Deed grants HSBC Ltd. a right of setoff against payments made on behalf of or overdrafts on specified accounts.[5081] Instead of covering HSBC's credit exposure arising from CREST, the Hong Kong Cash Deed covers HSBC's exposure from credit lines (both intraday and longer-term) extended to Lehman entities in the Asia-Pacific region.[5082]

[5077] *See* Cash Deed between HSBC and LBIE (Sept. 9, 2008), at §§ 4-5 [HBUS 1180]; Cash Deed between HSBC and LBHI(U.K.) (Sept. 9, 2008), at §§ 5-6 [HBUS 1190].

[5078] Cash Deed between HSBC and LBIE (Sept. 9, 2008), at § 22 [HBUS 1180]; Cash Deed between HSBC and LBHI(U.K.) (Sept. 9, 2008), at § 27 [HBUS 1190].

[5079] *See* e-mail from Patricia Gomes, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Sept. 12, 2008) [HBUS 1760] (announcing execution of Hong Kong deeds).

[5080] Cash Deed between LBAH and HSBC Ltd (Sept. 12, 2008), at p. 1 [HBAP 13].

[5081] *Compare id.* at § 1(f), *with* Cash Deed between HSBC and LBHI(U.K.) (Sept. 9, 2008), at § 1 [HBUS 1190].

[5082] Cash Deed between LBAH and HSBC Ltd (Sept. 12, 2008), at § 1(f) [HBAP 13]; *see also* e-mail from Patricia Gomes, HSBC, to Eddie C. H. Ching, HSBC (Sept. 12, 2008) [HBUS 7642] (stating that the Hong Kong deed secures "all Cat A and PSL of HK and India"). PSL lines are lines used for credit settlement activity and Cat A lines are for longer term credit products. Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 6 (defining Cat S as credit lines for settlement activity and Cat A as non-settlement loans); Nicholas J. Taylor, HSBC, Briefing Note — Project Milan (Aug. 18, 2008), at p. 1 [HBUS 90] (listing PSL credit lines under the heading, "Cat S").

The Hong Kong Cash Deed also grants HSBC Ltd. a right of setoff against debts incurred through providing clearing and settlement services to certain Lehman entities (including LBI) designated in the Hong Kong Cash Deed.[5083] As with the U.K. Cash Deeds, Lehman was obligated to maintain a sufficient balance in specified accounts to cover good faith estimates of HSBC's aggregate exposure covered by the deed.[5084]

Lehman could access the collateral – subject to HSBC Ltd.'s approval – if there were no debts in the specified accounts (and so long as HSBC Ltd. had no actual or contingent obligation to incur such a debt on Lehman's behalf); although HSBC Ltd. could not exercise the setoff rights contained in the deed against the remaining funds, HSBC Ltd. reserved its right to exercise any *other* rights of setoff it may have against those funds.[5085] The Hong Kong Cash Deed contains a choice-of-law provision specifying that the deed is to be governed by Hong Kong law.[5086]

LBAH signed the Hong Kong Cash Deed too late in the day on September 12 for HSBC to move the Hong Kong deposit into an account secured by the deed.[5087] The banks in Hong Kong were closed on Monday, September 15 for a public holiday, so the earliest HSBC could move the deposit into a secured account was September 16.[5088] HSBC counsel has represented that HSBC transferred the equivalent of approximately

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[5083] Cash Deed between LBAH and HSBC Ltd (Sept. 12, 2008), at §§ 1, 4 [HBAP 13].
[5084] *Id.* at § 5(a).
[5085] *Id.* at §§ 5(b), 6(a).
[5086] *Id.* at § 27.
[5087] E-mail from Patricia Gomes, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Sept. 12, 2008) [HBUS 1760].
[5088] *Id.*

$148 million (on September 16) from the cash collateral deposit into an LBAH cash account and then into a secured account as specified by the Hong Kong Cash Deed.[5089] HSBC has limited its document production from overseas subsidiaries, including HSBC Asia-Pacific ("HBAP"), but HSBC counsel has represented that the deposit was transferred out of the secured account and back to the LBAH cash account later in the day on September 16 on instructions from Lehman's Treasurer for the Asia-Pacific region, Gregory Ito.[5090] According to HSBC counsel, the Hong Kong deposit was commingled with other Lehman funds in the cash account.[5091]

HSBC counsel has also advised that KPMG, the provisional liquidators of LBAH, instructed HSBC to freeze all LBAH accounts, at which point all outgoing payments required prior approval from KPMG.[5092] Further, on October 3, 2008, KPMG instructed HSBC to transfer the balance of the Hong Kong deposit to an account specified by KPMG.[5093] HSBC counsel represented that HSBC Ltd. made the transfer on October 6 after receiving (with KPMG's approval) the equivalent of approximately $680,000 for checks clearing from the account and $3 million, which "was subsequently setoff against an obligation of LBAH to [HSBC Ltd.] under a loan agreement."[5094] HSBC

[5089] Memorandum from Ken Coleman, HSBC counsel, to Examiner, re: Transfers in Connection With the Hong Kong Cash Deed (Oct. 23, 2009), at p. 1.
[5090] *Id.*
[5091] *Id.*
[5092] *Id.*
[5093] *Id.*
[5094] *Id.*

counsel stated further that the $3 million setoff "took place automatically pursuant to the mandatory insolvency setoff under Section 35 of the Hong Kong Bankruptcy Ordinance, following the making of a winding up order against LBAH by the High Court of the Hong Kong Special Administrative Region on 19 November 2008."[5095]

(f) HSBC and LBHI Stipulated To Set Off and Return Some of the Funds Covered by the U.K. Cash Deeds

Prior to entering into a stipulation with LBHI, HSBC held the equivalent of approximately $495 million from the U.K. Cash Deeds.[5096] On September 9, 2009, the bankruptcy court approved an August 28, 2009 stipulation between HSBC and LBHI.[5097] The stipulation allows HSBC to set off the equivalent of approximately $164 million against these funds for overdrafts, $114,070 for interest, and unspecified amounts for additional accrued interests, costs and expenses pursuant to the terms of the U.K. Cash Deeds.[5098] HSBC and LBHI also stipulated that LBHI will remit a misdirected payment equivalent to approximately $999,516, which had been erroneously deposited in an account covered by the U.K. Cash Deeds.[5099] Additionally, HSBC agreed to return the equivalent of approximately $101 million to an account designated by LBHI once the

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[5095] *Id.*

[5096] Stipulation, Agreement and Order, Pursuant to Sections 362 and 553 of the Bankruptcy Code, Modifying the Automatic Stay for the Limited Purpose of Permitting HSBC Bank plc to Effect Setoff and Resolution of Certain Banking Arrangements Between Lehman Brothers Holdings Inc. and HSBC Bank plc, at p. 2, Docket No. 5089, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 9, 2009) (referring to account balance of EUR 343,446,459.96).

[5097] *Id.* at p. 8 (referring to setoff of GBP 99,992,714.37 for overdrafts and GBP 69,347.60 for interest).

[5098] *Id.* at pp. 2-3.

[5099] *Id.*

setoffs were complete.[5100] HSBC expressly reserved its rights to additional setoffs against the remaining funds, and LBHI agreed to "work in a commercially reasonable manner to address" those setoffs.[5101] As described above, HSBC counsel has represented that HSBC claims total more than $345 million related to various securities transactions.[5102]

(4) Other Issues Stemming from HSBC's Collateral Demand

(a) Lehman Included the Deposits Covered by the Cash Deeds in Its Reported Liquidity Pool

Lehman reported a liquidity pool in excess of $40 billion as of September 2, 2008.[5103] Lehman included the collateral placed with HSBC in connection with the cash deeds in its reported liquidity pool.[5104] Bridge told the Examiner that he was not aware that Lehman included the collateral in its liquidity pool, but opined that the cash Lehman posted with HSBC should not have been included in Lehman's liquidity pool

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[5100] *Id.* at p. 3 (referring to return of EUR 70 million).

[5101] *Id.*

[5102] *See* Ken Coleman, HSBC counsel, Spreadsheet of Claims by HSBC and Related Entities (Jan. 5, 2010).

[5103] FRBNY, "Lehman IB Updates" (Sept. 12, 2008) [FRBNY to Exam. 007965]. Earlier in the year, HSBC's May 12 "Global Annual Review" reported that Lehman had an "excess liquidity cushion" of $93 billion. HSBC, Lehman Global Annual Review (May 12, 2008), at p. 7 [HBUS 10281]. According to Taylor, the excess liquidity cushion was calculated differently than the liquidity pool, and the Global Annual Review data was often months out-of-date because of the preparation and review process for those reports. Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at pp. 4-5. The excess liquidity cushion was calculated by assuming 50 percent funding of non-investment grade commitments, then subtracting unsecured obligations maturing within 12 months and additional collateral required for trading in the event of a one notch ratings downgrade from the sum of unencumbered assets and global cash available. *Id.*

[5104] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 19; *see also*, *e.g.*, Lehman, Liquidity Update (Sept. 10, 2008), at p. 3 [LBHI_SEC07940_742574] (listing a U.K. deposit with a pledge value of $966 million with the comment, "HSBC, etc," categorizing Lehman's ability to monetize the deposit as "low"); Lehman, Ability to Monetize Table (Sept. 12, 2008) [LBEX-WGM 784607].

because Lehman did not have immediate access to the money.[5105] Bridge stated that, in his lay opinion, the cash deposit was encumbered collateral from the moment Lehman posted it.[5106] Bridge said that he did not believe that HSBC would have "pulled the plug" if Lehman had attempted to withdraw the cash it placed with HSBC before it was secured by the deeds, but he said that "a number of things would [have] happened."[5107] Bridge also noted that, given the size of the deposit with HSBC, Lehman's liquidity would likely have been impacted and that Lehman probably would have been obliged to report the restriction placed on the funds.[5108]

Taylor said that, in his view, the deposits were unencumbered before Lehman executed the deeds, but that HSBC had implemented processes through which he would be notified if Lehman attempted to withdraw the deposits.[5109] Taylor stated that an e-mail from Bridge in which Bridge said Lehman could not withdraw the deposits "without our say so" referred to such processes.[5110] Taylor described the deposits as having a "strong encumbrance" after Lehman executed the cash deeds.[5111]

Pellerani said that he was not aware of the precise terms of the U.K. Cash Deeds and did not know what happened to the cash once it was posted to HSBC, but said that

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[5105] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 7.
[5106] *Id.* at p. 6.
[5107] *Id.* at p. 7.
[5108] *Id.*
[5109] Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 9.
[5110] *Id.*; e-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Sept. 3, 2008) [HBUS 570].
[5111] Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 9.

he was "not counting on" using the cash. Pellerani assumed that if Lehman withdrew part of the deposit during the day, HSBC would have reduced its clearing and settlement services accordingly.[5112] As described in more detail in the Bank of New York Mellon Section below, Pellerani did not consider such deposits to be available for inclusion in the liquidity pool.[5113]

Analysts from rating agencies were unaware that Lehman's liquidity pool included the deposits with HSBC (or similar deposits with other banks).[5114] Fitch's analyst opined that it would be inappropriate to include encumbered assets in the liquidity pool and would have considered the restrictions on the cash deposits at HSBC and elsewhere "material."[5115] Analysts for Standard & Poor's and Moody's (interviewed on a later date) both stated that they "would have wanted to know" about the deposits.[5116]

HSBC returned the equivalent of approximately $282 million from the U.K. deposit to Lehman on September 11.[5117] Bridge told the Examiner that the return of

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[5112] Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at p. 8.

[5113] *See* Section III.A.5.f, *infra*; Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at pp. 3-4, 8.

[5114] Examiner's Interview of Eileen A. Fahey, Sept. 17, 2009, at p. 5; Examiner's Interview of Diane Hinton, Sept. 22, 2009, at p. 6; Examiner's Interview of Peter E. Nerby, Oct. 8, 2009, at p. 4.

[5115] Examiner's Interview of Eileen A. Fahey, Sept. 17, 2009, at p. 5.

[5116] Examiner's Interview of Diane Hinton, Sept. 22, 2009, at p. 6; Examiner's Interview of Peter E. Nerby, Oct. 8, 2009, at pp. 4-5.

[5117] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 7. According to Lehman's Daily Funding Call Update e-mail for September 11: "Trsy have reduced cash deposit with HSBC to GBP200m to release liquidity in the firm." E-mail from Maria Barrio, Lehman, to Neil Ullman, Lehman, *et al*. (Sept. 11, 2008) [LBEX-DOCID 1898196]. The Examiner's financial advisors' analysis of Lehman's transactions during

funds was the result of "rebalancing" the account in Lehman's favor based on credit usage.[5118]

(b) HSBC Considered Withholding Payments or Requiring Prefunding of Trades in the Asia-Pacific Region Prior to Lehman's Bankruptcy

On Sunday September 14, Taylor exchanged e-mails with other HSBC personnel regarding orders to withhold payments and/or requiring prefunding of trades for Lehman when the Asian markets opened on Monday.[5119] Taylor instructed HSBC personnel to "leave ourself the option to close [CREST lines covered by the cash deeds] and everything."[5120] Bridge told the Examiner that HSBC opened in Asia on a business as usual basis with Lehman on September 15.[5121]

(5) The Evidence Does Not Support the Existence of Colorable Claims Arising From HSBC's Demand That Lehman Provide Cash Collateral and Execute Cash Deeds in Order for HSBC to Continue Providing Clearing and Settlement Services

(a) The Parameters of the Examiner's Analysis

The Examiner focused on the transactions surrounding the cash deeds because of the amount of collateral they secured, the timing of HSBC's demand, and the potential

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this period shows that this report was erroneous, and that Lehman received EUR 200 million on September 11. Duff & Phelps, Preliminary Findings re: HSBC Deposits (Dec. 2, 2009), at p. 1.

[5118] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 7. Bridge stressed that HSBC approved the release and that Lehman could not have directed money out of the collateral accounts without HSBC's approval. *Id.* Taylor was unaware of the transfer. Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 3. Pellerani was also unaware of the transfer. Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at p. 8.

[5119] E-mail from Nicholas J. Taylor, HSBC, to Christine Coe, HSBC, *et al.* (Sept. 14, 2008) [HBUS 1987].

[5120] E-mail from Nicholas J. Taylor, HSBC, to Martin Nicholson, HSBC, *et al.* (Sept. 14, 2008) [HBUS 1999].

[5121] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 7.

consequences to Lehman had it refused to comply. This investigation has produced sufficient information to analyze plausible claims. However, the Examiner has had limited access to relevant documents held by HSBC (headquartered in the U.K.) and some of its overseas subsidiaries. Accordingly, this analysis relies in part on representations made by HSBC's counsel.[5122]

The Examiner's investigation has determined that the transactions related to the letters of credit, syndicated credit facility, the CSA agreements and the Hong Kong deposit do not represent a material portion of the estate.

HSBC counsel represented that HSBC returned the Hong Kong deposit to an LBAH cash account before transferring the funds to KPMG in their capacity as the provisional liquidators of LBAH, minus a $3 million setoff required under Hong Kong law and the equivalent of approximately $680,000 used for clearing checks on LBAH's cash account.[5123] As described above, HSBC counsel represented that KPMG approved the equivalent of approximately $680,000 for clearing checks and that the $3 million setoff was made pursuant to an order by the High Court of the Hong Kong Special Administrative Region.[5124]

[5122] *See, e.g.*, Memorandum from Ken Coleman, HSBC counsel, to Examiner, re: Transfers in Connection With the Hong Kong Cash Deed (Oct. 23, 2009).
[5123] *Id.* at p. 1.
[5124] *Id.*

HSBC's present claim based on the letters of credit is only $116,083 for fees, interest, expenses and funds drawn against the letters of credit by the beneficiaries.[5125] The remaining $6 million is contingent upon further draws by the beneficiary of the unexpired letter of credit.[5126] The Examiner's investigation has not uncovered any evidence that Lehman did not exchange fair value for these letters of credit.

Lehman agreed to contribute $25 million to a revolving credit facility for HSBC's benefit on August 15. However, Lehman never delivered the funds.[5127] HSBC has not brought a claim based on the side letter committing the $25 million.[5128]

Finally, the CSA agreements executed in the months preceding the bankruptcy gave each party a security interest in certain assets transferred in excess of the value of the parties' swap and derivatives trades; as a net provider of collateral as of the petition date, HSBC was providing Lehman with excess funds rather than the reverse.[5129] The Examiner's investigation has not uncovered any evidence that HSBC withheld any collateral from Lehman under the CSAs. These transactions are factually significant only insofar as they relate to or provide context for HSBC's efforts to secure the U.K. Deeds.

[5125] Annex A to Proof of Claim of HSBC Bank USA, N.A., at p. 3, Claim No. 18857, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2009).

[5126] *Id.* Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at pp. 7-8.

[5127] Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 8.

[5128] *See* Ken Coleman, HSBC counsel, Spreadsheet of Claims by HSBC and Related Entities (Jan. 5, 2010); *see also* Side Letter from HSBC to LBCB (Aug. 15, 2008) [LBEX-DOCID 89911] (signed by HSBC); Side Letter from HSBC to LBCB (Aug. 15, 2008) [LBEX-DOCID 89916] (signed by LBCB).

[5129] Jenner & Block, Memorandum re: Representations by HSBC counsel (Jan. 11, 2010), at p. 1.

(b) The Facts Provide Little to No Support for Invalidating the U.K. Cash Deeds

(i) Analytical Framework

a. English Law Governs Contract Claims Arising from the U.K. Cash Deeds

Express choice-of-law provisions in contracts are *prima facie* valid under New York law.[5130] A party seeking to invalidate an express choice-of-law provision must establish that enforcement of the clause "would be unreasonable, unjust, or would contravene public policy, or that the clause would be invalid because of fraud or overreaching."[5131] Each of the U.K. Cash Deeds contains an identical provision specifying that it is to be governed by and construed in accordance with English law.[5132] The deeds are between HSBC Bank plc, headquartered in London, and LBIE[5133] and the U.K. branch of LBHI,[5134] respectively. The relevant facts support a determination that the choice of law provision is valid.

Lehman may argue the choice-of-law provision is invalid because HSBC overreached by demanding that Lehman either execute the deeds or confront the alternative of HSBC ceasing CREST clearing and settlement services. The Examiner's

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[5130] *Boss v. Am. Express Fin. Advisors, Inc.*, 791 N.Y.S.2d 12, 14 (App. Div. 2005), *aff'd* 844 N.E.2d 1142 (N.Y. 2006).

[5131] *Id.* (citing *Koko Contracting v. Cont'l Envtl. Asbestos Removal Corp.*, 709 N.Y.S.2d 825, 826 (App. Div. 2000).

[5132] Cash Deed between HSBC and LBIE (Sept. 9, 2008), at § 22 [HBUS 1180]; Cash Deed between HSBC and LBHI(U.K.) (Sept. 9, 2008), at § 27 [HBUS 1190].

[5133] Cash Deed between HSBC and LBIE (Sept. 9, 2008), at p. 1 [HBUS 1180].

[5134] Cash Deed between HSBC and LBHI(U.K.) (Sept. 9, 2008), at p. 1 [HBUS 1190].

investigation has not uncovered any evidence that Lehman contested the choice-of-law provision, and, moreover, Lehman successfully negotiated favorable changes to other terms of the deeds (this issue is discussed in more detail below in reference to economic duress). There is no colorable argument that that the choice-of-law provision is invalid.

b. English Contract Law Treats Deeds Differently from Other Contracts

English law distinguishes deeds from "informal" contracts.[5135] Deeds must "(a) effect the transference of an interest, right or property; (b) create an obligation binding on some person or persons; [or] (c) confirm some act whereby an interest, right or property has already passed."[5136] An instrument must make clear on its face that the parties intended it to be a deed and it must be validly executed as a deed.[5137] If the deed is executed by a company (organized under the Companies Act), the instrument must be duly executed and "delivered as a deed" — meaning that it must be done evidencing an intent to be bound by a deed.[5138] Delivery is presumed upon execution, and generally, a company or corporation aggregate may duly execute deeds by affixing the corporation's common seal or through the signature of two signatories authorized by a director of the company, in the presence of a witness.[5139] However, corporations aggregate are required (at least in principle) to affix the company seal to execute a

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[5135] CHITTY ON CONTRACTS, 56 (H.G. Beale *et al.* eds., Thompson Reuters 2008) (1826) [hereinafter CHITTY].
[5136] *Id.* at 60-61.
[5137] *Id.* at 67.
[5138] *Id.* at 69.
[5139] *Id.* at 68-69.

deed.[5140] This requirement may be satisfied by affixing any seal and having the board of directors or one such member and a permanent officer (or deputy of a permanent officer) attest that it is the corporation's seal and was affixed in their presence.[5141]

The U.K. Cash Deeds meet these criteria. They transfer a right to the U.K. deposit from Lehman to HSBC and they expressly state that they are executed as deeds.[5142] Lehman's common seal is affixed to the LBIE deed,[5143] and Huw Rees and Craig Goldband signed the LBHI(U.K.) deed,[5144] which is accompanied by an authorization letter signed by Tonucci and Jeffrey Welikson (LBHI's secretary),[5145] and by a sheet of authorized signatures for verification.[5146]

(ii) The Evidence Does Not Support the Existence of a Colorable Claim That the U.K. Cash Deeds Are Invalid for Want of Consideration

English law does not ordinarily require consideration to enforce a contract contained in a deed, although consideration is required for other contracts.[5147] The

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[5140] *Id.* at 69.

[5141] *Id.*

[5142] Cash Deed between HSBC and LBIE (Sept. 9, 2008) [HBUS 1180]; Cash Deed between HSBC and LBHI(U.K.) (Sept. 9, 2008) [HBUS 1190].

[5143] LBIE Power of Attorney (July 9, 2008), at p. 1 [HBUS 1188] (attached to Cash Deed between HSBC and LBIE).

[5144] Cash Deed between HSBC and LBHI(U.K.) (Sept. 9, 2008), at p. 10 [HBUS 1190].

[5145] *See* LBHI(U.K.) Authorized Signature List (Apr. 2008), at pp. 1-3 [HBUS 1200].

[5146] LBHI(U.K.) Authorized Signature List "A"(Apr. 2008) [HBUS 1205].

[5147] CHITTY, 72 (citing *Morley v. Boothby* (1825) 130 Eng. Rep. 455, 456-57 (C.P.)).

absence of consideration to support a contract contained in a deed will, however, prevent parties from obtaining equitable remedies such as specific performance.[5148]

The evidence does not support the existence of a colorable claim for failure of consideration of the U.K. Cash Deed*s*. Because the CREST agreement grants HSBC "absolute discretion" to determine whether or not to continue providing CREST clearing and settlement services,[5149] Lehman received consideration in the form of HSBC's continuing to provide those services, at least temporarily, after it determined to withdraw from Lehman. Lehman may also have received consideration in the form of a higher rate of interest on the deposits secured by the deeds. Internal Lehman e-mails refer to promises by Bridge that Lehman would receive higher than market rates on the collateral deposits, although Lehman personnel complained that they did not receive the level of interest that they had expected.[5150] Even if Lehman did not receive consideration, the failure of consideration would not be sufficient to rescind the deeds because deeds do not require consideration under English law.

[5148] *Id.* (citing *Kekewich v. Manning* (1851) 42 Eng. Rep. 519, 525 (Ch.)).

[5149] Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (Aug. 19, 2008), at § 16.1 [HBEU 102].

[5150] E-mail from Barbara Ginet, Lehman, to Huw Rees, Lehman (Sept. 1, 2008) [LBEX-AM 008968].

(iii) The Evidence Does Not Support the Existence of a Colorable Claim for Economic Duress Because the CREST Agreement Allowed HSBC To Cease Clearing and Settlement at Its Absolute Discretion

The evidence does not support the existence of a colorable claim for economic duress against HSBC in connection with the Cash Deeds. Although Lehman agreed to execute the deeds after HSBC raised the possibility of the cessation of CREST clearing and settlement services, HSBC merely proposed to do what it had a contractual right to do: exercise its absolute discretion over the provision of CREST clearing and settlement services.[5151] Even without the "absolute discretion" provision of the CREST agreement, Lehman's ability to secure important concessions during negotiations over the cash deeds provides a factual basis to support a finding that Lehman's agreement was not the result of economic duress despite the severe potential consequences to Lehman had it failed to post the demanded collateral and failed to execute the cash deeds.

a. Elements of Economic Duress

English law recognizes economic duress as grounds to avoid a contract. A contract is voidable if the defendant applies "pressure (a) whose practical effect is that there is a compulsion on, or lack of practical choice for the victim, (b) which is illegitimate, and (c) which is a significant cause in inducing the claimant to enter into

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[5151] *See* CHITTY, 616 (citing *Alec Lobb Ltd. v. Total Oil G.B. Ltd.* [1983] 1 W.L.R. 87, 93-94 (Ch.) *varied on other points by* [1985] 1 W.L.R. 173) (A.C.); Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (Aug. 19, 2008), at § 16.1 [HBEU 102] (granting HSBC absolute discretion to terminate CREST clearing and settlement services).

the contract."[5152] A proposal does not rise to the level of economic duress if the principal reason for the complying party's agreement was that he or she was prepared to comply anyway, as is the case when the complying party agrees, believing he or she will lose little by granting the illegitimate demand.[5153]

In determining whether the defendant applied "illegitimate pressure," English courts look to "a range of factors," including:

> whether there has been an actual or threatened breach of contract; whether the person allegedly exerting the pressure has acted in good or bad faith; whether the victim had any realistic practical alternative but to submit to the pressure; whether the victim protested at the time; and whether he affirmed and sought to rely on the contract.[5154]

English courts have also made clear that "[t]hreatening to carry out something perfectly within one's rights will not normally amount to duress . . . ."[5155]

b. Application to Lehman Facts

Bridge said that HSBC was Lehman's primary CREST bank, that Lehman had no secondary bank, that it would have been impossible for Lehman to replace HSBC in the short term and "very difficult" in the medium term, and that both Lehman and HSBC understood HSBC's demand to mean that HSBC would cease to provide CREST

[5152] *DSND Subsea Ltd. v. Petroleum Geo-Servs. ASA*, [2000] B.L.R. 530 at [131] (Q.B.); *see also Dimskal Shipping Co. v. Int'l Transp. Workers Fed'n (The Evia Luck No. 2)* [1992] 2 AC 152, 165 (H.L.) (appeal taken from Eng.).

[5153] CHITTY, 607 (citing *Pao On v. Lau Liu Long* [1980] A.C. 614, 635 (P.C. 1979) (appeal taken from H.K.)).

[5154] *DSND Subsea Ltd. v. Petroleum Geo-Servs. ASA*, [2000] B.L.R. 530 at [131] (Q.B.).

[5155] CHITTY, 616 (citing *Alec Lobb Ltd. v. Total Oil G.B. Ltd.* [1983] 1 W.L.R. 87, 93-94 (Ch.) *varied on other points by* [1985] 1 W.L.R. 173) (A.C.).

clearing and settlement services if Lehman did not acquiesce.[5156] Pellerani described the demand as "put[ting] a gun to our head" because HSBC acting on its threat would have been "terminal."[5157]

For its part, HSBC believed that publicity of its decision to withdraw from Lehman would have sent negative market signals that could have precipitated Lehman's collapse.[5158] Although HSBC took care to prevent publicity while negotiating the cash deeds, ending the CREST relationship entirely would have been public and brought the same (or greater) risk of precipitating Lehman's collapse. Lehman had no practical option but to comply with HSBC's demand or risk the collapse of the firm.

Nevertheless, HSBC's conduct was legitimate under its agreement with Lehman. HSBC had "absolute discretion" to provide or not provide CREST services,[5159] and invoking the ability to cease clearing would not amount to duress despite the adverse consequences to Lehman.[5160]

In addition, Lehman only agreed to the terms of the deeds after an extended negotiation over several days that yielded more favorable terms on the points of its

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[5156] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 2; Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at pp. 6-7 (reporting that HSBC agreed to maintain credit lines that would have been difficult to replace if Lehman provided collateral to cover HSBC's exposure).

[5157] Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at p. 7.

[5158] *Id.*

[5159] Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (Aug. 19, 2008), at § 16.1 [HBEU 102].

[5160] *See* CHITTY, 616 (citing *Alec Lobb Ltd. v. Total Oil G.B. Ltd.* [1983] 1 W.L.R. 87, 93-94 (Ch.) *varied on other points by* [1985] 1 W.L.R. 173) (A.C.).

greatest concern.[5161] Lehman also obtained an agreement from HSBC to return the equivalent of approximately $800 million so that Lehman would be able to manage its cash requirements at quarter end.[5162] These facts support a finding that the agreements were not the result of duress.

c. Other Transactions Do Not Give Rise to Economic Duress Claims

HSBC cancelled or reduced other credit lines and products as part of Projects Opaque and Milan.[5163] However, HSBC did not make any demands until the August 18, 2008 meeting between Taylor and Tonucci. Indeed, as the name implies, Project Opaque was designed to avoid attracting any notice,[5164] and the Examiner's investigation has not uncovered any discussions between Lehman and HSBC about the reduction in credit prior to August 18. Bridge and Taylor described the credit lines cancelled or reduced under Projects Opaque and Milan as underused or unused, and the documents corroborate that assertion.[5165] Further, as described above, the

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[5161] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 6.

[5162] E-mail from Carlo Pellerani, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Aug. 28, 2008) [LBEX-AM 008853]; *see also* e-mail from Ian T. Lowitt, Lehman, to Jeremy Isaacs, Lehman (Aug. 28, 2008) [LBEX-AM 8940]; Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at pp. 8-9.

[5163] Memorandum from Nicholas J. Taylor, HSBC, to Global Financial Institutions Group, HSBC, re: Project Opaque [Draft] (July 28, 2008), at p. 1 [HBUS 16204] (describing Project Opaque); *see also* Financial Institutions Group, HSBC, Project Milan (Aug. 2008) [HBUS 17459] (substantially similar plan for Project Milan).

[5164] Memorandum from Nicholas J. Taylor, HSBC, to Global Financial Institutions Group, HSBC, re: Project Opaque [Draft] (July 28, 2008), at p. 1 [HBUS 16204] (referring to "covert reduction of exposure" in which "client and market assumes business as usual and GTB revenues protected.").

[5165] *See* Lehman, Spreadsheet of Credit Lines Subject to Examination by HSBC and LBHI (Aug. 28, 2008) [HBUS 237] (created in concert with Lehman to determine utilization of lines for further reductions).

cancellation of the unused day loan facility, the execution of CSAs, and the other transactions related to the letters of credit did not impact Lehman significantly.

Lehman may argue that HSBC's August 27, 2008 offer to reduce the approximately $1 billion deposit if Lehman reduced its use of credit lines amounted to an improper threat to cancel those lines unless Lehman posted sufficient collateral. HSBC has not produced the agreements governing each of the credit lines at issue. Counsel for HSBC has represented that HSBC provided these credit lines solely at its discretion.[5166]

Even if HSBC did not have the discretion to cancel these other lines, HSBC did have absolute discretion under the CREST agreement to cease providing CREST clearing and settlement services if Lehman did not provide sufficient collateral.[5167] Instead of an improper threat, HSBC would arguably have been proposing a modification to the agreements governing the other lines: HSBC would reduce the collateral required for continued CREST services in exchange for Lehman agreeing to reduce the other credit lines that HSBC (hypothetically) did not have discretion to reduce unilaterally.

[5166] Memorandum from Ken Coleman, HSBC counsel, to Examiner, re: Transfers in Connection With the Hong Kong Cash Deed (Oct. 23, 2009), at p. 1; *see also* Citigroup, Overview of GTS Clearing and Settlement Lines (Sept. 4, 2008), at p. 5 [CITI-LBHI-EXAM 00102127] (explaining that Citi provided uncommitted clearing lines, which meant the lines could be cancelled at Citi's discretion).

[5167] *See* Section III.A.5.d.iii.b, *supra*.

Further, the cancellation of the other lines was not a significant factor in Lehman's decision to post the collateral and execute the cash deeds. The immediate reaction within Lehman to the August 27 demand was the concern that HSBC would cease clearing and settling CREST trades.[5168] If anything, HSBC's offer to reduce the amount of the cash collateral demanded if Lehman reduced its use of intraday credit was viewed as an opportunity: Pellerani's response to the August 27 demand was to ask Bridge for assistance in identifying lines that could be cancelled.[5169] Thus, the loss of CREST clearing and settlement services dominated Lehman's concerns with regard to the collateral demand. The other credit reductions, on their own, were not a significant factor in Lehman's decision to execute the deeds and thus will not support a claim of economic duress.

(iv) The Evidence Does Not Support the Existence of a Colorable Claim that HSBC Violated a Duty of Good Faith and Fair Dealing by Demanding Cash Collateral

The evidence does not support the existence of a colorable claim that HSBC breached a duty of good faith and fair dealing under English law. HSBC's absolute discretion over offering CREST services is not subject to an obligation of good faith and

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[5168] *See* e-mail from Huw G. Rees, Lehman, to Andrew Yeung, Lehman, *et al.* (Aug. 28, 2008) [LBEX-AM 008941] ("[T]here is a possibility that, without an agreement, our UK clearing operations will be impacted."); e-mail from Carlo Pellerani, Lehman, to Paolo R. Tonucci, Lehman (Aug. 27, 2008) [LBEX-AM 008916] ("[W]e need to give them ~$1b of deposit by Friday with a legal right to set-off, non negotiable, or they will not settle for us."); e-mail from Paolo R. Tonucci, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Aug. 27, 2008) [LBEX-AM 008918] ("[T]hey want us to deposit cash by Friday if they are to continue clearing for us.").

[5169] E-mail from Carlo Pellerani, Lehman, to Guy Bridge, HSBC, *et al.* (Aug. 27, 2008) [HBUS 3].

fair dealing and, even if it were, HSBC's financial concerns support a determination that HSBC exercised its discretion in good faith when it decided to withdraw from Lehman.

a. English Law Does Not Recognize a Principle of Good Faith and Fair Dealing of General Application

"[I]in English contract law, there is no principle of good faith of general application . . . ."[5170] English courts have nevertheless implied terms requiring that parties bargain in good faith on particular kinds of contracts, such as employment contracts.[5171] English courts have "sometimes used the implication of a term to restrict the ambit of a unilateral discretionary power conferred on one of the parties by the contract,"[5172] but this would not prevent a commercial lender from conducting "its business in what it genuinely believes to be its best commercial interest."[5173] Express terms requiring parties to act in good faith are enforceable, but the court interprets those terms narrowly, such that an obligation to bargain in good faith will not be deemed violated absent indicia of fraud.[5174]

b. Application to Lehman Facts

HSBC would have made Lehman's situation significantly more difficult had HSBC simply ceased providing CREST clearing and settlement services in the short

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[5170] CHITTY, 20.

[5171] *Id.* at 28 (citing *Johnson v. Unisys Ltd* [2001] UKHL 13 [2003] 1 A.C. 518, 536 (H.L.) (appeal taken from Eng.)).

[5172] *Id.* at 29 (citing *Paragon Fin. plc v. Nash* [2001] EWCA Civ. 1466 [2002] 1 W.L.R. 685, 700 (Eng.)).

[5173] *Id.* (quoting *Paragon Fin. plc v. Pender* [2005] EWCA Civ. 760 [2005] 1 W.L.R. 3412, 3440 (Eng.)).

[5174] *Id.* at 26 (citing *Petromec Inc. v. Petrolo Brasileiro SA Petrobras (No.3)* [2005] EWCA Civ 891, [117]-[121] [2006] 1 Lloyd's Rep. 121, 153 (Eng.)).

term (as opposed to the "orderly withdrawal" from Lehman that HSBC in fact instituted).[5175] Lehman understood that it faced the possibility of HSBC ceasing to clear and settle trades if Lehman did not meet HSBC's demand that Lehman provide nearly $1 billion in collateral and that Lehman reduce its use of other credit products.[5176] HSBC provided CREST services solely at its discretion under the CREST agreement.[5177] Although the CREST agreement does not contain express terms imposing an obligation of good faith on determinations of whether or not to provide CREST services,[5178] the court might imply an obligation to exercise that discretion consistent with principles of good faith and fair dealing.

Even if the court were to imply such an obligation, English courts interpret such obligations narrowly (English courts likewise interpret express obligations narrowly).[5179] The facts support a determination that HSBC was motivated by a genuine concern for

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[5175] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at pp. 2, 4 (stating that Lehman could not replace clearing services in the short term and reiterating that HSBC adopted a cautious approach when withdrawing to avoid being blamed for causing Lehman's collapse).

[5176] *See* e-mail from Carlo Pellerani, Lehman, to Guy Bridge, HSBC (Aug. 2, 2008) [HBUS 3]; e-mail from Guy Bridge, HSBC, to Carlo Pellerani, Lehman (Aug. 23, 2008) [LBEX-AM 008910]; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 5; Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at pp. 6-7; Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at p. 7.

[5177] Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (Aug. 19, 2008), at § 16.1 [HBEU 102].

[5178] The only express requirement in the contract to act in good faith applies to Euroclear U.K. & Ireland in making determinations over whether a particular transaction was entered in error. Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (Aug. 19, 2008), at § 4.5 [HBEU 102]. Further, the agreement states that any action by HSBC taken in accordance with its normal procedures applicable to settlement banks will be considered to be taken in good faith and with due care. *Id.* at § 9.5.

[5179] CHITTY, 25 (citing *Petromec Inc. v. Petrolo Brasileiro SA Petrobras (No.3)* [2005] EWCA Civ 891, 117-121 [2006] 1 Lloyd's Rep. 121, 153 (Eng.)); *Id.* at 29 (quoting *Paragon Fin. plc v. Nash* [2001] EWCA Civ. 1466 [2002] W.L.R. 685, 702 (Eng.)).

its own commercial interests, which would be adequate to establish good faith despite the potential negative effect on Lehman.

Taylor's August 18 briefing note summarizing his meeting with Tonucci explains that HSBC's decision to reduce its credit risk with regard to Lehman was motivated by commercial concerns about exposure to the financial sector in general, and Lehman in particular.[5180] Interviews of HSBC personnel and the Examiner's review of documents corroborate that explanation.[5181] The Examiner's investigation has not revealed any indication of malice or ulterior motives in HSBC's determination to withdraw.

The U.K. Cash Deeds contain express terms imposing an obligation on HSBC to exercise good faith in determining the amount of collateral required to cover the exposures that were to be secured by the deeds.[5182] However, the good faith terms in the deeds would only be relevant to the question of whether HSBC exercised good faith in determining how much of HSBC's exposure to Lehman was covered by the deeds (and therefore, how much of the collateral Lehman provided was secured by the deeds). The Examiner has not discovered any evidence that these determinations were made in bad faith.

[5180] Nicholas J. Taylor, HSBC, Briefing Note — Project Milan (Aug. 18, 2008), at p. 2 [HBUS 90].

[5181] *See, e.g.*, Memorandum from Nicholas J. Taylor, HSBC, to Global Financial Institutions Group, HSBC, re: Project Opaque [Draft] (July 28, 2008), at p. 4 [HBUS 16204] (explaining credit risk impetus for Project Opaque); Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at pp. 4-6 (explaining source of concern about financial sector); Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 4 (agreeing with Taylor's assessment of withdrawing from Lehman).

[5182] Cash Deed between HSBC and LBIE (Sept. 9, 2008), at §§ 2(c), 3 [HBUS 1180]; Cash Deed between HSBC and LBHI(U.K.) (Sept. 9, 2008), at §§ 4(c), 5 [HBUS 1190].

(v) The Evidence Does Not Support the Existence of a Colorable Claim that HSBC Violated the Notice Provision of the CREST Agreement

The evidence does not support the existence of a colorable claim that HSBC violated the notice provision of the CREST agreement. As set forth below, the agreement states that HSBC may terminate the contract without notice, only requires 30-days' notice to the extent that HSBC "considers it practicable and appropriate" and exempts HSBC from any liability for failing to provide notice.

a. Construction of Terms

Terms of a contract are understood to bear the meaning that the parties using the terms would reasonably have understood them to mean against the relevant background of the transaction.[5183] Courts will attempt to give effect to the entire contract.[5184] If different parts of a contract are inconsistent with one another, the court may reject portions that would defeat the parties' intention as expressed by the contract as a whole.[5185] Clauses that limit or qualify, but do not entirely negate, obligations created in other clauses are not inconsistent.[5186] If an agreement gives one party

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[5183] CHITTY, 841-42 (discussing *Investors Comp. Scheme Ltd. v. W. Bromwich Bldg. Soc'y (No. 1)* [1998] 1 W.L.R. 896, 912 (H.L) (appeal taken from Eng.)).

[5184] *Id.* at 855 (citing *Taylor v. Rive Droite Music Ltd*. [2005] EWCA Civ 1300, [26] [2006] E.M.L.R 4, 65-66 (Eng.)).

[5185] *Id*.

[5186] *Id.* at 856 (citing *Pagnan SpA v. Tradax Ocean Transp. SA* [1987] 2 Lloyd's Rep. 342, 351).

discretion to rescind the agreement, that party may not exercise that discretion "arbitrarily, or capriciously, unreasonably" or in bad faith.[5187]

b. Application to Lehman Facts

Although HSBC had informed Lehman on August 18, 2008, of its intention to withdraw, HSBC did not set a date for cancelling CREST services until August 27, when Bridge informed Pellerani that HSBC would cease providing CREST services if Lehman did not provide collateral equivalent to approximately $945 million in two days' time.

Section 16.1 of the Terms and Conditions to the CREST agreement gives HSBC "absolute discretion to terminate without notice," qualifies that "absolute" discretion with a requirement that HSBC give 30-days' notice "where [HSBC] considers it practicable and appropriate," and provides that HSBC shall not have liability "in any event" for failing to provide notice.[5188] The second clause limits, but does not entirely negate, HSBC's exercise of discretion by conditioning it upon a secondary exercise of discretion. Thus, the "practicable and appropriate" clause suggests that termination without notice would be arbitrary, capricious, unreasonable, or in bad faith if HSBC had determined that notice would have been practicable and appropriate, and yet failed to provide any.

[5187] *Id.* at 244 (quoting *Selkirk v. Romar Invs., Ltd.* [1963] 1 W.L.R. 1415, 1422 (P.C.) (appeal taken from Bah.)).

[5188] Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (Aug. 19, 2008), at § 16.1 [HBEU 102].

The facts do not support a determination that HSBC's decision not to provide more advanced notice was arbitrary, capricious, unreasonable, or in bad faith. As described above, the court will not imply restrictions on a commercial lender's exercise of discretion that would prevent it from conducting "its business in what it genuinely believes to be its best commercial interest."[5189] Bridge informed the Examiner that HSBC intended to exit its relationship with Lehman as swiftly as practicable in an effort to protect HSBC's commercial interests,[5190] and Lehman had been able to provide the bulk of the collateral before being granted an extension on August 28.[5191] Thus, the notice, while short, would not violate the agreement.[5192] Moreover, more than a week before HSBC issued its two-day deadline, Taylor and Tonucci had already discussed HSBC's intention to request collateral. Furthermore, HSBC subsequently allowed Lehman to

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[5189] CHITTY, 29 (quoting *Paragon Fin. plc v. Pender* [2005] EWCA Civ. 760, [2005] 1 W.L.R. 3412, 3440).

[5190] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 4.

[5191] E-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Aug. 28, 2008) [HBUS 9250].

[5192] Even if the two-day notice did violate the agreement, HSBC has a colorable defense of waiver by estoppel. A contracting party that represents it will not enforce its strict legal rights under a contract is estopped from later asserting those rights against the party intended to rely upon the representation. CHITTY, 303 (citing *B.P. Exploration (Libya) v. Hunt (No.2)* [1979] 1. W.L.R. 783, 812 (Q.B), *aff'd* [1983] 2 A.C. 352). The representation may be inferred from conduct. *Id*. (citing *Bremer Handelsgesellschaft mbH v. Vanden Avenne-Izegem P.V.B.A.* [1978] 2 Lloyd's Rep. 109, 126 (H.L.)). Here, Lehman entered into a stipulation allowing HSBC to set off funds under the U.K. Cash Deeds instead of challenging the adequacy of the two-day ultimatum HSBC gave when it demanded Lehman execute the deeds or face the consequence of HSBC ceasing clearing services. *See* Stipulation, Agreement and Order, Pursuant to Sections 362 and 553 of the Bankruptcy Code, Modifying the Automatic Stay for the Limited Purpose of Permitting HSBC Bank plc to Effect Setoff and Resolution of Certain Banking Arrangements Between Lehman Brothers Holdings Inc. and HSBC Bank plc, Docket No. 5089, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 9, 2009).

delay posting the collateral until September 2.[5193] Finally, even if HSBC had violated the notice provision, the agreement exempts HSBC from liability.[5194]

(vi) The Cash Deeds Were Not Contracts of Adhesion or Standard Form Contracts

The evidence does not support the existence of a colorable claim that the cash deeds were contracts of adhesion or standard form contracts. HSBC and Lehman were sophisticated parties to an agreement that was the product of several days' worth of negotiations that secured changes from the initial proposed draft that were favorable to Lehman.[5195]

a. Characteristics of Standard Form Contracts or Contracts of Adhesion

Under English law, the court may modify or reject terms of a contract where contracting parties are of unequal bargaining power and the terms are offered on a take-it-or-leave-it basis.[5196]

b. Application to Lehman Facts

Even though HSBC and Lehman were both sophisticated parties, HSBC held substantially greater bargaining power. HSBC was the only bank that could provide

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[5193] E-mail from Carlo Pellerani, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Aug. 28, 2008) [LBEX-AM 008853]; *see* e-mail from Ian T. Lowitt, Lehman, to Jeremy Isaacs, Lehman (Aug. 28, 2008) [LBEX-AM 8940] (referring to a conversation with HSBC's CRO and HSBC's accommodation and its concern about Lehman over the quarter-end).

[5194] Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (Aug. 19, 2008), at § 16.1 [HBEU 102].

[5195] *See* Section III.A.5.d.3.e, *supra*.

[5196] *See Levison v. Patent Steam Carpet Cleaning Co.*, [1978] Q.B. 69, 79.

Lehman with CREST clearing and settlement services in the short term, and likely the medium term as well.[5197] HSBC would have had even more leverage if, as Bridge believed, ceasing to clear and settle CREST trades would have sent negative signals to the market that could have hastened Lehman's collapse.[5198]

Nevertheless, the deeds were not offered on a take-it-or-leave-it basis. HSBC was willing to negotiate the terms of the contracts as well as the size of the required deposit.[5199] Over a period of days, Lehman was able to negotiate more favorable terms, expanding its own access to the collateral, while narrowing the scope of debts HSBC could offset against the secured accounts.[5200] Thus, the evidence does not support the existence of a colorable claim that the U.K. Cash Deeds were contracts of adhesion or standard form contracts.

[5197] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 2 (stating that it would not be possible to replace HSBC's CREST services in the short term and would be very difficult to do so in the medium term); Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at pp. 6-7 (describing CREST settlement lines as the "lion's share" of the credit that would be difficult to replace quickly); Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at p. 7 (stating that cessation of clearing would have been "terminal" for Lehman).

[5198] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 4 (reiterating that HSBC attempted to exit its relationship with Lehman as quickly as possible, but also attempted to be flexible with Lehman out of concern that HSBC's actions might be viewed as the impetus of a Lehman collapse).

[5199] *See* e-mail from Carlo Pellerani, Lehman, to Guy Bridge, HSBC (Aug. 27, 2008) [HBUS 3]; e-mail from Guy Bridge, HSBC, to Carlo Pellerani, Lehman (Aug. 23, 2008) [LBEX-AM 008910] (discussing effect of credit usage on collateral requirements); Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 6.

[5200] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 6; e-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Sept. 3, 2008) [HBUS 570].

(c) Other Potential Theories of Liability

(i) English Law Governs the Remaining Potential Claims Even Though They Are Not Covered by the Choice-of-Law Provision of the Cash Deeds

a. Analytical Framework

Although English law governs the potential, material claims arising from the facts described herein, this analysis is conducted independent of the choice-of-law provision in the CREST agreement. New York law applies contractual choice-of-law clauses to claims sounding in tort only where the parties to a contract draft a "sufficiently broad" choice-of-law clause.[5201]

Here, the scope of the language in the U.K. Cash Deed*s* and CREST agreement is nearly identical to choice-of-law clauses New York courts have found insufficiently broad to cover tort claims: "This Deed is governed by and shall be construed in accordance with English law."[5202] The Examiner's investigation has not revealed any negotiations over the scope of the choice-of-law clause, or any other factual basis to support applying the choice-of-law provision to tort claims.

[5201] *Fin. One Public Co. v. Lehman Bros. Special Fin., Inc.*, 414 F.3d 325, 335 (2d Cir. 2005) (applying New York law).

[5202] *Compare* Cash Deed between HSBC and LBIE (Sept. 9, 2008), at § 22 [HBUS 1180], *and* Cash Deed between HSBC and LBHI(U.K.) (Sept. 9, 2008), at § 27 [HBUS 1190], *and* Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (Aug. 19, 2008), at § 24.1 [HBEU 102], *with Twinlab Corp. v. Paulson*, 724 N.Y.S.2d 496, 496 (App. Div. 2001) (choice-of-law provision specifying New York law would govern "validity, interpretation, construction, and performance" of contract not broad enough to govern tort claims that did not arise from contractual obligations), *and Fin. One Public Co.*, 414 F.3d at 335 (choice-of-law provision inapplicable to claim for setoff where contract did not establish right and only stated "this contract shall be governed by the laws of the State of New York").

Where the law of two or more jurisdictions may apply to a dispute, New York courts examine whether the laws conflict.[5203] Where a conflict exists, New York employs one of two methods to determine which law should apply, depending on the nature of the claim. New York employs a "center of gravity" test for contract claims and an "interest analysis" for tort claims and any other claim where no specific approach is called for.[5204] Quasi-contract claims are decided under the "center of gravity" test.[5205]

Under the center of gravity test, the court examines the place of negotiation, place of performance, execution location and subject matter of the contract, and domicile of the parties, giving the location of the contract's execution and performance the most weight.[5206]

Under an interest analysis, the court conducts two separate inquiries: "(1) what are the significant contacts and in which jurisdiction they are located; and (2) whether the purpose of the law is to regulate conduct or allocate loss."[5207] Where the purpose of the law is to regulate conduct, the law of the location of the tort generally governs.[5208] Where the purpose of the law is to allocate loss, parties with domiciles in different jurisdictions are generally governed by the law of the jurisdiction where the injury occurred and parties with domiciles in the same jurisdiction are generally governed by

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[5203] *K.T. v. Dash*, 827 N.Y.S.2d 112, 116 (App. Div. 2006).
[5204] *Fin. One Public Co.*, 414 F.3d at 336.
[5205] *Global Fin. Corp. v. Triarc Corp.*, 715 N.E.2d 482, 484 (N.Y. 1999).
[5206] *Brink's Ltd. v. S. African Airways*, 93 F.3d 1022, 1030-31 (2d Cir. 1996) (applying New York law).
[5207] *Padula v. Lilarn Props. Corp.*, 644 N.E.2d 1001, 1002 (N.Y. 1994).
[5208] *Id.*

the jurisdiction of the shared domicile.[5209] New York law considers a corporation to be domiciled in the jurisdiction of its headquarters.[5210] New York courts have also considered New York's policy interest in maintaining its "preeminent financial position" as "a financial capital of the world" by protecting "the justified expectations of the parties to [a] contract."[5211]

b. Application to Remaining Potential Claims

The potential claims arising from Lehman's relationship with HSBC are governed by English law. The facts do not implicate any conflict of laws over torts that allocate loss and the CREST agreement is the only contract that gives rise to claims that may be material to the bankruptcy proceedings.

English Law Will Govern Claims Based on Quasi-Contract and Conduct-Regulating Tort Claims. The U.K. Cash Deeds were signed in London and governed the U.K.-based CREST clearing and settlement services. HSBC is headquartered in London. The Lehman parties to the deed were LBHI(U.K.) and LBIE. LBHI(U.K.) was a London-based branch office of LBHI, and LBIE was headquartered in the U.K. These facts support a determination that the "center of gravity" test requires the application of English law.

[5209] *Cooney v. Osgood Mach., Inc.*, 612 N.E.2d 277, 281 (N.Y. 1993).

[5210] *Schultz v. Boy Scouts of Am., Inc.*, 480 N.E.2d 679, 682 (N.Y. 1985).

[5211] *Wells Fargo Asia Ltd. v. Citibank, N.A.*, 936 F.2d 723, 726 (2d Cir. 1991) (quoting *J. Zeevi & Sons, Ltd. v. Grindlays Bank (Uganda) Ltd.*, 333 N.E.2d 168, 172 (N.Y. 1975)).

The same facts support the existence of significant contacts to the U.K. for the "analysis of interests" test. Further, any tortious conduct arising from the deeds would have occurred in the U.K., as did any injury to LBIE and LBHI(U.K.). To the extent that there is a conflict of laws over torts that regulate conduct between any parties or over torts that allocate losses between parties with the same domicile, these facts support a determination that the "analysis of interests" test requires the application of English law.

(ii) The Evidence Does Not Support The Existence Of a Colorable Claim For Unjust Enrichment Because Lehman Conveyed a Benefit on HSBC Pursuant to Lehman's Valid Contractual Obligations

The evidence does not support the existence of a colorable claim that HSBC was unjustly enriched through the cash deeds. The cash deeds are likely valid contracts, under which Lehman had a duty to convey a benefit to HSBC for which Lehman received consideration. As described above, the Examiner's investigation has not uncovered sufficient facts to support a colorable claim to invalidate the cash deeds. On these facts, HSBC would have a defense to a claim of unjust enrichment because any benefit conveyed by Lehman pursuant to the cash deed transactions was conveyed pursuant to Lehman's duty to perform its valid contractual obligations.

a. Elements of Unjust Enrichment

Unjust enrichment is a quasi-contractual claim in New York.[5212] Where the court determines there is a conflict between English and New York law, the court will apply the "center of gravity test." [5213] As described above, this will likely result in the application of English law.

English law does not recognize a general cause of action of "unjust enrichment," but the principle of unjust enrichment has been recognized judicially[5214] and statutorily[5215] as a basis for recovery in individual instances where the law creates a right of restitution, such as an action for money had and received.[5216]

The elements of the unjust enrichment principle under English law are: (1) enrichment of the defendant by receipt of a benefit, (2) at the expense of the claimant, (3) where the retention of the benefit is unjust and (4) where there is no defense to the claim.[5217] Among the defenses to claims based on the principle of unjust enrichment are that the claimant conferred the benefit to the defendant pursuant to a common law,

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[5212] *Goldman v. Metro. Life Ins. Co.*, 841 N.E.2d 742, 746 (N.Y. 2005).

[5213] *Fin. One Public Co.*, 414 F.3d at 336.

[5214] CHITTY, 1843 (citing *Lipkin Gorman v. Karpnale Ltd*. [1991] 2 A.C. 548, 559 (H.L.) (appeal taken from Eng.)).

[5215] *Id*. (citing the Civil Liability (Contribution) Act, 1978, c. 47; the Insolvency Act, 1986 c. 45 § 382(4); and the Torts (Interference with Goods) Act, 1977 c. 32 § 7(4)).

[5216] *Id*. at 1845 (citing *Moses v. Macferlan* (1760) 97 Eng. Rep. 676, 678 (K.B.)).

[5217] *Id*. (citing *Banque Financiere de la Cite v. Parc (Battersea) Ltd.* [1999] 1 A.C. 221, 234 (H.L.) (appeal taken from Eng.).

equitable or statutory duty[5218] and that the claimant is estopped from bringing a claim.[5219]

b. Application to Lehman Facts

HSBC received a benefit from Lehman in the form of the U.K. and Hong Kong deposits, and an additional benefit in the form of security through the cash deeds. HSBC acquired this benefit by causing Lehman to believe that HSBC would cease providing CREST settlement and clearing services for Lehman if it did not meet HSBC's demands.[5220] The consequences of not complying were severe: It would have been impossible for Lehman to replace HSBC's services quickly and, therefore, HSBC's withdrawal would have quickly and inevitably become public knowledge.[5221] Such a negative market signal could have had a significant adverse effect on Lehman's situation.[5222] HSBC was careful, however, to avoid alerting any market participants of its intent to withdraw from Lehman.[5223]

Nevertheless, HSBC received the deposits and the additional security through the cash deeds in exchange for continuing to provide CREST clearing and settlement services. As described above, there are facts supporting the validity of these contracts

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[5218] *Id*. at 1846 (citing *Ocean Shipping Ltd. v. Creditcorp Ltd*. [1994] 1 W.L.R. 161, 164 (H.L.) (appeal taken from Eng.)).

[5219] *Id*.

[5220] See Sections III.A.5.d.3, *supra*.

[5221] See *id.*

[5222] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at pp. 2, 4; Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at p. 7.

[5223] *See, e.g.*, Memorandum from Nicholas J. Taylor, HSBC, to Global Financial Institutions Group, HSBC [Draft] (July 28, 2008), at p. 4 [HBUS 16204] (referring to "covert reduction of exposure").

and the legitimacy of HSBC's demands. Under English law, these facts would constitute a defense to a claim based on unjust enrichment to the extent that they establish that any benefit HSBC received was not unjust, but was conveyed pursuant to Lehman's duty to perform under valid contracts. Further, LBHI has already agreed to allow HSBC to set off the funds under the U.K. Cash Deeds, and so it may be estopped from claiming that HSBC was unjustly enriched through those deeds.[5224]

(iii) The Evidence Does Not Support a Colorable Claim That HSBC Breached a Fiduciary Duty to Lehman Because HSBC and Lehman Were Sophisticated Parties in a Relationship Governed by an Agreement That Limited HSBC's Obligations

HSBC did not owe Lehman a fiduciary duty independent of HSBC's role as an agent in the CREST system. The terms and conditions impose limited obligations on HSBC to execute CREST trades pursuant to the contract, and those obligations were subject to various indemnifications and exemptions from liability. Most importantly, the agreement imposed no obligation on HSBC to continue providing clearing and settlement services.

[5224] *See* Stipulation, Agreement and Order, Pursuant to Sections 362 and 553 of the Bankruptcy Code, Modifying the Automatic Stay for the Limited Purpose of Permitting HSBC Bank plc to Effect Setoff and Resolution of Certain Banking Arrangements Between Lehman Brothers Holdings Inc. and HSBC Bank plc, Docket No. 5089, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 9, 2009).

a. Elements of Breach of Fiduciary Duty and Misappropriation

Breach of fiduciary duty is a conduct-regulating tort in New York.[5225] Where the court determines there is a conflict between English and New York law, the court will apply an interest analysis to determine which to apply.[5226] As described above, this will likely result in the application of English law.

English law recognizes a fiduciary relationship where one party "has undertaken to act for or on behalf of another in a particular matter or circumstance which gives rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty. . . . Breach of fiduciary obligation, therefore, connotes disloyalty or infidelity."[5227] Parties to relationships governed by commercial contracts negotiated at arms-length are generally understood to represent their own interests.[5228] Nevertheless, "[t]he existence of the contract does not exclude the co-existence of concurrent fiduciary duties (indeed the contract may well be their source); but the contract can and does modify the extent and nature of the general duty that would otherwise arise."[5229]

[5225] *Reid v. Ernst & Young Global, Ltd.*, No. 604028/2005, 2006 WL 3455259, at *7 (N.Y. Sup. Ct. Nov. 15, 2006).
[5226] *See id.*
[5227] *Bristol and W. Bldg. Soc'y v. Mothew* [1998] Ch. 1, 18.
[5228] Christa Band, *Conflicts of Interests in Financial Services and Markets*, 21 J. OF INT'L BANKING L. AND REG. 677, 678-79 (2006).
[5229] *Henderson v. Merrett Syndicates* [1995] 2 A.C. 145 206 (H.L.) (appeal taken from Eng.).

b. Application to Lehman Facts

HSBC acted as Lehman's agent when executing Lehman's sterling-denominated securities trades in the CREST system[5230] and so may have owed Lehman a duty of loyalty in providing those services. Additionally, HSBC used its knowledge of Lehman's need for HSBC credit support as leverage to encourage Lehman to make an additional commitment to HSBC through the syndicated credit facility, even though HSBC had been covertly reducing Lehman's credit through Project Opaque.

However, HSBC acted as Lehman's agent in a sharply circumscribed context, and certainly did not owe Lehman any fiduciary duties beyond that. Both Lehman and HSBC are highly sophisticated entities conducting business with one another and dealing with each other through numerous arms-length transactions. Although HSBC acted as Lehman's agent in executing CREST trades, the Examiner's investigation has not uncovered any evidence that HSBC had any obligation to provide credit to support those services. These facts would undermine any claim under English law that HSBC had any broader fiduciary obligation (if it had any obligation at all) beyond providing CREST clearing and settlement services to Lehman as dictated by the limited terms of the agreement between the parties.

[5230] *See* Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (Aug. 19, 2008), at §§ 4.1, 6 [HBEU 102]; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 3 (describing HSBC's role in CREST trades as "standing in" for Lehman).

The agreement between HSBC and Lehman limits HSBC's obligations in several ways, the most significant of which was HSBC's absolute discretion to terminate CREST services at any time.[5231] Further, the CREST agreement contains various exclusions of HSBC's liability under the agreement,[5232] agreements to indemnify HSBC,[5233] and an acknowledgement that HSBC does not owe Lehman a duty of care to monitor or enforce compliance by any person with any obligations applicable to participation in the CREST system.[5234] These provisions limit the scope of HSBC's obligations to Lehman, and exclude any parallel duty to ensure that Lehman complied with the requirements of the CREST system. This supports a determination that HSBC was only obliged to execute Lehman's CREST trades, and owed no further duty to assist Lehman. Moreover, HSBC's obligation to execute Lehman's CREST trades was itself contingent upon HSBC's absolute discretion over whether to terminate the agreement.[5235]

Lehman's willingness to contribute $25 million to HSBC's syndicated credit facility in the hope of securing credit support from HSBC in the future may indicate that Lehman believed HSBC would provide assistance beyond the narrowly defined obligations in the CREST agreement, but such belief alone would not establish a fiduciary duty. Further, HSBC personnel, at least initially, supported allowing Lehman

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[5231] *See* Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (Aug. 19, 2008), at § 16.1 [HBEU 102].
[5232] *Id*. at §§ 3.4-3.5.
[5233] *Id.* at § 7.
[5234] *Id.* at § 9.7.
[5235] *See id*. at § 16.1.

to withdraw its commitment.[5236] Although there is conflicting evidence regarding what role HSBC played in the final decision not to allow Lehman to withdraw, the decision was based, at least in part, on considerations that Lehman's withdrawal would have sent a negative signal to the market, and the concomitant risk of precipitating Lehman's collapse.[5237]

Thus, HSBC does not appear to have had any relevant fiduciary obligations to Lehman beyond acting as its agent when executing CREST trades. Lehman and HSBC were commercial parties to an arms-length transaction governed by an agreement that substantially limited HSBC's obligations to Lehman and, moreover, expressly gave HSBC absolute discretion over the provision of credit and settlement services.

(iv) The Evidence Does Not Support a Colorable Claim that HSBC's Demand for Collateral Tortiously Interfered With Lehman's Other Business or Contracts Because HSBC Was Acting To Protect Its Own Economic Interests

Even if HSBC's actions related to the cash deeds were to have factored materially into Lehman's decision to file for bankruptcy, the evidence does not support the

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[5236] E-mail from Nicholas J. Taylor, HSBC, to Guy Bridge, HSBC, *et al.* (Aug. 27, 2008) [HBEU 129] (agreeing that HSBC should cancel Lehman's commitment to the syndicated facility).

[5237] *Compare* Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 8 (stating that the agent bank administering the revolver made the ultimate decision), *with* e-mail from Nicholas J. Taylor, HSBC, to Craig T. Thiele, HSBC (Sept. 9, 2008) [HBUS 5709] (referring to discussion and decision within HSBC not to consent to the cancellation), *and* e-mail from Paul M. Lopez, HSBC, to Guy Bridge, HSBC, *et al.* (Sept. 2, 2008) [HBUS 566] [redacted]

existence of a colorable claim of tortious interference under English law because HSBC demanded collateral in order to protect its economic interests.[5238]

a. Elements of Tortious Interference

Tortious interference is a conduct-regulating tort in New York.[5239] Where the court determines English and New York law conflict, it will apply an interest analysis to determine which to apply.[5240] As described above, this will likely result in the application of English law.

Under English law, a party commits the tort of interference with rights where the defendant procures or induces the violation of a right held by the plaintiff through some actionable wrong.[5241] Injury alone is insufficient to sustain a tort of interference if the defendant acted lawfully and the plaintiff's legal rights were not violated.[5242] Knowingly inducing a third party to break a contract with the claimant (or threatening to do so) is an interference with contractual rights absent some reasonable justification or excuse.[5243] The pursuit of "normal and legitimate business interests" is considered a

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[5238] Nicholas J. Taylor, HSBC, Briefing Note — Project Milan (Aug. 18, 2008), at pp. 1-2 [HBUS 90].

[5239] *See Discover Group, Inc. v. Lexmark Int'l, Inc.*, 333 F. Supp. 2d 78, 84 (E.D.N.Y. 2004) (applying New York law).

[5240] *See id.*

[5241] *Law Debenture Trust Corp. v. Ural Caspian Oil Corp.* [1995] Ch. 152, 155.

[5242] *Id.*

[5243] *Pitman Training Ltd. and Another v. Nominet U.K. and Another* [1997] F.S.R. 797, 807 (Ch.) (finding no interference with contract where the defendant induced a domain name registrar to restore its use of a particular URL that another domain name registrar had subsequently allocated to another company).

reasonable justification even where it may have the effect of causing a third party to breach a contract.[5244]

b. Application to Lehman Facts

HSBC's demand that Lehman provide the equivalent of $945 million in collateral reduced Lehman's cash on hand in the week prior to the petition date. According to Lehman's internal post-mortem analysis of its bankruptcy, the loss of liquidity to clearing banks' collateral demands may have been the cause of the bankruptcy.[5245] By September 14, LBHI's "free cash" available for intraday funding had dwindled to $2 billion, while LBIE faced a projected cash shortfall of $4.5 billion.[5246] According to the post-mortem, this prompted Lehman to place LBIE into administration, which caused a cross-default that triggered LBHI's filing.[5247] Through the bankruptcy, LBHI breached contracts with numerous counterparties. Had Lehman refused to provide HSBC with collateral and had HSBC *immediately* ceased providing CREST services, the same result likely would have occurred, given that HSBC personnel were concerned that publicity of the plan to *eventually* withdraw could precipitate Lehman's collapse.[5248]

Even if the post-mortem analysis were correct, HSBC would have a defense to a claim of tortious interference. HSBC acted to protect its economic interests by securing

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[5244] *Id.* at 809.
[5245] Lehman, Liquidity of Lehman Brothers (Oct. 7, 2008), at p. 9 [LBHI_SEC07940_844701].
[5246] *Id.*
[5247] *Id.*
[5248] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at pp. 2, 4.

its own credit risk against a potential default by Lehman. Taylor's August 18 memorandum summarizing the meeting where he informed Tonucci of HSBC's plan for an "orderly withdrawal" states that the decision "is on the basis of deteriorating risk and business fundamentals, continuing performance/valuation uncertainty, capital erosion, and significant [Financial Institutions] Group exposure to Lehman in particular and the sector as a whole."[5249] Interviews with HSBC personnel have corroborated the claim that HSBC's demand for collateral was motivated by a desire to reduce its unsecured exposure to Lehman because of these concerns.[5250] Further, it is not clear that the post-mortem analysis correctly identifies LBIE's default as the cause of LBHI's bankruptcy, as the bankruptcy may have been inevitable before that point. Interviews with members of LBHI's Board of Directors indicate that Lehman already decided to file for bankruptcy on September 14 at the prompting (though not necessarily the explicit instruction) of U.S. regulators.[5251] Regulators made these judgments independent of an analysis of how LBIE's entering administration would impact LBHI's funding; Thomas Baxter, the General Counsel for the FRBNY, said that the Government was taken by

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[5249] Nicholas J. Taylor, HSBC, Briefing Note — Project Milan (Aug. 18, 2008), at p. 2 [HBUS 90].

[5250] Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 4; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 4.

[5251] Examiner's Interview of John F. Akers, Apr. 22, 2009, at pp. 13-14; Examiner's Interview of Roger Berlind, May 8, 2009, at p. 11; Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at pp. 13-14; Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 16; *see also* Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 14, 2008), at pp. 3-5 [LBEX-AM 003932] (unanimously voting to file for bankruptcy protection following a conference call with Thomas Baxter, Jr., general counsel of the FRBNY, and Christopher Cox, then-Chairman of the SEC).

surprise by the effect of LBIE entering administration.[5252] These facts tend to undermine a claim for tortious interference under English law.

(v) The Evidence Does Not Support a Finding that HSBC Fraudulently or Negligently Misrepresented Its Plan to Withdraw

The evidence does not support the existence of a colorable claim of fraudulent misrepresentation, fraudulent inducement, or negligent misrepresentation under English law against HSBC in relation to the cash deeds or the prospect of continued credit support in exchange for participating in the syndicated revolver.

a. Elements of Fraud and Misrepresentation

Fraud is a conduct-regulating tort in New York.[5253] Where the court determines English and New York law conflict, it will apply an interest analysis to determine which to apply.[5254] As described above, this will likely result in the application of English law.

The elements of misrepresentation in English law are derived from common law, and the relief available is governed by the Misrepresentation Act of 1967.[5255] A misrepresentation must be (1) "a false statement of fact, past or present, as distinct from a statement of opinion, or of intention or mere commendatory statements,"[5256] (2) by or

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[5252] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 11.
[5253] *Chase Manhattan Bank v. N.H. Ins. Co.*, 749 N.Y.S.2d 632, 634-35 (Sup. Ct. 2002).
[5254] *Id.*
[5255] CHITTY, 503-06.
[5256] *Id*. at 505 (citing *Dimmock v. Hallett* (1866-67) L.R. 2 Ch. App. 21, 27).

known to a party to the contract or a party's agent,[5257] (3) that the claimant was intended to act upon.[5258]

To prove fraudulent misrepresentation, the claimant must also establish that the representation was made in the absence of an honest belief.[5259] A defendant who suspects, but does not know, that a statement is inaccurate will have made the statement in the absence of an honest belief.[5260]

To prove negligent misrepresentation, the claimant must show: (1) that the representation was made without reasonable grounds for believing it to be true; and (2) either (a) that the defendant owed a duty to the claimant or (b) that the defendant induced the claimant to enter into a contract through the misrepresentation.[5261]

The Misrepresentation Act allows damages to be awarded for fraudulent and negligent misrepresentations.[5262] Claimants may also seek rescission, but the Act grants the court discretion to impose damages instead of rescission for negligent misrepresentation.[5263] If the claimant seeks rescission of a contract instead of damages,

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[5257] *Id*. at 516 (citing *Hasan v. Wilson* [1977] 1 Lloyd's Rep. 431, 444 (Q.B.)).
[5258] *Id*. at 519.
[5259] *Id*. at 530 (citing *Derry v. Peek* (1889) 14 App. Cas. 337, 379 (H.L.) (appeal taken from Eng.)).
[5260] *Id*. (citing *Reese River Silver Mining Co. v. Smith* (1869) L.R. 4 H.L. 64, 79-80 (H.L.) (appeal taken from Eng.)).
[5261] *Id*. at 540-541 (citing *Howard Marine & Dredging Co. v. A. Ogden & Sons (Excavations) Ltd.* [1978] Q.B. 574, 595).
[5262] Misrepresentation Act, 1967 c. 7 § 2(1).
[5263] *Id*. § 2(2).

the claimant need only show that the misstatement "materially influenced" the decision to enter into the contract.[5264]

b. Application to Lehman Facts

HSBC began reducing its exposure to Lehman through Project Opaque by means calculated to conceal its actions from Lehman.[5265] Meanwhile, HSBC pursued a $25 million commitment from Lehman for HSBC's syndicated credit facility, aware that Lehman was participating in the hope that HSBC would continue to provide credit support.[5266] Taylor encouraged this belief, suggesting that Lehman participate in the facility in "the context of reciprocity and [HSBC's] continuing support during this period."[5267] Lehman formally committed to the facility on August 15, three days before HSBC notified Lehman that it intended to exit the relationship.[5268]

However, it is not clear that Taylor or anyone else at HSBC led Lehman to believe that committing $25 million to the syndicated credit facility would secure continued credit support from HSBC rather than merely securing an improved relationship with HSBC and a favorable disposition toward continued support. Pellerani remarked only that HSBC's management appreciated Lehman's participation,

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[5264] CHITTY, 524 (citing *Edgington v. Fitzmaurice* (1885) 29 Ch. D 459, 483 (describing materiality as "actively present to [the hearer's] mind")).

[5265] *See* Memorandum from Nicholas J. Taylor, HSBC, to Global Financial Institutions Group, HSBC [Draft] (July 28, 2008), at p. 1 [HBUS 16204].

[5266] E-mail from Nicholas J. Taylor, HSBC, to Mark Stadler, HSBC, *et al.* (June 15, 2008) [HBUS 9925]; e-mail from Guy Bridge, HSBC, to Craig T. Thiele, HSBC, *et al.* (June 17, 2008) [HBUS 10046].

[5267] E-mail from Nicholas J. Taylor, HSBC, to Mark Stadler, HSBC, *et al.* (June 15, 2008) [HBUS 9925].

[5268] Side Letter from HSBC to LBCB (Aug. 15, 2008) [LBEX-DOCID 89911] (signed by HSBC); Side Letter from HSBC to LBCB (Aug. 15, 2008) [LBEX-DOCID 89916] (signed by LBCB).

and that it would serve to "cement the relationship" and made no mention of continued credit support.[5269] Further, the agreement itself contains a merger clause and makes no promise of continued support.[5270] In addition, the CREST agreement requires that any variation of its terms be made in writing.[5271] Taylor's initial willingness to allow Lehman to cancel its commitment once he informed Tonucci of HSBC's plan to withdraw also undermines any theory that Taylor made intentional misrepresentations to secure Lehman's commitment before Lehman learned of the withdrawal.[5272]

Finally, the Examiner's investigation has not revealed any evidence of fraudulent or negligent misrepresentation in connection with the cash deed*s* themselves. To the contrary, once HSBC informed Lehman of its intention to withdraw, HSBC was forthright about its intentions to continue to reduce its exposure through the cash deeds, and even disclosed its intentions to request additional collateral following the execution of the deeds.[5273] Although HSBC decided to withdraw from Lehman before August 18, HSBC had no duty to inform Lehman of its plan to terminate the CREST

[5269] E-mail from Carlo Pellerani, Lehman, to Ian T. Lowitt, Lehman (Aug. 27, 2008) [LBEX-AM 008936] (summarizing events leading to HSBC's decision to withdraw, including the then-recent commitment to the credit facility).

[5270] *See* Three-Year Revolving Credit Agreement (July 11, 2008), at § 19.07 [LBEX-DOCID 1029995]; *see also* Side Letter from HSBC to LBCB (Aug. 15, 2008) [LBEX-DOCID 89911] (signed by HSBC); Side Letter from HSBC to LBCB (Aug. 15, 2008) [LBEX-DOCID 89916] (signed by LBCB).

[5271] Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (Aug. 19, 2008), at § 17.1 [HBEU 102].

[5272] *See* e-mail from Nicholas J. Taylor, HSBC, to Guy Bridge, HSBC, *et al.* (Aug. 27, 2008) [HBUS 129] (agreeing that HSBC should allow Lehman to exit the facility).

[5273] E-mail from Guy Bridge, HSBC, to Carlo Pellerani, Lehman (Aug. 27, 2008) [HBUS 1].

agreement because the CREST agreement allowed HSBC to terminate at any time.[5274] Thus, the evidence does not support the existence of a colorable claim against HSBC for fraudulent misrepresentation or negligent misrepresentation under English law.

e) Lehman's Dealings With Bank of America

This Section briefly summarizes Lehman's dealings with Bank of America ("BofA") in 2008. At the time of this writing, Lehman and BofA are before the Court in an adversary proceeding. The pending dispute stems from BofA's November 10, 2008 setoff of approximately $509 million from various LBHI accounts.[5275] Specifically, BofA set off the funds against debts it claims LBSF incurred through derivative and swap agreements with BofA.[5276]

Out of deference to the Court and to avoid interfering with active litigation, the Examiner has limited his direct investigation of this claim and does not reach conclusions about the relative merits of the parties' arguments. However, the $500 million collateral deposit and the related negotiations in 2008 are significant to the Examiner's investigation of Lehman's liquidity pool, discussed in more detail in Section 5.i of this Report. In particular, as noted in Appendix 19, "Lehman's Dealings With Bank of America," and Section 5.i, the Security Agreement executed by Lehman and

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[5274] Terms and Conditions Relating to CREST Settlement Bank Facilities Made Available to a CREST Member or Sponsored Member (Aug. 19, 2008), at § 16.1 [HBEU 102]. Although HSBC agrees to provide at least 30-days notice "where [HSBC] considers it practicable and appropriate," HSBC is not subject to liability for failing to do so. *Id.*

[5275] Joint Stipulation of Undisputed Facts, at ¶ 44, Docket No. 74, *Bank of Am., N.A. v. Lehman Bros. Holdings, Inc. (In re Lehman Bros. Holdings, Inc.)*, No. 08-01753 (Bankr. S.D.N.Y. Dec. 7, 2009).

[5276] *Id*. at ¶ 45.

BofA on August 25, 2008 contains a provision requiring Lehman to provide three-days' written notice in order to retrieve any part of the collateral deposit. This is significant to the Examiner's investigation because Lehman continued to include the $500 million collateral deposit in Lehman's liquidity pool calculations, and Lehman inserted the three-day notice provision into the September Guaranty and Security Agreement with JPMorgan.

A more complete summary of Lehman's interaction with BofA is contained in "Appendix 19 – Lehman's Dealings with the Bank of America."

f) Lehman's Dealings With Bank of New York Mellon

The Bank of New York Mellon ("BNYM") provided, among other services, account support to Lehman for Lehman's European commercial paper trading program and account and financing support for medium-term note issuances and redemptions.[5277] As a result, BNYM believed that it bore intraday credit risk from Lehman, and requested collateral in August of 2008.[5278]

On December 3, 2009, the Court approved a stipulation among LBHI, LBSF and BNYM that requires BNYM to return a $170 million collateral deposit to LBHI.[5279] BNYM acquired these funds through a series of transfers between September 10 and 12,

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[5277] E-mail from Graham Kettle, Lehman, to Joseph Igoe, Lehman, *et al*. (Aug. 21, 2008) [LBEX-DOCID 1066642] (explaining sources of BNYM's intraday exposure to Lehman).

[5278] *Id.*

[5279] Stipulation and Agreed Order Between Lehman Brothers Holdings Inc., Lehman Brothers Special Financing Inc. and Bank of New York Mellon Regarding (1) Turnover of Collateral Deposit and (2) Return of Misdirected Wires, at pp. 1-2, Docket No. 6040, *In re Lehman Bros. Holdings, Inc.*, Case No. 08-13555 (Bankr. S.D.N.Y. Dec. 3, 2009).

2008,[5280] and held them pursuant to a collateral deposit agreement executed on September 11, 2008.[5281] Because the parties have agreed to the return of the funds, this transaction is primarily relevant to the Examiner's Report because of the relationship of the collateral deposit to Lehman's reported liquidity pool (as discussed *infra*, Section 5.i).

(1) BNYM Demands and Receives a Collateral Deposit

A relationship manager at BNYM for Lehman's accounts contacted Emil Cornejo on August 20, 2008 to request that Lehman prefund its European commercial paper and medium term note programs.[5282] After a series of meetings, LBHI and BNYM agreed on September 8, 2008 that LBHI New York would open a money market account with BNYM and maintain a sufficient deposit to cover BNYM's forecasted intraday exposure to Lehman.[5283]

On September 11, 2008, LBHI and BNYM's London branch executed an agreement that required Lehman to deposit $125 million initially and thereafter

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[5280] E-mail from Graham Kettle, Lehman, to Scott Alvey, Lehman, *et al.* (Sept. 10, 2008) [LBEX-DOCID 1065130] (ordering the transfer of $125 million from LBHI to an account held for the benefit of BNYM); e-mail from Steven J. Engel, Lehman, to Graham Kettle, Lehman, *et al.* (Sept. 10, 2008) [LBEX-DOCID 65930] (providing transaction details); e-mail from Craig L. Jones, Lehman, to Stirling Fielding, Lehman, *et al*. (Sept. 10, 2008) [LBEX-DOCID 65919] (confirming outgoing payment); e-mail from Graham Kettle, Lehman, to Steven J. Engel, Lehman, *et al*. (Sept. 11, 2008) [LBEX-DOCID 65879] (reporting BNYM ordering the return of $75 million to Lehman); e-mail from Graham Kettle, Lehman, to Daniel J. Fleming, Lehman, *et al.* (Sept. 12, 2008) [LBEX-DOCID 65923] (reporting deposit of $120 million with BNYM).

[5281] Collateral Deposit Agreement between Lehman Brothers Holdings, Inc. and the Bank of New York Mellon, London Branch (Sept. 11, 2008) [LBEX-DOCID 1031225] (final version for execution).

[5282] E-mail from Joseph Igoe, Lehman, to Emil F. Cornejo, Lehman, *et al.* (Aug. 20, 2008) [LBEX-DOCID 1066675] (forwarding summary of call with BNYM's Global Risk Manager).

[5283] E-mail from Graham Kettle, Lehman, to Carlo Pellerani, Lehman, *et al.* (Sept. 8, 2008) [LBEX-DOCID 65890].

maintain a collateral account with at least $50 million (with more required if BNYM forecasted greater intraday exposure).[5284] The funds were transferred to BNYM's London branch by LBHI(U.K.).[5285]

On September 12, BNYM held $170 million in collateral under the September 11 agreement.[5286] Lehman expected to be able to withdraw $120 million from the account on Monday, September 15, leaving BNYM with the minimum $50 million collateral required under the September 11 agreement.[5287] However, because of the bankruptcy filing on September 15, BNYM was left holding the $170 million deposit.[5288]

[5284] E-mail from Gerry Barber, BNYM, to Carlo Pellerani, Lehman, *et al*. (Sept. 11, 2008) [LBEX-DOCID 1065087] (attaching "Final Version" of collateral deposit agreement); Collateral Deposit Agreement between Lehman Brothers Holdings, Inc. and the Bank of New York Mellon, London Branch (Sept. 11, 2008), at §§ 1.1, 2.3 [LBEX-DOCID 1031225] (setting minimum deposit at $50 million). The agreement allowed BNYM to set off "all present and future monies, obligations and liabilities" LBHI or other specified Lehman entities owed under any "legal documentation . . . related to the issuance of securities." *Id.* at §§ 1.1, 4. If any of BNYM's agreements with Lehman required BNYM to make a payment on Lehman's behalf, Lehman had three business days to repay BNYM, after which BNYM could withdraw an equivalent amount from the collateral deposit. *Id.* at § 3. Lehman was entitled to direct BNYM to transfer any excess collateral out of the account. *Id.* at § 3.1.5. Further, BNYM could, in its "absolute discretion," allow Lehman to withdraw funds from the collateral account even though Lehman was not otherwise entitled to do so under the agreement. *Id.* at § 5.3.

[5285] *See* e-mail from Graham Kettle, Lehman, to Huw Rees, Lehman, *et al.* (Sept. 12, 2008) [LBEX-DOCID 65923] (announcing successful payment of $120 million to BNYM by LBHI(U.K.), per the agreement).

[5286] E-mail from Graham Kettle, Lehman, to Daniel J. Fleming, Lehman, *et al.* (Sept. 12, 2008) [LBEX-DOCID 065923] (discussing $120 million payment to BNYM on September 12 in addition to $50 million already held by BNYM).

[5287] E-mail from Graham Kettle, Lehman, to Daniel J. Fleming, Lehman, *et al*. (Sept. 12, 2008) [LBEX-DOCID 065875] (discussing $120 million payment to BNYM on September 12 and expectation that BNYM would return $120 million to Lehman on September 15).

[5288] *See* Stipulation and Agreed Order Between Lehman Brothers Holdings Inc., Lehman Brothers Special Financing Inc. and Bank of New York Mellon Regarding (1) Turnover of Collateral Deposit and (2) Return of Misdirected Wires, at p. 1, Docket No. 6040, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Dec. 3, 2009).

(2) The Deposit Is Significant Because of Internal Lehman Concerns About Including It in Its Pool

The parties' stipulation to return the collateral deposit to Lehman removes the need for substantial analysis of the transfers described above. Moreover, at the time, Lehman personnel regarded meeting BNYM's demand as a minor concession compared to the benefits a good relationship with BNYM provided.[5289]

For example, on September 10, 2008, Janet Birney suggested meeting BNYM's demands without further negotiation in light of the significant amount of business BNYM brought Lehman: "The economics of the $600 million don't make sense to argue over as we invest $15B with them."[5290] Stirling Fielding agreed, stating, "my view is that we are too busy right now to be worrying over this. . . . However, if Steve Engel says he reall[y] needs the liquidity that might change things."[5291] Nevertheless, this deposit is

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[5289] E-mail from Stirling Fielding, Lehman, to Janet Birney, Lehman (Sept. 10, 2008) [LBEX-DOCID 1066546].

[5290] E-mail from Janet Birney, Lehman, to Stirling Fielding, Lehman (Sept. 10, 2008) [LBEX-DOCID 1066546] (misspelling in original). BNYM reduced its demand to $125 million after Lehman exited the trades that generated most of BNYM's intraday exposure. *See* e-mail from Sara Mahoney, Lehman, to Janet Birney, Lehman (Sept. 10, 2008) [LBEX-DOCID 1065014] ("Looks like we will only be paying $50mil now"); e-mail from Graham Kettle, Lehman, to Emil F. Cornejo, Lehman, *et al.* (Sept. 10, 2008) [LBEX-DOCID 1065036] (reporting that a delay in exiting a trade will require Lehman initially deposit $125 million). BNYM ultimately held $170 million because Lehman placed a $120 million collateral deposit with BNYM on Friday, September 12, 2008, even though BNYM was already holding a $50 million collateral deposit. E-mail from Graham Kettle, Lehman, to Daniel J. Fleming, Lehman, *et al.* (Sept. 12, 2008) [LBEX-DOCID 065923]. Lehman expected that BNYM would return the $120 million deposit on Monday, September 15. E-mail from Graham Kettle, Lehman, to Daniel J. Fleming, Lehman, *et al*. (Sept. 12, 2008) [LBEX-DOCID 065875].

[5291] E-mail from Stirling Fielding, Lehman, to Janet Birney, Lehman (Sept. 10, 2008) [LBEX-DOCID 1066546].

significant in light of the Examiner's findings with regard to Lehman's reported liquidity pool.

The September 9, 2008 "Ability to Monetize" internal chart of Lehman's liquidity pool includes a "Dreyfus" entry in the "Low" ability to monetize.[5292] It is not clear that this is the same Dreyfus account used for the BNYM agreement because Lehman did not designate the Dreyfus account for use with the BNYM collateral deposit until September 10.[5293] However, Lehman was "already placing cash in a [BNYM] money fund" on September 8.[5294]

It is clear that Lehman intended to include the deposit in its liquidity pool. In a September 8 e-mail exchange, Carlo Pellerani, Lehman's International Treasurer, asked Graham Kettle, Lehman's vice president of Cash and Collateral Management, why Kettle had said Lehman and BNYM had held a "good meeting" when Lehman had just agreed to place $500 million in collateral in a BNYM money market account.[5295] Kettle responded:

[5292] Lehman, Liquidity Pool Summary (Sept. 9, 2008), at p. 4 [LBHI_SEC07940_557815] (attached to e-mail from Robert Azerad, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (Sept. 9, 2008) [LBHI_SEC07940_557814], circulating a revised "ability to monetize" table). See Section 5.i of this Report for further discussion of this chart.

[5293] E-mail from Graham Kettle, Lehman, to Scott Alvey, Lehman, *et al.* (Sept. 10, 2008) [LBEX-DOCID 1065130].

[5294] E-mail from Graham Kettle, Lehman, to Carlo Pellerani, Lehman, *et al.* (Sept. 8, 2008) [LBEX-DOCID 065890].

[5295] E-mail from Carlo Pellerani, Lehman, to Graham Kettle, Lehman, *et al*. (Sept. 8, 2008) [LBEX-DOCID 065890]. The amount of the required deposit fluctuated over the next few days as Lehman attempted to reduce BNYM's intraday exposure. *See* e-mail from Sara Mahoney, Lehman, to Janet Birney, Lehman (Sept. 10, 2008) [LBEX-DOCID 1065014] ("Looks like we will only be paying $50mil now"); e-mail from

> The only reason I say good is the fact we are already placing cash in a [BNYM] money fund, so its not additional — all that would change is that it will be placed on behalf of LBHINY and [BNYM] be taking a pledge over this. Does not effect our liquidity pool.[5296]

Pellerani replied: "Disagree with that view. If we need to have this locked then there is an argument for this not to be available liquidity."[5297] Cornejo then responded to Pellerani: "Carlo, we don't have the legal docs yet, but it would not be a pledge. The money will be in a Lehman account, with some right of offset."[5298]

Pellerani told the Examiner that he did not understand Cornejo's distinction between pledged deposits and deposits subject to a right of setoff.[5299] Indeed, Pellerani was also unaware of other strategies – the "three-day provision" and the five-day horizon for monetizing "liquid" assets – Lehman relied upon to justify including deposits at clearing banks in the liquidity pool.[5300] In Pellerani's view, assets placed at

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Graham Kettle, Lehman, to Emil F. Cornejo, Lehman, *et al.* (Sept. 10, 2008) [LBEX-DOCID 1065036] (reporting that a delay in exiting a trade required Lehman to initially deposit $125 million).

[5296] E-mail from Graham Kettle, Lehman, to Carlo Pellerani, Lehman, *et al.* (Sept. 8, 2008) [LBEX-DOCID 065890].

[5297] E-mail from Carlo Pellerani, Lehman, to Graham Kettle, Lehman, *et al*. (Sept. 8, 2008) [LBEX-DOCID 065890].

[5298] E-mail from Emil F. Cornejo, Lehman, to Daniel J. Fleming, Lehman, *et al*. (Sept. 8, 2008) [LBEX-DOCID 065890]. Note that in July, Citibank personnel had proposed to Cornejo that Lehman agree to the terms of but not actually execute a pledge for the $2 billion comfort deposit. E-mail from Paolo R. Tonucci, Lehman, to Emil F. Cornejo, Lehman, *et al.* (July 14, 2008) [LBHI_SEC07940_528212] (discussing Citibank proposal). This issue is discussed in more detail in Section III.A.5.c of this Report.

[5299] Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at p. 5.

[5300] This is corroborated by Pellerani's e-mail exchanges with Rees during the negotiations over the HSBC cash deeds. Pellerani ordered Rees to remove the three-day provision that had been carried over from the Bank of America agreement on the grounds that neither Pellerani nor Rees knew why it had been included in the first place, and it appeared to them to be against Lehman's interests. E-mail from Carlo Pellerani, Lehman, to Huw Rees, Lehman, *et al.* (Sept. 9, 2008) [LBEX-AM 008965] ("I would also like to question why that clause was embedded in the BofA agreement and remove it."). As discussed in App. 19, according to BofA, the three-day provision had been included expressly to allow Lehman to continue

clearing banks to secure clearing and settlement services were not available liquidity and should not have been included in the pool.[5301] Nevertheless, this exchange illustrates one of Lehman's responses to arguments against including in its liquidity pool deposits Lehman had placed to induce banks to continue providing intraday credit or clearing and settlement services. This issue is analyzed in more detail in the Liquidity Section of this Report at Section 5.i.

g) Lehman's Dealings With Standard Bank

Standard Bank was Lehman's clearing and settlement bank for trades in South Africa.[5302] Standard Bank, like other clearing banks, demanded and received a collateral deposit shortly before Lehman's bankruptcy.[5303] The Standard Bank deposit – $200 million[5304] – is small relative to the other clearing-bank deposits, only applied to LBIE and LBI's clearing-related debts in the South African market,[5305] and was set off against approximately $10 million in advances of settlement funds on September 16.[5306]

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counting the BofA deposit in its liquidity pool. *See* Memorandum of Law in Opposition to Lehman Brothers' Motion for Summary Judgment and in Further Support of Bank of America's Motion for Summary Judgment, at pp. 6, 17, Docket No. 58, *Bank of Am., N.A. v. Lehman Bros. Holdings, Inc. (In re Lehman Bros. Holdings, Inc.*), No. 08-01753 (Bankr. S.D.N.Y. Oct. 19, 2009).

[5301] Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at pp. 4-5.

[5302] E-mail from Jonathan Seeranj, Lehman, to Stirling Fielding, Lehman, *et al.* (Sept. 4, 2008) [LBEX-DOCID 455717].

[5303] E-mail from Joseph Igoe, Lehman, to Steve Durrant, Lehman, *et al.* (Sept. 9, 2008) [LBEX-DOCID 455717].

[5304] *Id.*

[5305] Letter from Kenny Fihla, Standard Bank, to Huw Rees, Lehman, re: Notice of Enforcement of Pledge and Cession (Sept. 16, 2008), at p. 1 [LBEX-DOCID 1090737].

[5306] *Id.*

On August 7, 2008, LBIE's account with Standard Bank ran an intraday overdraft of ZAR 2.1 billion (approximately $280 million) that was not cleared until shortly before the close of the day.[5307] As a consequence, Standard Bank was "unsettled" by the "possible overnight overdraft of a substantial amount."[5308] On August 18, Standard Bank requested that Lehman begin prefunding its trades.[5309] On August 21, Lehman ran another intraday overdraft at Standard Bank and, again, did not repay the funds until just before the close of the day.[5310]

Standard Bank and Lehman continued discussing how to address Standard Bank's concerns[5311] until September 5, 2008, when Standard Bank informed Lehman that it must pledge $200 million in collateral, and that Standard Bank would fail Lehman's

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[5307] Letter from Hugh Lilienfeld, Standard Bank, to Joseph Igoe, Lehman, re: Custody Settlement Arrangements (Aug. 18, 2008), at p. 1 [LBEX-DOCID 2806149] (demanding prefunding for trades because of "substantial" possible overdraft that "unsettled" Standard Bank on August 7); e-mail from Odette van der Merwe, First Rand Bank, to Abbie Goddard, Lehman, *et al*. (Aug. 7, 2008) [LBEX-DOCID 49831] (chronicling attempts to ensure payments arrive in time to clear overdraft before the end of the day). There are conflicting accounts among the parties to the relevant transactions – Citigroup, Lehman, First Rand, and Standard Bank – over which bank was responsible for the delay. E-mail from Joseph Igoe, Lehman, to Steve Durrant, Lehman, *et al*. (Sept. 9, 2008) [LBEX-DOCID 1058373] ("Citibank was late in paying our cash agent, First Rand, who in turn was late in paying Standard Bank"); e-mail from Catherine Mwangi, Citigroup, to Katherine Lukas, Citigroup (Aug. 7, 2008) [CITI-LBHI-EXAM 00017552] (internal Citigroup e-mail chain stating that Citigroup was waiting on First Rand); e-mail from Odette van der Merwe, First Rand Bank, to Abbie Goddard, Lehman, *et al*. (Aug. 7, 2008) [LBEX-DOCID 49831] (chronicling attempts to ensure payments arrive in time to clear overdraft before the end of the day).

[5308] Letter from Hugh Lilienfeld, Standard Bank, to Joseph Igoe, Lehman, re: Custody Settlement Arrangements (Aug. 18, 2008), at p. 1 [LBEX-DOCID 2806149].

[5309] *Id*.

[5310] E-mail from Abbie Goddard, Lehman, to Stirling Fielding, Lehman, *et al.* (Aug. 21, 2008) [LBEX-DOCID 617] (discussing complaints from Standard Bank).

[5311] E-mail from Stirling Fielding, Lehman, to Robert Eby, Lehman, *et al.* (Sept. 3, 2008) [LBEX-DOCID 1669].

trades that were not timely funded or supported by adequate collateral.[5312] The next day, Standard Bank set a deadline of September 9 to receive the funds or it would cease settling Lehman's trades.[5313]

Accordingly, Lehman made a $200 million deposit on September 9.[5314] On September 11, LBIE executed and delivered a pledge agreement to cover the deposit.[5315] The pledge agreement allows Standard Bank to set off debts LBIE or LBI owed Standard in connection with clearing and settlement in the South African market.[5316] On September 16, Standard Bank set off $10,422,859.72 from LBIE's account to cover advances for trades settling on September 15 and 16.[5317]

Lehman's revised September 9, 2008 "ability to monetize" chart, discussed in more detail in Section 5.i, includes an entry for a collateral deposit of $200 million titled "STANDARDJOB," associated with LBIE and assigned to the "mid" category of the

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[5312] E-mail from Steve Durrant, Lehman, to Shaun Lawrence, Lehman, *et al.* (Sept. 8, 2008) [LBEX-DOCID 1058390] (e-mail chain discussing how to respond to Standard Bank).

[5313] E-mail from Joseph Igoe, Lehman, to Steve Durrant, Lehman, *et al.* (Sept. 9, 2008) [LBEX-DOCID 455717] (brief chronology of events in Lehman's interaction with Standard Bank between March 2008 and September 2008).

[5314] *Id.* At least one e-mail claims that the deposit was actually made on September 8, 2008. E-mail from Maria Barrio, Lehman, to Neal Ullman, Lehman, *et al*. (Sept. 10, 2008) [LBEX-DOCID 1075773] (referring to "pledged collateral" requested and received on September 8). The confusion may have arisen from overnight deposits Lehman had placed with Standard Bank since September 5. E-mail from Carlo Pellerani, Lehman, to Paolo R. Tonucci, Lehman (Sept. 5, 2008) [LBEX-DOCID 2443971].

[5315] E-mail from Stirling Fielding, Lehman, to Maria Barrio, Lehman, *et al.* (Sept. 11, 2008) [LBEX-DOCID 1777132].

[5316] Letter from Kenny Fihla, Standard Bank, to Huw Rees, Lehman, re: Notice of Enforcement of Pledge and Cession (Sept. 16, 2008), at p. 1 [LBEX-DOCID 1090737].

[5317] *Id.*

ability to monetize.[5318] To date, neither the Examiner nor the Examiner's financial advisors have been able to identify a transfer from a U.S. debtor as the source of the September 9 deposit of $200 million.

h) Lehman's Dealings With the Federal Reserve Bank of New York

This Section analyzes Lehman's relationship with the Federal Reserve Bank of New York ("FRBNY"). The FRBNY was a major creditor of Lehman Brothers, in particular during the one-week period between LBHI's petition date and that of its broker-dealer subsidiary, LBI. The Examiner has investigated Lehman's interactions with the FRBNY in the context of the FRBNY's role as a secured lender to Lehman following Bear Stearns' near collapse.[5319]

This Section of the Report is divided into two parts: (1) an overview of the FRBNY's role managing monetary policy; and (2) a discussion of Lehman's borrowings under various FRBNY liquidity facilities.

(1) The FRBNY Supervises Deposit-Taking Institutions and Assists in Managing Monetary Policy, but Lacks Authority To Regulate Investment Bank Holding Companies

The FRBNY is the largest of the 12 regional Federal Reserve Banks, which together with the Federal Reserve Board of Governors, comprise the U.S. Federal

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[5318] Lehman, Liquidity Pool Summary (Sept. 9, 2008), at p. 2 [LBHI_SEC07940_557815].

[5319] In its capacity as a potential secured lender, the FRBNY also conducted intensive monitoring of Lehman's liquidity position, and embedded analysts on-site at Lehman to that end. The FRBNY's liquidity monitoring function is discussed at Section III.A.6.

Reserve System.[5320] The Federal Reserve Banks supervise and regulate "bank holding companies," or depository institutions such as national and state-chartered banks.[5321] These depository institutions are distinguished from securities broker-dealers, such as investment banks, for which the SEC serves as primary regulator.[5322]

In addition to examining deposit-taking institutions, the FRBNY occupies a special role in discharging the Federal Reserve System's statutorily-mandated obligation to set monetary policy. Section 2a of the Federal Reserve Act of 1913 charges the Board of Governors and the Federal Open Market Committee ("FOMC") – of which the President of FRBNY is a member – with setting monetary policy in order to achieve "maximum employment, stable prices, and moderate long-term interest rates."[5323] The Federal Reserve System employs three policy tools toward this end. The first tool, known as Open Market Operations ("OMO"), allows the FRBNY to buy and sell Treasuries on the secondary market in transactions with certain securities dealers; the FRBNY adds credit to the banking system when it buys Treasuries, and drains credit when it sells the securities.[5324] Second, each of the 12 Federal Reserve Banks is authorized to extend, on a collateralized basis, short-term loans directly to depository

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[5320] Federal Reserve Bank of New York, *Introduction to the New York Fed*, http://www.newyorkfed.org/aboutthefed/introtothefed.html (Nov. 2009).

[5321] *Id.*

[5322] *See Systemic Risk and Financial Markets: Before the H. Comm. on Financial Servs.*, 110th Cong. 6-8 (2008) (statement of then-SEC Chairman Christopher Cox) (distinguishing banking activity and securities-related activity, and describing the SEC's responsibility as a regulator of the latter).

[5323] 12 U.S.C. § 225a (2006).

[5324] Federal Reserve Bank of New York, *Introduction to the New York Fed*, http://www.newyorkfed.org/aboutthefed/introtothefed.html (Nov. 2009).

institutions temporarily in need of liquidity; such lending is conducted via the so-called "discount window."[5325] Third, the FOMC sets requirements for levels of funds depository institutions must leave on reserve with Federal Reserve banks; by increasing or decreasing reserve requirements the FOMC can increase or decrease bank credit, and consequently encourage or restrain monetary activity. According to the FRBNY, "a reduction in the reserve [requirements]," by freeing up funds for banks to lend to commercial borrowers, "would be viewed as stimulative monetary policy."[5326] The three mechanisms outlined above all influence the supply of money in the economy, and thereby "the cost and availability of credit," and affect economic activity and prices.[5327]

(2) In Response to the Bear Stearns Near Collapse, the FRBNY Created a Variety of Facilities To Backstop the Liquidity of Broker-Dealers; Lehman, In Turn, Drew on These Facilities

(a) The Primary Dealer Credit Facility

Bear Stearns' near collapse occurred largely over the course of a mere two days – March 13 and 14, 2008. The near collapse was viewed by the market as a classic "run on the bank;" counterparties and customers lost confidence in the firm's viability, pulled deposits and withdrew short-term secured financing. The Bear Stearns run was unique, however, in that the investment bank suffered a complete loss of liquidity despite being

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[5325] *Id.*

[5326] *Id.*

[5327] *Id.*

considered adequately capitalized by regulators, and possessing liquid collateral against which it should have been able to secure financing. Bear's regulators took note of this novel circumstance. As then-SEC Chairman Christopher Cox stated in an address to securities traders:

> The Bear Stearns experience demonstrated . . . that the prevailing measurements of capital and liquidity that were then being used by the SEC and by every bank and securities regulator . . . were inadequate to prevent the "run on the bank" that Bear endured. In just two days between Thursday, March 13, and the close of business on Friday, March 14, Bear's liquidity pool fell by over 83% — from $12 billion to $2 billion.
>
> This was a development that . . . [no] bank regulatory model had anticipated. Short-term secured financing was unavailable even when Bear offered high quality collateral such as agency securities. What neither the [SEC] regulatory approach nor any existing regulatory model had taken into account is the possibility that secured funding, even if it was over-collateralized with U.S. Treasury or agency securities, might disappear in a crisis of confidence.[5328]

Thus, after Bear Stearns, market participants were sensitive to the fact that an investment bank may be adequately capitalized, hold liquid collateral, and nonetheless collapse in a liquidity crisis. In response, Chairman Cox called for a system of mandatory regulation of investment bank holding companies.[5329] The FRBNY, however, devised a program more narrowly-tailored in an effort to mitigate the problem at hand.

Section 13(3) of the Federal Reserve Act allows the Board of Governors of the Federal Reserve to authorize the Federal Reserve Banks to make secured loans to

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[5328] Christopher Cox, then-Chairman, Secs. and Exchange Comm., Address to the Securities Traders 12th Annual Washington Conference (May 7, 2008), *available at* http://www.sec.gov/news/speech/2008/spch050708cc.htm.

[5329] *Id.*

virtually any individual or corporation in "unusual and exigent circumstances" when the borrower is "unable to secure adequate credit accommodations from other banking institutions."[5330] On March 16, 2008, "at the height of the Bear Stearns crisis" the Board of Governors of the Federal Reserve granted the FRBNY the authority to establish the Primary Dealer Credit Facility ("PDCF").[5331]

Under the PDCF, the FRBNY would make collateralized loans to broker-dealers, such as LBI, and in effect, act as a repo counterparty. Unlike a typical counterparty, though, with the creation of the PDCF, the FRBNY was generally understood by market participants to be the "lender of last resort to the broker-dealers."[5332] Reflecting the fact that broker-dealer liquidity had become increasingly dependent on overnight repos to obtain short-term secured financing,[5333] the PDCF was structured as an overnight facility.

Pursuant to the Federal Reserve Act's requirement that a Federal Reserve Bank lend only on a secured basis, and according to the convention in repo lending, the FRBNY advanced funds against a schedule of collateral. Collateral accepted by the PDCF initially consisted of: Treasuries, government agency securities, mortgage-

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[5330] 12 U.S.C. § 343 (2006).

[5331] Tobias Adrian, *et al.*, *The Federal Reserve's Primary Dealer Credit Facility*, Current Issues in Econ. & Fin., Aug. 2009, at p.1, *available at* http://www.newyorkfed.org/research/current_issues/ci15-4.pdf [hereinafter "Current Issues: PDCF"]; *see also* Press Release, Board of Governors of the Federal Reserve System (March 16, 2008) (announcing creation of the PDCF), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20080316a.htm.

[5332] E-mail from Stephen Lax, Lehman, to Stephen Lax, Lehman (Mar. 23, 2008) [LBHI_SEC07940_077953] (quoting Press Release, Standard & Poor's, S&P Affirms Leman Bros., Goldman Sachs (Mar. 23, 2008)).

[5333] Current Issues: PDCF, at pp. 1-2.

backed securities issued or guaranteed by government agencies, and investment grade corporate, municipal, mortgage- and asset-backed securities priced by clearing banks.[5334] The FRBNY set the lending rate for PDCF advances equal to the rate charged by the Federal Reserve's discount window, available to depository institutions.[5335] In fact, the PDCF was frequently analogized to the traditional discount window, or viewed as expanding the discount window to securities broker-dealers.[5336]

On Sunday, September 14, 2008, the day before LBHI filed for bankruptcy, the class of eligible collateral was expanded to "closely match the types of collateral that can be pledged in the tri-party repo systems of the two major clearing banks."[5337] That is, the pool of eligible collateral was expanded to include non-investment grade securities and equities.

(b) The Market Greeted the Creation of the PDCF as a Positive Step Toward Backstopping Broker-Dealer Liquidity, and as Shoring Up Lehman's Liquidity

The market greeted the news of the creation of the PDCF positively. The Canadian rating agency, DBRS, stated in a press release: "DBRS views the [PDCF] as particularly valuable in the current stressed market conditions, as it adds a highly

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[5334] Press Release, Board of Governors of the Federal Reserve System (Sept. 14, 2008) (announcing the expansion of PDCF-eligible collateral), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20080914a.htm.

[5335] Current Issues: PDCF, at p. 8.

[5336] *Id.* at p. 4.

[5337] Press Release, Board of Governors of the Federal Reserve System (Sept. 14, 2008) (announcing the expansion of PDCF-eligible collateral), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20080914a.htm.

reliable source of liquidity to the range of existing funding options available to the major broker dealers."[5338] Given that Lehman was widely perceived to be the investment bank with a business model closest to Bear Stearns', and as a result, the next most vulnerable firm,[5339] the PDCF was viewed as particularly helpful in buoying Lehman's liquidity. Citigroup's Global Markets Equity Research division upgraded Lehman to "buy" on the back of the expansion of the PDCF. Referring to the PDCF, the Citigroup analysis states: "In our view, it's tough to have a liquidity-driven meltdown when you're being backed by government entities that have the ability to print money."[5340] The Citigroup analysis elaborated on that point: "With $34b in liquidity at the parent company, [and] the ability to get access to over $200b in liquidity from the Fed's primary dealer credit facility, . . . access to liquidity is a non-issue."[5341] Lehman also promoted this line of thinking. In a statement issued on Monday March 17, 2008, Fuld said: "The Federal Reserve's decision to create a lending facility for primary dealers and permit a broad range of investment-grade securities to serve as collateral

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[5338] Press Release, DBRS, DBRS Confirms Lehman Brothers at AA (low), Keeps Stable Trend (Mar. 18, 2008) [LBHI_SEC07940_076814].
[5339] Landon Thomas, Jr., *Aftershocks of a Collapse, With a Bank at the Epicenter*, N.Y. Times, Mar. 18, 2008, at p. C1.
[5340] Citi Global Markets Equity Research, Citigroup, Lehman Brothers Holdings Inc. (LEH): Upgrading To Buy; Reality Will Trump Fear (Mar. 28, 2008), at p. 1 [CITIGROUP 0006117].
[5341] *Id.*

improves the liquidity picture and, from my perspective, takes the liquidity issue for the entire industry off the table."[5342]

(c) In Addition to a Liquidity Backstop, Lehman Viewed the PDCF as an Outlet for Its Illiquid Positions

The PDCF not only provided Lehman with a ready response to those who speculated it would go the way of Bear Stearns, but also a potential vehicle to finance its illiquid corporate and real estate loans. A day after the PDCF became operational, Lehman personnel commented: "I think the new 'Primary Dealer Credit Facility' is a LOT bigger deal than it is being played to be . . . ."[5343] They mused that if Lehman could use the PDCF "as a warehouse for all types of collateral, we should have plenty of flexibility to structure and rethink CLO/CDO structures . . . ."[5344] Additionally, by viewing the PDCF as "available to serve as a 'warehouse' for short term securities [b]acked by corporate loans,"[5345] the facility "MAY BE THE 'EXIT STRATEGY' FUNDING SOURCE WE NEED TO GET NEW COMPETITION IN THE CORPORATE LOAN MARKET."[5346]

[5342] Zachery Kouwe, *Lehman Is Not Ready To Fuld — Chairman Bullish Despite 19% Drop*, N.Y. Post, Mar. 18, 2008, at p. 37.

[5343] E-mail from Geoffrey Feldkamp, Lehman, to Eric Felder, Lehman, *et al.* (Mar. 18, 2008) [LBHI_SEC07940_390192].

[5344] *Id.*

[5345] *Id.*

[5346] *Id.* (capitalization in original). Feldkamp hypothesized that banks would be able to take advantage of the PDCF's warehousing potential over the long term, believing the FRBNY could not discontinue the temporary program in the near term, and that the program would eventually become entrenched:

> Bernanke and co may have 'saved the day', and JPM has a great public affairs approach to make the Bear deal look extremely positive for everyone, by emphasizing how it will be looking

Lehman did indeed create securitizations for the PDCF with a view toward treating the new facility as a "warehouse" for its illiquid leveraged loans. In March 2008, Lehman packaged 66 corporate loans to create the "Freedom CLO."[5347] The transaction consisted of two tranches: a $2.26 billion senior note, priced at par, rated single A, and designed to be PDCF eligible, and an unrated $570 million equity tranche.[5348] The loans that Freedom "repackaged" included high-yield leveraged loans,[5349] which Lehman had difficulty moving off its books,[5350] and included unsecured loans to Countrywide Financial Corp.[5351]

Lehman did not intend to market its Freedom CLO, or other similar securitizations, to investors. Rather, Lehman created the CLOs exclusively to pledge to the PDCF.[5352] An internal presentation documenting the securitization process for

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> forward to applying this new [CDO packaging] technology to [the] resolution of this crisis. Once applied successfully, the Fed will not be able to end the facility. They'll have to conti[n]ue it and manage it as a standard monetary policy tool.

Id.

[5347] Lehman, Liquidity Funding and Review Special Topics, Apr. 14, 2008, at p. 5 [LBEX-WGM 677805].

[5348] *Id.*; Memorandum from Margaret Sear, Lehman, *et al.*, to Files, Lehman (Apr. 11, 2008), at p. 1 [LBEX-WGM 762264] (discussing accounting practices applied to Freedom CLO notes and use at the PDCF).

[5349] Lehman, Securitizing Leveraged Loans: Freedom, Spruce, Thalia CLOs [LBEX-WGM 835699].

[5350] Pierre Paulden, *Lehman Creates CLO to Get Buyout Loans Off Its Books*, Bloomberg.com, Mar. 3, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=a4fHfr0N0dbI&refer=home. The article notes that Credit Suisse and Deutsche Bank had engaged in similar transactions to reduce the impact of buyout loans on their balance sheets without selling those loans on the open market.

[5351] E-mail from Jan H. Voigts, FRBNY, to Arthur G. Angulo, FRBNY, *et al.* (Apr. 9, 2008) [FRBNY to Exam. 030264] (cover e-mail and attached excerpt of the indenture for the Freedom CLO)).

[5352] *See* Lehman, Securitizing Leveraged Loans: Freedom, Spruce, Thalia CLOs, at p. 2 [LBEX-WGM 835699] (noting that the "opening of the Fed / ECB discount windows to non-banks provided trigger to complete [Freedom securitization] immediately" and that Freedom, Spruce, Thalia, and other Lehman-structured products were "not meant to be marketed"); *see also* e-mail from Marie Stewart, Lehman, to Jonathan Cohen, Lehman, *et al*. (May 8, 2008) [LBHI_SEC07940_1069905] (noting that the SASCO

Freedom and similar CLOs named "Spruce" and "Thalia," noted that the "[r]epackage[d] portfolio of HY [high yield leveraged loans]" constituting the securitizations, "are not meant to be marketed."[5353] Handwriting from an unknown source underlines this sentence and notes at the margin: "No intention to market."[5354]

Lehman may have also managed its disclosures to ensure that the public did not become aware that the CLOs were not created to be sold on the open market, but rather were intended solely to be pledged to the PDCF. An April 4, 2008 e-mail containing edits to talking points concerning the Freedom CLO to be delivered by Fuld stated:

> Given that the press has not focused (yet) on the Fed window in relation to the [Freedom] CLO, I'd suggest deleting the reference in the summary below. Press will be in attendance at the shareholder meeting and my concern is that volunteering this information would result in a story.[5355]

It is unclear, based solely on the e-mail, why a reference linking the FRBNY's liquidity facility to the Freedom CLO was deleted. One explanation could be that

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securitization "[l]ike Freedom CLO and Spruce CLO . . . is just creating securities to take to the Fed window"). Further evidence that Freedom CLO-style transactions had limited liquidity value outside of the PDCF is found in Citibank's rejection of Freedom and similar CLOs when they were offered by Lehman as collateral to secure Citi's intraday clearing exposure. *E.g.*, e-mail from Anthony Lieggi, Citigroup, to Michael Mauerstein, Citigroup, *et al*. (Aug. 1, 2008) [CITI-LBHI-EXAM 00082156] (quoting exchange among Citigroup analysts and Mauerstein about pricing Lehman CLOs). Lieggi noted that Citibank was unable to obtain pricing data from Bloomberg for the collateral offered by Lehman ("Freedom," "Spruce," "Pine," "Verano" and "Kingfisher" CLOs). *Id.* Lieggi also noted that a Citibank risk manager assigned to Lehman, Tom Fontana, "expressed strong concern" about this collateral. *Id.* According to Mauerstein, these CLOs were "bottom of the barrel" securities that Lehman could not repo out. Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 8. Mauerstein said that the securities "may have been investment-rated, but we know what that means now." *Id.*

[5353] Lehman, Securitizing Leveraged Loans: Freedom, Spruce, Thalia CLOs, at p. 2 [LBEX-WGM 835699].

[5354] *Id.*

[5355] E-mail from Kerrie Cohen, Lehman, to Erin Callan, Lehman, *et al.* (April 8, 2008) [LBHI_SEC07940_087671]. The talking points included below the break of the e-mail do not include reference to any FRBNY facility, so it seems that Cohen may have deleted the references already, in the e-mail she sent to Callan.

Lehman did not want the public to learn that it had securitized illiquid loans exclusively to be pledged to the PDCF. Another reason may have been to hide the fact that Lehman needed to access the PDCF in the first place, given that accessing the securities dealers' lender of last resort could have negative signaling implications.[5356]

The FRBNY was aware that Lehman viewed the PDCF not only as a liquidity backstop for financing quality assets, but also as a means to finance its illiquid assets. Describing a March 20, 2008 meeting between the FRBNY and Lehman's senior management, FRBNY examiner Jan Voigts wrote that Lehman "intended to use the PDCF as both a backstop, and business opportunity."[5357] With respect to the Freedom securitization in particular, Voigts wrote that Lehman saw the PDCF

> as an opportunity to move illiquid assets into a securitization that would be PDCF eligible. They [Lehman] also noted they intended to create 2 or 3 additional PDCF eligible securitizations. We avoided comment on the securitization but noted the firm's intention to use the PDCF as an opportunity to finance assets they could not finance elsewhere.[5358]

Thus, the FRBNY was aware that Lehman viewed the PDCF as an opportunity to finance its repackaged illiquid corporate loans. The Examiner's investigation has not determined whether the FRBNY also understood that these Freedom-style securitizations were never intended for sale on the broader market. In response to a question from FRBNY analyst Patricia Mosser on whether Voigts knew "if they

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[5356] Lehman's concerns regarding the negative signaling effects of tapping the PDCF are discussed below.
[5357] E-mail from Jan H. Voigts, FRBNY, to Timothy F. Geithner, FRBNY, *et al.* (Apr. 9, 2008) [FRBNY to Exam. 026077].
[5358] *Id.*

[Lehman] intend to pledge to triparty or PDCF,"[5359] Voigts replied that the Freedom CLO was "created with the PDCF in mind."[5360]

According to internal Lehman documents, Lehman did in fact pledge the Freedom CLO to the PDCF. On three dates, March 24, 25 and 26, 2008, Lehman pledged the Freedom CLO to the FRBNY on an overnight basis, and received $2.13 billion for each transfer.[5361] FRBNY discussions concerning the CLO's underlying assets, however, took place on or around April 9, 2008[5362] — more than a week after the FRBNY began accepting the CLO.

(d) Lehman Was Reluctant to Draw on the PDCF Because of a Perceived "Stigma" Attached to Borrowing from the Facility

Paradoxically, while the PDCF was created to mitigate the liquidity flight caused by the loss of confidence in an investment bank, use of the PDCF was seen both within Lehman, and possibly by the broader market, as an event that could trigger a loss of confidence. A report by Lehman Brothers Capital Markets Prime Services captured a common critique of the facility:

[5359] E-mail from Patricia Mosser, FRBNY, to Jan H. Voigts, FRBNY, *et al.* (Apr. 9, 2008) [FRBNY to Exam. 026079].

[5360] E-mail from Jan H. Voigts, FRBNY, to Patricia Mosser, FRBNY (Apr. 9, 2008) [FRBNY to Exam. 026078].

[5361] Memorandum from Margaret Sear, Lehman, *et al.*, to Files, Lehman (Apr. 11, 2008), at p. 1 [LBEX-WGM 762264] (accounting policy memorandum).

[5362] *E.g.*, e-mail from Jan H. Voigts, FRBNY, to Timothy F. Geithner, FRBNY, *et al.* (Apr. 9, 2008) [FRBNY to Exam. 026077] (internal FRBNY exchange regarding the Freedom CLO); e-mail from Jan H. Voigts, FRBNY, to Arthur G. Angulo, FRBNY, *et al.* (Apr. 9, 2008) [FRBNY to Exam. 030264] (same).

> PDCF borrowing has a considerable stigma in spite of the Fed's efforts to cloak access and guarantee anonymity. Instead, primary dealers view the PDCF as a last resort and will exhaust all other financing sources before pledging collateral here. For this reason, borrowing at this program has evaporated since the [Bear Stearns] merger closed.[5363]

Lehman complained internally, and to the FRBNY, about the stigma attached to PDCF borrowing. In an internal e-mail, Lehman personnel appeared to view the PDCF as a net negative, writing that Lehman could not use it due to its "stigma," owing to the fact that "should the Fed disclose the [PDCF] borrowers, it would likely further damage confidence in the institutions that tapped the facilities."[5364] Yet, at the same time, Lehman personnel suggested that the mere existence of FRBNY facilities forced Lehman to "quell rumors and bad press,"[5365] presumably regarding whether Lehman was suffering liquidity problems or was forced to access the PDCF. Tonucci also complained of the stigma, elevating his concerns to the FRBNY. Tonucci relayed the rumor to the FRBNY, which he attributed to Standard & Poor's, that "usage of the PDCF would cause [the rating agency] to change [Lehman's] outlook from stable to negative."[5366]

[5363] Lehman, Liquid Markets: TSLF expansion (Aug. 21, 2008), at p. 2 [LBHI_SEC07940_2218563].

[5364] E-mail from Stephen Lax, Lehman, to Kevin Thatcher, Lehman, *et al.* (June 4, 2008) [LBHI_SEC07940_3207832].

[5365] *Id.*

[5366] E-mail from Brian Peters , FRBNY, to Steven Manzari, FRBNY, *et al.* (Mar. 19, 2008) [FRBNY to Exam. 032418] (quoting earlier e-mail from Manzari). Peters replied that he spoke to Standard & Poor's Diane Hinton who said the rumor was "not at all" true. *Id.*

In recognition of the danger inherent in allowing market participants to believe Lehman had tapped the PDCF, in the late spring, summer, and early fall of 2008, the firm was careful to advise the market that it was not currently accessing the facility.[5367]

(e) Lehman Accessed the PDCF Ten Times in 2008; Lehman's Use of the PDCF Was Concentrated in Periods Immediately After the Bear Stearns Near Collapse, and Immediately After LBHI Filed for Bankruptcy

Lehman drew on the PDCF facility sparingly prior to its bankruptcy. Lehman accessed the PDCF seven times in the liquidity stress period that followed the Fed-brokered sale of Bear Stearns to JPMorgan.[5368] Both internally, and to third parties, Lehman characterized these draws as "tests,"[5369] although witnesses from the FRBNY have stated that these were not strictly "tests," but instances in which Lehman drew upon the facility for liquidity purposes.[5370]

Lehman documents reveal the dates for all seven instances, prior to LBHI's bankruptcy, on which Lehman pledged collateral to the PDCF in exchange for cash loans. On March 18, 19 and 20, Lehman pledged collateral to the PDCF in return for

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[5367] Joe Bel Bruno, *Lehman Bros. Denies It Approached Federal Reserve*, Associated Press (June 3, 2008) (quoting Tonucci as saying Lehman last accessed the primary broker-dealer facility "on April 16 for testing purposes").

[5368] Robert Azerad, Lehman, 2008 Q2 – Liquidity Position (June 6, 2008), at p. 3 [LBHI_SEC07940_516173] (attached to e-mail from Robert Azerad, Lehman, to John Feraca, Lehman, *et al.* (June 7, 2008) [LBHI_SEC07940_516172]).

[5369] *E.g.*, Robert Azerad, Lehman, 2008 Q2 – Liquidity Position (June 6, 2008), at p. 3 [LBHI_SEC07940_516173] (referring to "test trades" with the PDCF); *see also* Joe Bel Bruno, *Lehman Bros. Denies It Approached Federal Reserve*, Associated Press (June 3, 2008) (quoting Tonucci as stating "[t]he last time we accessed the [PDCF] facility was on April 16 for testing purposes").

[5370] *E.g.*, Examiner's Interview of Thomas Baxter, Jr., May 20, 2009, at p. 4.

$1.6 billion, $2.3 billion, and $2.3 billion in cash, respectively.[5371] On March 24, 25 and 26, Lehman, via LBI, pledged the $2.26 billion senior tranche of its Freedom CLO to the PDCF for $2.13 billion in cash financing.[5372] On April 16, 2008, Lehman pledged an unknown class of collateral to the PDCF, likely in the amount of $2 billion.[5373]

Lehman abstained from obtaining liquidity from the PDCF during the week prior to bankruptcy, as its liquidity pool came under pressure due to clearing bank collateral requests and associated liens. Immediately after LBHI filed for Chapter 11, however, LBI again resorted to the facility. On September 15, 2008, LBI borrowed $28 billion from the PDCF against $31.7 billion of collateral.[5374] Likewise, on September 16, LBI obtained $19.7 billion of financing against $23 billion of collateral.[5375] Finally, on September 17, 2008, the day Barclays announced it would acquire the Lehman broker-dealer, LBI obtained $20.4 billion against $23.3 billion of collateral.[5376]

[5371] Lehman, Presentation to the Federal Reserve: Update on Capital, Leverage & Liquidity (May 28, 2008) [LBHI_SEC07940_062599].

[5372] Memorandum from Margaret Sear, Lehman, *et al.*, to Files, Lehman (Apr. 11, 2008), at p. 2 [LBEX-WGM 762264] (accounting policy memorandum).

[5373] Robert Azerad, Lehman, 2008 Q2 -- Liquidity Position (June 6, 2008), at p. 3 [LBHI_SEC07940_516173]; *see also* Joe Bel Bruno, *Lehman Bros. Denies It Approached Federal Reserve*, Associated Press (June 3, 2008) (quoting Tonucci as stating "[t]he last time we accessed the [PDCF] facility was on April 16 for testing purposes").

[5374] *See* e-mail from David Weisbrod, JPMorgan, to Jamie L. Dimon, JPMorgan, *et al*. (Sept. 15, 2008) [JPM-2004 0080146] (noting that Lehman borrowed $28 billion from the PDCF on September 15, 2008); Examiner's Interview of Robert Azerad, Sept. 23, 2009, at p. 5.

[5375] *Id.*

[5376] *Id.* Analysis of potential claims arising from Lehman's borrowings from the FRBNY are analyzed in Section III.B of this Report.

(3) Other FRBNY Liquidity Facilities

(a) The Term Secured Lending Facility

The Term Securities Lending Facility ("TSLF") was created on March 11, 2008 amid the series of events that led to the near collapse of Bear Stearns.[5377] In the weeks preceding the near collapse of Bear, the FRBNY was growing increasingly concerned over the tightening of liquidity in the mortgage-backed securities ("MBS") market.[5378] During that period, officials in the FRBNY were involved in intense discussions over how to restore liquidity to the market. One idea was to "swap-out" treasuries to broker-dealers in exchange for their otherwise illiquid MBS.[5379]

This proposal was eventually realized in the TSLF. Under the TSLF, to this day, every 28 days, broker-dealers engage in a competitive auction where they can swap MBS and other securities for Treasuries.[5380]

Lehman borrowed from the TSLF,[5381] which, unlike the PDCF, did not have a stigma associated with its use.

[5377] Examiner's Interview of Thomas Baxter, Jr. May 20, 2009, at p. 6.

[5378] *Id.*

[5379] *Id.*

[5380] Federal Reserve Bank of New York, Frequently Asked Questions, http://www.newyorkfed.org/markets/tslf_faq.html (June 25, 2009).

[5381] Declaration of Shari D. Leventhal In Support of Trustee's Motion for Entry of an Order Approving a Settlement Agreement, at p. 2, Docket No. 387, *Special Investor Protection Corp. v. Lehman Brothers Inc.*, (*In re Lehman Brothers Holdings Inc.*) No-08-0420 (Bankr. S.D.N.Y. Dec. 5, 2008) (noting that the FRBNY traded with LBI under the PDCF, OMO, and TSLF).

(b) Open Markets Operations

Open Market Operations ("OMO") lending is one of the basic ways the FRBNY controls the supply of Treasuries, and thereby implements monetary policy.[5382] The FRBNY buys and sells Treasuries in transactions with broker-dealers under the OMO program by engaging in repo and reverse repo transactions with those entities. The FRBNY advances Treasuries against a large pool of eligible collateral, including investment grade asset-backed securities, corporates and MBS. The FRBNY was a creditor to Lehman under the OMO.[5383]

i) Lehman's Liquidity Pool

(1) Introduction and Executive Summary

The Examiner's investigation of Lehman's clearing banks and other lenders, as directed by the eighth bullet of the Examiner Order, required that the Examiner review Lehman's liquidity pool, that is, cash, government securities and other high-quality assets that Lehman set aside for its known funding needs.[5384] Multiple witnesses confirmed that certain assets Lehman deposited with or pledged to its clearing banks were counted in Lehman's liquidity pool. By the second week of September 2008, as

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[5382] *Id.*

[5383] *Id.*

[5384] The January 16, 2009 Order directing the U.S. Trustee to appoint an Examiner charged the Examiner with investigating, among other things:

> The transactions and transfers, including but not limited to the pledging or granting of collateral security interest among the debtors and the pre-chapter 11 lenders and/or financial participants including but not limited to, JPMorgan Chase, Citigroup, Inc., Bank of America, the Federal Reserve Bank of New York and others.

Order Directing Appointment of an Examiner Pursuant to Section 1104(c)(2) of the Bankruptcy Code, at p. 4, Docket No. 2569, *In re Lehman Brothers Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Jan. 16, 2009).

market pressures and collateral calls increased, Lehman no longer had sufficient assets in its liquidity pool to weather a crisis. The inadequacy of Lehman's liquidity pool is directly connected to Lehman's bankruptcy filing.[5385]

Like its peer institutions, Lehman was "heavily reliant upon wholesale financing sources"[5386] to fund a substantial portion of its balance sheet every 24 hours using overnight repos. Liquidity – the immediate ability to access funds – is the life's blood of an investment bank. "Liquidity is more important than capital; most entities which go bankrupt do so because they run out of financing, not because the value of their assets falls below the value of their liabilities."[5387] One witness explained, "corporates die of cancer," but "financial firms [like Lehman] die of heart attacks."[5388]

Lehman knew that liquidity played a crucial role in its business model. Its annual report stated, "Liquidity, that is access to funds, is essential to our businesses."[5389] Lehman also knew that the consequences of a liquidity disruption could be catastrophic. As Erin Callan noted after Bear Stearns' near collapse, "liquidity is the

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[5385] The Examiner Order also mandates that the Examiner investigate "[t]he events that occurred from September 4, 2008 through September 15, 2008 or prior thereto that may have resulted in the commencement of the LBHI chapter 11 case." *Id*.

[5386] Diane Hinton, Standard & Poor's RatingsDirect, Liquidity Management In Times Of Stress: How The Major U.S. Broker-Dealers Fare (Nov. 8, 2007), at p. 2 [LBHI_SEC07940_439424].

[5387] E-mail from Paul Shotton, Lehman, to Christopher M. O'Meara, Lehman (Apr. 15, 2008) [LBHI_SEC07940_768467].

[5388] Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 9.

[5389] Lehman Brothers Holdings Inc., Annual Report for 2007 as of Nov. 30, 2007 (Form 10-K) (filed on Jan. 29, 2008), at p. 17 ("LBHI 2007 10-K").

thing that will kill you in a moment."[5390] For this reason, Lehman paid careful attention to its liquidity pool and to how it described the pool to the public. But as pressures mounted during the summer of 2008, Lehman began to include encumbered assets in its liquidity pool.

Beginning in June 2008, Lehman agreed to deposit $2 billion with Citigroup to cover clearing-related concerns. Lehman believed it could call the deposit back, so it continued to count the $2 billion in its liquidity pool. But Citigroup held the view that it had a right of setoff against the deposit and Lehman understood that a withdrawal of the deposit would have an impact on Citi's willingness to clear and settle trades for Lehman.[5391]

Lehman's deposit with Citigroup was the start of a trend. During the summer, Lehman posted billions in collateral to its clearing banks through more direct pledges. A week after Citigroup requested collateral, Lehman pledged more than $5 billion in securities to JPMorgan, Lehman's primary U.S. clearing bank, to mitigate the effects of the bank's revised margin requirements. But Lehman continued to include most of this collateral in its liquidity pool.

[5390] Maria Bartiromo, *Lehman CFO Erin Callan: Back from Ugly Monday*, Business Week, Mar. 20, 2008.

[5391] *See, e.g.*, FRBNY, Lehman IB Update, (July 14, 2008) [FRBNY to Exam. 008163] (an FRBNY analyst reported that Lehman's Global Treasurer, Paolo R. Tonucci said, "even though Lehman 'technically' has access to the $2B [Citigroup deposit], if they [Lehman] pull it or a major portion thereof, Citi will stop clearing.").

August 2008 brought additional demands for collateral. Lehman met these demands but still counted the collateral in its liquidity pool. On August 14, 2008, Bank of America began demanding collateral to secure intraday exposures. Lehman posted $500 million with the bank, subject to a security agreement dated August 25, 2008. Lehman included this collateral in its liquidity pool despite the fact that the collateral was subject to a security interest, was returnable to Lehman only on three days' notice and was placed to ensure that Bank of America would continue its clearing operations. Likewise, in late August, at JPMorgan's request, Lehman and JPMorgan executed a security agreement and holding company guaranty, formalizing JPMorgan's intraday security interest in two specified accounts. Lehman included amounts in these accounts in its liquidity pool, even though JPMorgan required almost all of the funds in those accounts each morning to unwind the previous day's triparty-repo trades. HSBC requested and received more than $800 million to secure its intraday credit exposure to Lehman on August 28, an amount also included in Lehman's liquidity pool. And from September 9 through 12, JPMorgan requested and received more than $8 billion in cash to secure JPMorgan's exposure to Lehman, an amount that Lehman also included in its liquidity pool.

Lehman took the position that including the Citigroup deposit and Lehman's intraday collateral with JPMorgan in its liquidity pool was appropriate. But the SEC and the rating agencies later expressed contrary views. While there may have been

legitimate differences of opinion as to the appropriateness of counting the Citigroup deposit and the intraday collateral in the liquidity pool, it is far more difficult to justify Lehman's counting of *pledged* assets in Lehman's liquidity pool, such as those Lehman pledged to JPMorgan on or after September 10, 2008.

The FRBNY knew that Lehman included pledged assets in its liquidity pool, but as Lehman's lender rather than its regulator, the FRBNY took no steps to compel Lehman to disclose the discrepancy between Lehman's reported liquidity pool figure and the actual, smaller number. Lehman's primary regulator, the SEC, was unaware of the extent to which Lehman was including clearing-bank collateral in its liquidity pool. The SEC did not have a full understanding of the encumbrances on Lehman's liquidity pool until September 12 – the Friday before Lehman's bankruptcy filing.[5392]

Most significantly, Lehman never advised the rating agencies or the investing public of the deposits and pledges affecting its liquidity pool. During Lehman's earnings announcement on September 10, CFO Ian Lowitt said nothing about these encumbrances. Although there is some evidence that Lowitt knew that the liquidity pool contained clearing-bank collateral, the Examiner concludes that there is not sufficient evidence to support the existence of a colorable claim that Lowitt breached his

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[5392] The SEC asserts that it was aware, prior to this date, that Lehman pledged "$5 billion of previously unencumbered assets, and not cash" to JPMorgan "on an intraday basis." The SEC also asserts, however, that it "was told by Lehman personnel that [the pledge did] not affect the liquidity pool." Letter from Samuel M. Forstein, Assistant General Counsel, Securities and Exchange Commission, to Robert L. Byman, Counsel to the Examiner (Jan. 29, 2010) (on file with the Examiner). The Examiner has no other documentation to support this assertion.

fiduciary duties to the corporation and its shareholders through material omissions and misrepresentations regarding Lehman's liquidity pool.

(2) The Importance of Liquidity to Broker-Dealers and Investment Bank Holding Companies Generally

"Liquidity is the ability of a bank to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses."[5393] Liquidity is absolutely critical to the broker-dealer and investment bank holding company business model due to the fact that these financial entities are dependent on short-term secured financing to fund their daily operations.[5394] The near collapse of Bear Stearns, and ultimately, the collapse of Lehman, is testimony to the fact that investment banks "live and die by liquidity."[5395]

After Bear Stearns fell, Lehman was widely regarded as the investment bank second-most dependent on short-term secured financing.[5396] A June 30, 2008 Morgan Stanley research report noted Lehman's "disproportionate reliance on 'repo' funding" –

[5393] Bank for International Settlements, Basel Committee on Banking Supervision, Principles for Sound Liquidity Risk Management and Supervision (Sept. 2008), at p. 1.

[5394] *See, e.g.*, Current Issues: PDCF, at p. 2 ("Primary dealers [*i.e.*, broker-dealers] rely heavily on the repo market – the market for repurchase agreements – to finance their portfolios of securities. . . . [T]he primary dealers stand out as the market's largest group of borrowers. . . . Repos constitute a major source of short-term financing for broker-dealers . . . .").

[5395] Diane Hinton, Standard & Poor's RatingsDirect, Liquidity Management In Times Of Stress: How The Major U.S. Broker-Dealers Fare (Nov. 8, 2007), at p. 3 [LBHI_SEC07940_439424].

[5396] *See, e.g.*, Morgan Stanley, Bruised, Not Broken – and Poised for Profitability (June 30, 2008), at p. 8 [FRBNY to Exam. 027135] ("Given [Lehman's] relative size, less diverse revenue composition vs. larger peers, and short-term funding profile, the firm had to contend with heightened scrutiny leading up to and following the liquidity run on Bear Stearns.").

a type of short-term (usually overnight) financing.[5397] As of the first quarter of 2008, "repo funding accounted for 5.7x of [Lehman's] liquidity reserve compared with 2.6x for peers."[5398] In the second quarter of fiscal year 2008, repo borrowings accounted for nearly 26% of the liabilities on Lehman's balance sheet.[5399] Lehman's reliance on short-term repos for day-to-day funding left it vulnerable to the risk of a liquidity crisis in the event those repos stopped rolling. Lehman acknowledged this point in its public filings, noting:

> Liquidity, that is ready access to funds, is essential to our businesses. Financial institutions rely on external borrowings for the vast majority of their funding, and failures in our industry are typically the result of insufficient liquidity.[5400]

An internal Lehman document noted: "Short term secured financing represents the largest source of secured funding for the Firm. Consequently, one key objective is to ensure that these funding sources are maintained in adverse market environments[.]"[5401] Thus, for a firm dependent on short-term financing, the importance of liquidity takes on a special dimension.

[5397] *Id*.

[5398] *Id*.

[5399] *See id.* at p. 17 (According to a table created by Morgan Stanley research, using Lehman company data and Morgan Stanley research estimates, Lehman's balance sheet included $158.677 billion of "Securities Sold Under Repo Agreements" included in the "Collateralized Borrowings" portion of Lehman's "Liabilities." Total liabilities were estimated to be $612.724 billion. $158.677 billion is 25.9% of $612.724 billion.).

[5400] LBHI 2007 10-K, at p. 17.

[5401] Lehman, Funding Lehman Brothers (Sept. 11, 2008), at p. 6 [LBHI_SEC07940_744139].

(3) Lehman's Liquidity Pool

(a) The Purpose and Composition of Lehman's Liquidity Pool

In regulatory filings and disclosures to the public, Lehman represented that it maintained a "liquidity pool . . . primarily intended to cover expected cash outflows for twelve months in a stressed liquidity environment."[5402] The pool was designed on the assumption that Lehman could not issue new unsecured debt or generate liquidity outside that pool of assets to satisfy the expected cash outflows during the stressed twelve-month period.[5403] These "expected cash outflows" consisted of obligations such as: portions of long-term debt coming current; maturing short-term, unsecured debt such as commercial paper; and bank loans and hybrid financial instruments coming due within a one-year span.[5404] Additionally, the liquidity pool was designed to cover contingent collateral calls in connection with Lehman's derivatives contracts, that is, automatic collateral pledges to derivatives counterparties under ISDA (International Swaps and Derivatives Association, Inc.) CSA (Credit Support Annex) agreements, triggered in the event that Lehman suffered a ratings downgrade.[5405]

[5402] Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2008 (Form 10-Q) (filed on July 10, 2008), at p. 80 ("LBHI 10-Q (July 10, 2008)").

[5403] *Id*.

[5404] *See id*.

[5405] *See id.* at pp. 80-82 (noting that the liquidity pool was sized to cover, among other things, "additional collateral that would be required to be posted against derivative contracts and other secured funding arrangements" in the event of a one-notch ratings downgrade).

Although the pool was "primarily intended to cover expected cash outflows for twelve months in a stressed liquidity environment,"[5406] Lehman described the pool as being available to cover other events as well. For instance, Lehman reported that "[a]s a last resort," the liquidity pool was "available" to the firm "to mitigate the loss of secured funding capacity."[5407] Specifically, the liquidity pool was reported to be "available" to mitigate a "loss of repo capacity" on at least $32 billion in illiquid assets.[5408]

Lehman reported the size of its liquidity pool as $34 billion at the end of the first quarter of 2008,[5409] $45 billion at the end of the second quarter[5410] and $42 billion at the end of the third quarter.[5411] Intra-quarter in 2008, following the near collapse of Bear Stearns, Lehman, primarily through Laura Vecchio, head of the Project Management Office,[5412] and Global Treasurer Paolo Tonucci,[5413] provided daily liquidity pool

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[5406] *Id.* at p. 80.
[5407] *Id.* at p. 84.
[5408] *Id.* at p. 85.
[5409] Final Transcript of Lehman Brothers Holdings Inc., First Quarter 2008 Earnings Call (Mar. 18, 2008), at p. 9.
[5410] Final Transcript of Lehman Brothers Holdings Inc., Second Quarter 2008 Earnings Call (June 16, 2008), at p. 10.
[5411] Final Transcript of Lehman Brothers Holdings Inc., Third Quarter 2008 Earnings Call (Sept. 10, 2008), at p. 11.
[5412] Vecchio transmitted reports regarding Lehman's liquidity pool and risk management to the FRBNY and SEC; however, she did not create the reports. Rather, Treasury and Risk Management were responsible for the contents of their respective reports. Examiner's Interview of Laura M. Vecchio, Apr. 16, 2009, at p. 4.
[5413] Tonucci provided verbal updates to FRBNY on-site analyst Jan Voigts. *See, e.g.*, FRBNY, Lehman IB Update (July 11, 2008) [FRBNY to Exam. 008207] (summarizing updated liquidity pool and repo information gleaned through a "Discussion with Treasurer").

estimates to the SEC and FRBNY.[5414] The quarter-end figures disclosed to regulators were the same as those disclosed publicly. The intra-quarter liquidity pool estimates were similar to those disclosed at quarter-end.[5415]

Lehman's 10-Q for the second quarter of 2008 reported that the pool of assets held to meet its maturing obligations was composed primarily of "cash instruments, government and agency securities and overnight repurchase agreements collateralized by government and agency securities."[5416] In the second quarter of 2008, Lehman's liquidity pool did indeed contain such assets: true to its regulatory filings and disclosures, as of May 31, 2008, the majority of the pool was invested in treasuries, and government and agency securities.[5417]

Lehman represented that its liquidity pool was unencumbered. After detailing the composition of the liquidity pool, the second quarter 10-Q provided "[e]stimated values of the liquidity pool and other unencumbered (*i.e.*, unpledged) asset

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[5414] *See, e.g.*, FED Documentation [LBEX-WGM 030111] (attachment to e-mail with list of documentation and verbal updates that Lehman was to provide to the FRBNY on daily, weekly, and quarterly bases. "Liquidity Pool Detail – Footnote" and "Liquidity Executive Summary" were two daily written reports distributed to the FRBNY. The FRBNY also received a daily verbal "Estimate of Liquidity Pool."); e-mail from Laura M. Vecchio, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Mar. 31, 2008) [LBEX-WGM 030110] (attaching "FED Documentation"); Examiner's Interview of Jan H. Voigts, Aug. 21, 2009, at p. 6 (confirming that the FRBNY received the documents listed in Vecchio's March 31, 2008 e-mail to Tonucci).

[5415] *See, e.g.*, FRBNY, Lehman IB Updates (Aug. 18, 2008-Sept. 12, 2008) [FRBNY to Exam. 007943] (updates produced by FRBNY in the course of monitoring Lehman's liquidity; the intra-quarter reporting for third quarter 2008 reflects that Lehman's pool fluctuated, day-over-day between $38 and $42 billion).

[5416] LBHI 10-Q (July 10, 2008), at p. 81. In addition to describing "unencumbered" assets as "unpledged" assets, Lehman publicly described "unencumbered" assets as those "that have not been financed against, [and are] available . . . to get additional cash at any time." Transcript of Lehman Brothers Holdings Inc., First Quarter 2008 Earnings Call (March 18, 2008).

[5417] *See* Lehman, Detailed Liquidity Pool Composition, (May 31, 2008), pp. 1-14 [LBEX-BARLQP 0000437].

portfolios."[5418] Lehman emphasized the liquid, unencumbered nature of the assets in its liquidity pool to regulators. For example, in a presentation to the SEC dated March 14, 2008, Lehman characterized its liquidity pool as composed of "primarily cash and cash equivalents and *unencumbered, liquid,* investment grade collateral."[5419] Likewise, in a presentation to the Office of Thrift Supervision ("OTS") on April 4, 2008, Lehman represented that its liquidity pool was composed of "primarily cash and cash equivalents and *unencumbered, liquid,* investment grade collateral."[5420] Similarly, in materials prepared for a joint presentation to the Federal Reserve and SEC dated March 26, 2008, Lehman held out its liquidity pool as "invested in instruments that can be *monetized at short notice in all market environments*."[5421]

Lehman emphasized the purportedly liquid, easy-to-monetize nature of its liquidity pool to its significant repo counterparties and clearing banks as well. For example, in response to inquiries about Lehman's liquidity pool by JPMorgan's Mark Doctoroff, Lehman Cash and Collateral Management head Dan Fleming said on

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[5418] LBHI 10-Q (filed July 10, 2008), at p. 81.

[5419] Lehman, Presentation to: U.S. Securities & Exchange Commission, Liquidity & Funding 2008 Q1 Review (Mar. 14, 2008), at p. 5 [LBHI_SEC07940_446200] (emphasis added); *see also* e-mail from Peter Giacone, Lehman, to Laura M. Vecchio, Lehman, *et al.* (Mar. 14, 2008) [LBEX-DOCID 4227753] (describing the meeting as having gone very well and having lasted about 90 minutes).

[5420] Lehman, Presentation to: OTS, OTS Quarterly Review, First Quarter 2008 (Apr. 4, 2008), at p. 26 [LBHI_SEC07940_473107] (emphasis added); *see also* e-mail from Ronald S. Marcus, OTS, to Thomas Francis, Lehman, *et al*. (Apr. 9, 2008) [LBEX-DOCID 357853] (following up on the April 7 presentation Lehman made regarding Audit, Finance and Risk Management).

[5421] Lehman, Presentation to Federal Reserve and SEC, Liquidity Management at Lehman Brothers (Mar. 26, 2008), at p. 2 [LBHI_SEC07940_741690] (emphasis added); *see also* e-mail from Paolo R. Tonucci, Lehman, to John F. Coghlan, Lehman, *et al*. (Mar. 28, 2008) [LBEX-DOCID 125099] (forwarding the presentation given the previous day to the SEC and Federal Reserve).

September 2, 2008 that about "90%" of Lehman's "$42 billion" liquidity pool "was invested in cash and cash equivalents, [g]overnment and [a]gency securities and E1 (major index) equities, *all of which can be monetized at very short notice*."[5422] Tonucci told the Examiner that Lehman's internal definition of a "liquid" asset, appropriate for inclusion in the liquidity pool, was one that could be monetized within five days.[5423] However, International Treasurer Carlo Pellerani was not familiar with this internal definition, and the Examiner is not aware of any document that sets forth such a definition of "liquidity."[5424] No law, SEC regulation or GAAP-style rule governed the definition of a "liquid" asset in the context of a CSE's liquidity pool, although Matthew Eichner, former Assistant Director of the SEC's Division of Trading and Markets, which supervised Lehman under the CSE program, told the Examiner he conveyed to Lehman that assets in its liquidity pool should be monetizable "within twenty-four hours."[5425]

[5422] E-mail from Daniel J. Fleming, Lehman, to Mark G. Doctoroff, JPMorgan, *et al.* (Sept. 2, 2008) [LBEX-AM 042892] (emphasis added). Fleming also disclosed that "[t]he balance . . . was invested in Lehman CLO securities, two thirds of which are backed by corporate loans, which have been relatively liquid." *Id.*

[5423] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 17. Tonucci could not cite a particular Lehman document that established this five-day definition, but he stated his belief that this was official policy, predating his tenure as Global Treasurer. *Id*. Steven Engel, former Global Head of Funding at Lehman, echoed this standard; he stated that assets in Lehman's liquidity pool should be monetizable in about a week. Examiner's Interview of Steven J. Engel, Oct. 30, 2009, at p. 9 & n.6.

[5424] Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at pp. 2, 5.

[5425] Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at p. 6. Eichner said that he conveyed to Lehman the "twenty-four hour" monetization standard found in an SEC memorandum defining the scope of SEC liquidity inspections; however, Eichner could not recall to whom at Lehman or when he conveyed the monetization standard. *Id*. *See also* Memorandum from Phillip Minnick, SEC, *et al*., to Erik Sirri, SEC, *et al*., re: Parent Company Liquidity Inspections Scope Memorandum for the Consolidated Supervised Entities ("CSE") (Feb. 20, 2008), at p. 2 [LBEX-WGM 017294] (providing the twenty-four hour standard). It is likely that Lehman saw this memorandum as well, given that it bears a Lehman Bates-stamp.

(b) Lehman Tested Its Liquidity Pool and Shared the Results of These Tests with Rating Agencies

Periodically, throughout 2008, Lehman tested the adequacy of its liquidity pool in self-run analyses designed to ensure that liquidity could be mobilized to satisfy obligations, not only over a 12-month period, but also in a more severe liquidity shock closer to the "run on the bank" scenario that befell Bear Stearns.[5426] For example, a presentation dated May 28, 2008 included an analysis designed to test the adequacy of Lehman's liquidity pool against a stress scenario three-to-four times more severe than what Lehman experienced during the Bear Stearns crisis the week of March 17, 2008.[5427] In that analysis, Lehman entered a hypothetical four-week stress period with a $44.4 billion liquidity pool, and successfully weathered the scenario, retaining $20.5 billion at the end of the stress-period.[5428] Lehman thereafter disclosed in its public filings that the liquidity pool was available to "mitigate[]" the "cash outflows" contemplated in its liquidity "stress testing."[5429]

[5426] *See, e.g.*, Lehman, Presentation to the Federal Reserve, Update On Capital, Leverage & Liquidity (May 28, 2008), at pp. 5-14 [LBHI_SEC07940_527576] (including a liquidity stress scenario designed to test the adequacy of Lehman's liquidity pool).

[5427] *Id.* at p. 12.

[5428] *Id*. at p. 13.

[5429] LBHI 10-Q (filed July 10, 2008), at p. 85. These liquidity stress tests, conducted by Lehman's Treasury function, are distinct from Lehman's market risk stress tests conducted by Lehman's Market Risk Management function. *See* Lehman, ICAAP Supporting Document: Market Risk Management Overview (May 2008), at p. 19 [LBEX-DOCID 383057].

Although such analyses were originally developed at the request of Lehman's regulators,[5430] Lehman distributed the results of the stress tests to rating agencies, counterparties, and other market participants. The firm distributed one such analysis to Standard & Poor's in the third quarter of 2008 – a time when Lehman was besieged by short sellers, market rumors, and increasingly large CDS spreads, and was pressed to demonstrate its ability to withstand a looming liquidity crisis.[5431] Similar to the analyses shared with regulators, this scenario assumed Lehman would incur substantial losses in both secured and unsecured funding, and contingent collateral calls triggered by a two-level ratings downgrade. More specifically, the stress scenario assumed a significant loss in Lehman's ability to obtain short-term secured financing from its repo of asset-backed securities, equities and corporates, as well as prime broker free credit balances.[5432] Further, the analysis assumed Lehman would not be able to roll its unsecured short-term debt or commercial paper.[5433] While these liquidity sources evaporated, outstanding debt obligations would continue to come due, requiring Lehman to draw on its liquidity pool to satisfy maturing short-term debt, current portions of its maturing long-term debt, commercial paper, and CSA-mandated

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[5430] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 22; Joint Request of SEC and FRBNY: Liquidity Scenarios for CSEs (May 20, 2008), at p. 1 [LBHI_SEC07940_505195]; Lehman, Finance & Risk Committee of the Board: Risk, Liquidity, Capital And Balance Sheet (Sept. 9, 2008), at. p. 11 [LBHI_SEC07940_742509].

[5431] Lehman, Standard & Poor's Overview of Lehman's 3Q 2008, Results and Game Plan (Sept. 5, 2008), at pp. 41-42 [LBHI_SEC09740_747779]. *See* Section III.A.3 of this Report, which discusses Lehman's financial condition during the third quarter of 2008.

[5432] *Id.* at p. 41.

[5433] *Id*.

collateral calls.[5434] According to Lehman's analysis, its $42 billion liquidity pool, combined with LBI's, LBIE's, LBJ's and Bankhaus' liquidity pools, would allow it to withstand a four-week liquidity shock and emerge from the crisis with a $13 billion cash position.[5435]

(c) Market Participants Formed Favorable Opinions of Lehman's Liquidity on the Basis of Lehman's Representations About Its Liquidity Pool

On the basis of Lehman's reported liquidity pool, specifically its reported size and composition of easy-to-monetize assets, market participants formed positive opinions of Lehman's liquidity profile. Certain influential participants, and rating agencies in particular, cited Lehman's liquidity pool as the basis for concluding that Lehman's liquidity position was sound. For example, an April 15, 2008 Moody's report titled "Liquidity Risk Assessment: Lehman Brothers Holdings Inc." concludes: "Moody's views the liquidity profile of [LBHI] as very strong."[5436] "The basis for Moody's assessment of Lehman's liquidity," the report continues, "is the strength of their overall funding framework, which includes an ample liquidity cushion of high-quality unencumbered assets."[5437]

[5434] *See id.* (noting that the liquidity stress scenario assumed that CSA agreements would require additional collateralization and that loans would continue to be funded per the funding schedule for leveraged loans).
[5435] *Id.* at p. 42.
[5436] Moody's Investment Service Global Credit Research, Liquidity Risk Assessment: Lehman Brothers Holdings Inc. (Apr. 15, 2008), at p. 1 [LBHI_SEC07940_090274].
[5437] *Id*.

Even as late as September 11, 2008 – less than two business days before LBHI filed for bankruptcy – market analysts cited Lehman's large liquidity pool as support for the conclusion that the firm's "[l]iquidity risk appears low."[5438] In a research memo recommending a "neutral" rating for LBHI, The Buckingham Research Group analysts cited Lehman's $42 billion reported liquidity pool, along with its lack of reliance on prime brokerage free credit balances and access to the Federal Reserve's Primary Dealer Credit Facility ("PDCF") window, to reach the conclusion that "[Lehman] remains well positioned in a 'run on the bank' scenario;"[5439] and: "[B]ottom line, run on the bank scenario risk seems very low with respect to [Lehman]."[5440] Thus Lehman's large, and reportedly unencumbered, liquidity pool gave rating agencies and market participants a positive impression of Lehman's liquidity – and financial viability – right up to the days immediately preceding LBHI's bankruptcy.

[5438] The Buckingham Research Group, Lehman Brothers (LEH), Rating Agency Risk Too High (Sept. 11, 2008), at p. 3 [LBEX-WGM 928802].

[5439] *Id*.

[5440] *Id*.

(4) Lehman's Clearing Banks Sought Collateral Pledges and Cash Deposits To Secure Intraday Credit Risk; Lehman Included This Collateral in Its Liquidity Pool

After the sudden near collapse of Bear Stearns in March 2008, counterparties and clearing banks focused their attention on those institutions regarded as the next-most vulnerable. Lehman, with its large leverage ratios and real-estate heavy balance sheet, was widely seen as a particularly vulnerable firm.[5441] In a progression of events, banks demanded collateral from Lehman; Lehman met those demands but continued to include the collateral in its liquidity pool.

(a) Lehman Pledged CLOs and Other Securities to JPMorgan Throughout the Summer of 2008 to Meet Triparty-Repo Margin Requirements

JPMorgan served as Lehman's clearing bank for triparty repos.[5442] In a triparty repo, Lehman pledged collateral to a counterparty's account at JPMorgan, typically overnight in exchange for cash, which was then transferred to Lehman's account at JPMorgan. The following morning the repo matured, and JPMorgan "unwound" the trade: Lehman returned the cash, plus interest, to the repo counterparty's account,

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[5441] *See, e.g.*, Examiner's Interview of Ben S. Bernanke, Dec. 22, 2009, at p. 6 (Bernanke "knew" Lehman was the weakest of the investment banks, after Bear Stearns); Examiner's Interview of Treasury Secretary Timothy F. Geithner, Nov. 24, 2009, at p. 2 (after Bear Stearns nearly collapsed, Geithner regarded Lehman as the weakest investment bank, followed by Merrill Lynch); Jenny Anderson, *At Lehman, Allaying Fears About Being the Next to Fall*, N.Y. Times, Mar. 18, 2008 (noting similarities between Bear Stearns and Lehman business models, in particular reliance on short-term financing and the mortgage market).

[5442] *See* Section III.A.5.b of this Report, which discusses Lehman's dealings with JPMorgan. JPMorgan is one of only two clearing banks providing triparty-repo clearing services in the United States. The other is Bank of New York Mellon. Working Group on Government Securities Clearance and Settlement, *Report to the Federal Reserve Board* (Dec. 2003), at p. 10.

while the counterparty returned the collateral to Lehman. To facilitate the unwind process, JPMorgan advanced Lehman intraday credit, secured by the collateral returned by triparty investors, which was, ideally, repaid by the end of the day as Lehman re-booked trades.[5443]

JPMorgan historically gave full value to the securities pledged by Lehman securing intraday-credit advances. Citing "[m]arket [r]isk" inherent in triparty-repo financing, JPMorgan advised Lehman in February 2008 that it would begin applying haircuts to collateral that Lehman posted to secure intraday credit advances.[5444] As originally envisioned by JPMorgan, this margin requirement would be phased in incrementally over the course of five to six weeks.[5445] The size of the haircut was to be equivalent to the haircut that triparty investors imposed on Lehman collateral.[5446] In other words, JPMorgan would retain intraday the same margin that triparty investors held overnight. Upon learning of JPMorgan's proposal to discount Lehman collateral, Fleming elevated the issue to Tonucci, noting: "The [haircut] proposal may create very

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[5443] *See* Section III.A.5.b of this Report, which provides a more detailed discussion of JPMorgan's role in clearing Lehman's triparty-repo trades; *see also* Counterparty Risk Management Policy Group III, *Containing Systemic Risk: The Road to Reform* (Aug. 6, 2008), at p. 114 (noting that clearing banks extend intraday credit to dealers through unwinding triparty repos at the beginning of the trading day by crediting the triparty investor's account on behalf of the dealer).

[5444] E-mail from Janet Birney, Lehman, to Daniel J. Fleming, Lehman *et al*. (Feb. 26, 2008) [LBHI_SEC07940_436414].

[5445] *Id.* It ultimately took the course of the summer. *See* Section III.A.5.b of this Report, which discusses Lehman's dealings with JPMorgan.

[5446] E-mail from Janet Birney, Lehman, to Daniel J. Fleming, Lehman *et al*. (Feb. 26, 2008) [LBHI_SEC07940_436414].

sizeable intraday liquidity challenges for us."[5447] Thus, Fleming recognized this margin-requirement created a tension between two competing priorities for Lehman: providing its clearing banks with adequate security so that Lehman could continue obtaining short-term secured financing, while simultaneously attempting to maintain its reported liquidity pool.[5448]

Subsequently, JPMorgan imposed the investor margin in 20% increments beginning on March 17, 2008.[5449] The full triparty-investor margin was imposed by August 14, 2008.[5450]

JPMorgan's margin requirements negatively affected Lehman's Net Free Equity ("NFE").[5451] NFE was the measure of risk exposure that JPMorgan calculated to determine whether it would continue extending clearing advances to its client broker-dealers.[5452] In its simplest form, NFE was the market value of Lehman securities pledged to JPMorgan plus any unsecured credit line JPMorgan extended to Lehman

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[5447] E-mail from Daniel Fleming, Lehman to Paolo R. Tonucci, Lehman (Feb. 26, 2008) [LBHI_SEC07940_436414].

[5448] Fleming was not referring specifically to the liquidity pool in his February 26, 2008 e-mail; rather, he was referring to potential intraday liquidity issues. These are, however, two sides of the same coin, as intraday liquidity shortfalls may have required Lehman to dip into its liquidity pool.

[5449] *See* Section III.A.5.b of this Report, which discusses Lehman's dealings with JPMorgan. S*ee* JPMorgan Second Written Responses, at p. 4.

[5450] E-mail from Craig L. Jones, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Aug. 14, 2008) [LBEX-AM 001764] (informing Tonucci that the intraday margin imposed by JPMorgan reached 100% that day). The total amount of the haircut was "~$5bn." *Id.*

[5451] *See* e-mail from Janet Birney, Lehman, to Jack Fondacaro, Lehman, *et al*. (May 2, 2008) [LBEX-DOCID 036292]; Discussion Points [LBEX-DOCID 077455] (noting that changes to JPMorgan's margin requirements would impact Lehman's NFE).

[5452] *See* Section III.A.5.b of this Report, which discusses Lehman's dealings with JPMorgan, and NFE in particular.

minus cash advanced by JPMorgan to Lehman.[5453] An NFE value greater than zero indicated that Lehman had not depleted its available credit with JPMorgan. If a trade would put NFE below zero, that trade would be stopped.[5454] Fleming relayed to the Examiner that an "NFE deficit" would result in an inability to clear particular triparty-repo trades – a scenario which he characterized as disastrous for Lehman, given Lehman's dependence on triparty-repo financing.[5455]

Additionally, JPMorgan concluded that triparty-repo investors had themselves inadequately assessed risks in the margins they charged.[5456] Thus, in order to mitigate liquidation and price risk, JPMorgan advised Lehman, as well as other broker-dealer clients, that additional margin would be required, based on collateral type, above and beyond the margin required by triparty-repo investors. JPMorgan's new "risk-based margin" would take into account "liquidation risk" (to account for one-day price

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[5453] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at p. 5.

[5454] *Id*.

[5455] Examiner's Interview of Daniel J. Fleming, Sept. 24, 2009, at pp. 4-5, 7. When asked what would have happened if JPMorgan ceased to provide secured financing on an intraday basis through its clearing services, Fleming responded: "September 15 [2008] [the date of LBHI's bankruptcy filing] is a good example of what happens." *Id.* at p. 5. Later in the interview, Fleming reiterated that without JPMorgan's clearing services, "Lehman wouldn't be able to open its doors." And a loss of JPMorgan clearing services would be akin to "having no gas in your car." *Id.* at p. 7. *See* Section III.A.5.b.1.c of this Report, which discusses Lehman's dealings with JPMorgan, triparty repos, and NFE.

[5456] Examiner's Interview of Ricardo S. Chiavenato, Sept. 21, 2009, at pp. 9-10; Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at p. 4 (overnight investors were not overly concerned about liquidation pricing because they assumed clearing banks would unwind securities).

volatility for securities) and "price risk" (an estimate of potential vendor-price overstatement for illiquid securities).[5457]

Lehman initially transferred roughly $5.7 billion face value in collateral to JPMorgan on June 19, 2008, to begin covering risk-based margin.[5458] This collateral consisted of certain collateralized loan obligations ("CLOs") including Freedom, Spruce and Pine, a commercial real estate ("CRE") collateralized debt obligation ("CDO") known as SASCO and the asset-backed commercial paper ("ABCP") known as Fenway.[5459]

Lehman continued to transfer collateral to JPMorgan after the initial June 19, 2008 delivery. By the beginning of August 2008, as part of continuing efforts by Lehman to mitigate the effects of JPMorgan's margin requirements, Lehman had posted approximately $9 billion of collateral at JPMorgan.[5460] By August 7, 2008, an LBI clearance account at JPMorgan called "LCD" held securities called Freedom, Pine,

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[5457] JPMorgan, Triparty Repo Discussion – Lehman (May 29, 2008), at p. 10 [JPM-EXAMINER00006028].

[5458] E-mail from Craig L. Jones, Lehman, to John Feraca, Lehman, *et al.* (June 19, 2008) [LBEX-AM 001775] ("Today we moved several unencumbered assets (Sasco, Freedom, Spruce, Pine, Fenway) to LCPI's DTC box at Chase"); JPMorgan Second Written Responses, at p. 5.

[5459] E-mail from Craig L. Jones, Lehman, to John Feraca, Lehman, *et al.* (June 19, 2008) [LBEX-AM 001775] CLOs and CDOs are forms of asset-backed securities that derive their value from underlying assets; in the case of these two security types, revenue streams from loan and debt payments respectively. ABCP is commercial paper that derives its value in part from underlying assets rather than solely from its issuer's promise to pay.

[5460] E-mail from Janet Birney, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Aug. 5, 2008) [LBHI_SEC07940_534733]; e-mail from Ricardo S. Chiavenato, JPMorgan, to Edward J. Corral, JPMorgan, *et al*. (Aug. 5, 2008) [JPM-2004 0061153] (noting that JPMorgan held $9 billion in Lehman collateral). Although in an August 5, 2008 e-mail Chiavenato referred to Lehman's collateral as coming from LCPI, JPMorgan counsel stated that this e-mail is incorrect in that regard; the collateral was located in LCD, an account owned and pledged by LBI. *See* JPMorgan Second Written Responses, at pp. 5-6.

Spruce, Verano, SASCO, Kingfisher, HD Supply and Fenway.[5461] Securities held in LCD contributed to LBI's NFE.[5462] Then, from August 8 to 11, 2008, Lehman transferred the Spruce, Freedom, Pine, Kingfisher, Verano, and Fenway securities from LCD to an LBHI account at JPMorgan called "LCE."[5463] Securities in LCE did not contribute to LBI's NFE; yet LBHI was operationally required to maintain securities valued at $5 billion in the LCE account.[5464] On August 15, 2008, Lehman removed Freedom from LCE and on September 2, Lehman transferred Kingfisher from LCE to LCD.[5465]

(b) The Securities Posted to Meet JPMorgan's Margin Requirements Were Included in Lehman's Liquidity Pool

Lehman posted five securities with JPMorgan on June 19, 2008 (SASCO, Freedom, Spruce, Pine, and Fenway).[5466] On that same date, Lehman included four of the five securities in its liquidity pool (SASCO, Spruce, Pine, and Fenway).[5467]

[5461] *See* JPMorgan Second Written Responses, at pp. 5-6.

[5462] *See id*.

[5463] *See, e.g.,* e-mail from Michael Prestolino, Lehman, to Craig L. Jones, Lehman, *et al.* (Aug. 8, 2008) [LBEX-DOCID 046703]; Lehman, Prices for LCD Box (Aug. 8, 2008) [LBEX-DOCID 023772] (showing prices for Freedom, Pine, Spruce, Verano assets located in the LCD box, and noting that they are to be transferred to LBHI).

[5464] JPMorgan First Written Responses, at p. 10 (noting that, because Lehman had the ability to move collateral in and out of the LCE account but JPMorgan wanted Lehman to keep collateral in the account to secure margin requirements, JPMorgan placed a $5 billion debit on the LCE account, requiring Lehman to maintain at least that amount in LCE); *see* e-mail from Michael A. Mego, JPMorgan, to Karen M. Sharf, JPMorgan, *et al*. (Aug. 23, 2008) [JPM-EXAMINER00005942] (describing the $5 billion debit); *see also* Section III.A.5.b of this Report, which discusses Lehman's dealings with JPMorgan.

[5465] JPMorgan Second Written Responses, at pp. 7-8; *see also* Appendix 18 of this Report, which discusses Lehman's collateral at JPMorgan.

[5466] E-mail from Craig L. Jones, Lehman, to John Feraca, Lehman, *et al.* (June 19, 2008) [LBEX-AM 001775] ("Today we moved several unencumbered assets (Sasco, Freedom, Spruce, Pine, Fenway) to LCPI's DTC box at Chase"); JPMorgan Second Written Responses, at p. 5.

Tonucci acknowledged that at least some of the securities posted to meet JPMorgan's margin requirements were included in Lehman's liquidity pool.[5468] A JPMorgan internal agenda from a September 4, 2008 meeting with Lehman reflects JPMorgan's knowledge that the securities were included in Lehman's pool.[5469]

The Examiner has reviewed detailed CUSIP-by-CUSIP inventories of the liquidity pool for dates in March through September 2008. The following table shows the securities collateral that Lehman transferred to either the LCD or LCE collateral accounts at JPMorgan and simultaneously included in the liquidity pool.

[5467] Lehman, Detailed Liquidity Pool Composition (June 19, 2008), at pp. 21-22 [LBEX-BARLQP 0002062] (showing SASCO, Spruce, Pine, and Fenway securities in the liquidity pool).

[5468] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 19.

[5469] JPMorgan, Lehman Brothers Holdings Inc. Briefing Memorandum (Sept. 4, 2008), at p. 2 [JPM-2004 0006170].

Pledge Value (in $ billions) of JPMorgan Securities Collateral in the Liquidity Pool [5470]

	19-Jun	10-Jul	24-Jul	14-Aug	11-Sep
Freedom				1.1	
Pine	1.0	1.0	0.1	1.0	0.9
Spruce	1.0	0.9	0.8	0.8	0.7
Verano				1.3	1.2
SASCO	1.1	1.1	0.9	1.7	0.5
Fenway	1.7	1.0	2.0		
Kingfisher		0.8	0.8	0.8	0.9
Total CDO/ABCP In the Liquidity Pool:	**4.8**	**4.8**	**4.6**	**6.7**	**4.2**

As the table indicates, as of June 19, 2008, the date that Lehman initially transferred the securities collateral to JPMorgan, $4.8 billion of the liquidity pool was comprised of assets posted to JPMorgan clearing accounts.

(c) On June 12, 2008, Lehman Transferred $2 Billion to Citi as "Comfort" for Continuing CLS Settlement

Citibank, N.A. was LBI's agent-bank on the CLS system.[5471] The CLS system was a trading platform, operated by a consortium of banks, for the clearance and settlement

[5470] Duff & Phelps, LBHI Securitizations in the Liquidity Pool (Jan. 10, 2010) (data compiled by comparing securities in the "LCE" and "LCD" Position Summaries for specified dates (sourced from "RCBPPR92 Reports") with the Detailed Liquidity Pool Compositions for those same dates).

[5471] *See* Section III.A.5.c of this Report, which discusses Lehman's dealings with Citigroup. The LBI-Citibank CLS relationship was established by a "CLS Settlement Services Agreement for CLS User Members" dated December 19, 2003. This CLS agreement was amended and restated in a "Citibank CLS Settlement Services Amended and Restated Agreement for CLS User Members" dated October 28, 2004. References to the "CLS Agreement" refer to the agreement as amended and restated.

of FX trades.[5472] As a "user member" of the CLS system, LBI relied on Citi to execute its FX trades on CLS.[5473] In doing so, Citi would extend intraday credit to LBI, and by extension assume a certain amount of intraday risk in connection with that credit.[5474]

On June 5, 2008, Lehman previewed its second-quarter earnings announcement to Citi, in which Lehman disclosed an anticipated record $2.6 billion loss.[5475] CFO Erin Callan formally delivered the announcement of a $2.8 billion loss on June 9. The market reacted poorly.[5476] Lehman announced on June 12 that Callan and Lehman President and COO, Joe Gregory, had been removed from their positions.[5477] As a result of Lehman's rapidly declining stock price and negative market reactions to Lehman's earnings announcement, Citi experienced a three-fold increase in novation requests.[5478] Citibank risk manager Thomas Fontana stated, in an internal June 12 Citi e-mail

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[5472] *See* Section III.A.5.c of this Report, which discusses Lehman's dealings with Citigroup; Examiner's Interview of Jonathan D. Williams, Aug. 5, 2009, at p. 5.

[5473] Three other Lehman entities were user members. *See* Section III.A.5.c of this Report, which discusses Lehman's dealings with Citigroup. Examiner's Interview of Jonathan D. Williams, Aug. 5, 2009, at p. 5.

[5474] *See* Section III.A.5.c of this Report, which discusses Lehman's dealings with Citigroup; *see also* Lehman, Citibank Clearing and Intraday Credit (June 17, 2008), at p. 3 [LBHI_SEC07940_745595] (noting that Citibank's provision of intraday credit is necessary for efficient CLS settlement).

[5475] Lehman, Q2 2008 Update (June 4, 2008), at p. 2 [CITI-LBHI-EXAM 00078768]; e-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (June 4, 2008) [CITI-LBHI-EXAM 00081461] (describing the agenda for the June 5 meeting as including a look at Lehman's second quarter results).

[5476] E-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al.* (June 12, 2008) [CITI-LBHI-EXAM 00072923] (noting negative market reaction).

[5477] *Id*. ("Fuld oust CFO [Callan] and COO [Gregory]. Lowitt brought back to CFO role.").

[5478] Lehman, CITIGROUP Call Report (June 17, 2008), at p. 1 [LBEX-AM 008578] (recounting remarks made by Citi CRO Brian Leach in a June 17, 2008 meeting with Lehman). In a novation, the clearing bank stepped into the counterparty's shoes, and faced Lehman directly in a trade. The clearing bank became fully exposed to the trading risks associated with facing Lehman.

exchange, that Citi was passing on novation requests and loss of confidence in Lehman was "huge."[5479]

Citi was loath to reject these counterparty requests and desired additional security for the increased risk exposure it faced in novating these trades.[5480] In a later e-mail in the same chain, Fontana wrote that Citi's "internal team has lost complete confidence [in Lehman]. No telling what will happen."[5481]

Thus, on June 12, 2008, Fleming informed Lowitt (on his first day on the job as CFO) that Citi was seeking a $3 to 5 billion cash deposit to cover its intraday exposure.[5482] Later that day, Lehman agreed to deposit $2 billion with Citibank.[5483] In an e-mail to Lowitt and Tonucci, Fleming characterized the terms of the deposit as: "[n]o lien or right of offset, a straight overnight fed funds deposit."[5484] The assumption that the deposit was freely returnable, and distinguishable from a "pledge" of collateral, was

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[5479] E-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (June 12, 2008) [CITI-LBHI-EXAM 00072923].

[5480] Jasmin Herrera, Lehman, Global Creditor Relations–Highlights Citigroup (June 16, 2008), at p. 1 [LBEX-AM 008660] ("Until June 12, 2008, Citibank has consistently been Lehman's strongest provider of credit. However, due to a substantial increase in novation requests from counterparties, Citi requested that we collateralize $3-$5 B in intraday exposure. Lehman declined, but did agree to a $2B term deposit, callable daily.").

[5481] E-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (June 12, 2008) [CITI-LBHI-EXAM 00072923].

[5482] E-mail from Daniel J. Fleming, Lehman to Ian T. Lowitt, Lehman (June 12, 2008) [LBEX-AM 008609]; Jasmin Herrera, Lehman, Global Creditor Relations–Highlights Citigroup (June 16, 2008), at p. 1 [LBEX-AM 008660] (stating that Citi requested Lehman collateralize $3-5 billion in intraday exposure).

[5483] E-mail from Daniel J. Fleming, Lehman to Ian T. Lowitt, Lehman, *et al*. (June 12, 2008) [LBEX-AM 008608]. Citi had requested and received a similar deposit from Bear Stearns in the summer of 2007. E-mail from Christopher M. Foskett, Citigroup, to John Havens, Citigroup, *et al*. (June 12, 2008) [CITI-LBHI-EXAM 00026400].

[5484] E-mail from Daniel J. Fleming, Lehman to Ian T. Lowitt, Lehman, *et al*. (June 12, 2008) [LBEX-AM 008608].

widely held within Lehman.[5485] In his interview with the Examiner, Tonucci stated that there were "no restrictions" on Lehman's ability to get the deposit back.[5486] He also stated that the deposit was a "good faith" deposit intended to maintain Citibank's "good will."[5487] Lehman was "always beholden to an extent on the good will of its clearing banks," Tonucci explained.[5488]

Lehman's internal statements that Citi did not have a right of offset against the deposit and that no conditions attached to the return of the deposit were not shared within Citi. It was Citi's view that under either New York state law or the Uniform Commercial Code, Citibank had a right of setoff against the $2 billion.[5489] Citi recognized that it was not secured by a pledge agreement.[5490] Fontana, in one e-mail, noted that a similar deposit agreement Citi reached with Bear Stearns a year earlier was better than that with Lehman because it provided a right to offset, whereas there was no "clean right of offset" with respect to the Lehman deposit.[5491] Michael Mauerstein, a relationship manager for Lehman at Citigroup, also contrasted the Lehman deposit with

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[5485] For example, an internal Lehman agenda for a meeting with Citibank, dated June 17, 2008, stated: "Lehman did not agree to pledge cash or give the right to set-off on collateral as Citi requested, but we reluctantly did agree to deposit $2B in a call account, callable daily." Lehman, Citigroup Agenda (June 17, 2008), at p. 2 [LBEX-AM 008597].

[5486] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 18.

[5487] *Id*.

[5488] *Id*.

[5489] Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 5; Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 5; Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 5.

[5490] E-mail from Paul S. Galant, Citigroup, to Jerry Olivo, Citigroup, *et al.* (Aug. 29, 2008) [CITI-LBHI-EXAM 00076678] (distinguishing between the $2 billion deposit and a formal pledge of securities).

[5491] E-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (June 12, 2008) [CITI-LBHI-EXAM 00073732].

the Bear Stearns deposit, noting that Lehman was not borrowing from Citi and had not executed a "promissory note with 'right of offset' language" with Lehman as it had with Bear Stearns.[5492] In late August, however, Mauerstein stated that although Citi did not view the deposit as "collateral" and that Lehman could "ask [for it] to be returned at any time," "we consider that we have a right of offset under NYS [New York state] law."[5493] In response to Mauerstein's e-mail highlighting the distinction between treating the $2 billion as "collateral" versus a "deposit," Citibank's Jerry Olivo stated, "Mike, I am aware and understand all of this – though their asking for the deposit back does have distinct impacts on clearing capacity."[5494]

While Lehman characterized the $2 billion deposit as an overnight deposit with no strings attached, Citibank subjected it to a number of internal controls designed to keep the $2 billion within Citi. Shortly after Lehman made the deposit, Fontana stated in an internal Citi exchange that his main concerns were "keeping the liquidity [of the deposit] within Citi and being able to control the release of the deposit."[5495] With those

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[5492] E-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (June 12, 2008) [CITI-LBHI-EXAM 00073732].

[5493] E-mail from Michael Mauerstein, Citigroup, to Katherine Lukas, Citigroup, *et al*. (Aug. 29, 2008) [CITI-LBHI-EXAM 00076678]. In this same e-mail exchange, Citigroup's Paul Galant also stated: "Overnight deposits that can be yanked at anytime by the client count for nothing as it relates to collateral / security interest." Galant then directed Mauerstein and his team to get a collateral pledge of securities to replace the deposit as soon as possible. E-mail from Paul S. Galant, Citigroup, to Jerry Olivo, Citigroup, *et al*. (Aug. 29, 2008) [CITI-LBHI-EXAM 00076678].

[5494] E-mail from Jerry Olivo, Citigroup, to Michael Mauerstein, Citigroup, *et al.* (Aug. 29, 2008) [CITI-LBHI-EXAM 00076678].

[5495] E-mail from Thomas Fontana, Citigroup, to Robert Blackburn, Citigroup, *et al*. (June 19, 2008) [CITI-LBHI-EXAM 00018405].

concerns in mind, Citi set up a notification structure whereby Citi's Risk Treasury desk was instructed to notify Fontana of any Lehman request for the deposit prior to the release of the deposit.[5496]

In discussions concerning the most appropriate interest rate to provide Lehman on the $2 billion, and how to count the "comfort deposit" internally within Citi's systems, Olivo characterized the deposit as "essentially captive funds."[5497] Additionally, Citi described the comfort deposit internally as "an overnight investment that gets rolled on a daily basis" and explained that a process was in place for Fontana to be notified before any withdrawal was made.[5498]

Fontana confirmed that a notification process such as the one described above governed the release of the deposit. Fontana said that while Citi would likely have released the deposit if asked, Citi would have decided internally if it would continue to conduct "business as usual" with Lehman prior to releasing the deposit.[5499]

Thus, while Lehman considered the deposit to be lien-free and offered merely as a "good faith" gesture to maintain a positive working relationship, Citi believed that it had the right to set off against the deposit, and that withdrawal of the deposit would

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[5496] *Id*.

[5497] E-mail from Jerry Olivo, Citigroup, to Robert Blackburn, Citigroup, *et al*. (June 25, 2008) [CITI-LBHI-EXAM 00020787].

[5498] E-mail from Katherine Lukas, Citigroup, to Ranjit Chatterji, Citigroup, *et al*. (Aug. 27, 2008) [CITI-LBHI-EXAM 00020787].

[5499] Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 2.

have negative implications for Citi's ability to clear for Lehman.[5500] Further, Citi subjected the deposit to an internal procedure under which release of the deposit would have been subject to its risk desk's notification and approval.

(d) The Citi "Comfort Deposit" Was Included in Lehman's Liquidity Pool

Tonucci acknowledged that Lehman included the "comfort deposit" in Lehman's liquidity pool.[5501] Fleming stated that, because Lehman was at least legally entitled to the $2 billion deposit and it was returnable on relatively short notice, it was appropriate for Lehman to include it in the liquidity pool.[5502] Yet Erin Callan, when asked if she would have included in the liquidity pool deposits that were required to conduct business, such as the $2 billion cash deposit with Citi, said she probably would not have been comfortable doing so.[5503] Lehman International Treasurer Carlo Pellerani, although unaware that Lehman included clearing-bank collateral or deposits in its liquidity pool, agreed that funds allocated to clearing banks to cover exposures, intraday or otherwise, were not appropriate for inclusion in the liquidity pool.[5504] Similarly, Steve Engel, former Lehman Senior Vice-President, Funding Desk, expressed his disagreement with Lehman's decision to include the $2 billion cash deposit at Citi in

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[5500] Lehman management knew at least as of early August that Citibank believed it had a right to offset the deposit. *See* Lehman, CITIGROUP Call Report (Aug. 7, 2008), at p. 1 [LBEX-DOCID 450310] (reporting that Citibank believed it had a right to offset the deposit).

[5501] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 19.

[5502] Examiner's Interview of Daniel J. Fleming, Sept. 24, 2009, at p. 7.

[5503] Examiner's Interview of Erin M. Callan, Oct. 23, 2009, at pp. 4, 16.

[5504] Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at pp. 4-5.

its liquidity pool.[5505] He reasoned that, if the assets were not readily convertible to cash or capable of being repoed, they did not belong in the liquidity pool.[5506]

Citi understood that Lehman included the $2 billion deposit in its liquidity pool.[5507] From Mauerstein's perspective, Lehman's decision about what to report in its liquidity pool was a matter between Lehman and its regulators.[5508] Foskett, Mauerstein and Fontana each acknowledged that they did not consider the June 12 cash deposit formally encumbered when it was initially made.[5509]

Officials from the SEC advised the Examiner that they knew Lehman included the $2 billion Citi deposit in Lehman's liquidity pool, and that the SEC did not think it was appropriate for Lehman to include these funds in its liquidity pool.[5510] According to the SEC, the issue was escalated internally at the SEC and the SEC discounted those

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[5505] Examiner's Interview of Steven J. Engel, Oct. 30, 2009, at p. 10.

[5506] *Id*.

[5507] Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at pp. 2, 5. However, Fontana did not know whether Lehman was including other clearing bank deposits or pledges in its pool. When presented with such a hypothetical, Fontana stated, "the whole thing [pool] could have been pledged out!" and said this was a question Citi should have asked at the time. *Id*. at p. 5; e-mail from Michael Mauerstein, Citigroup, to Thomas Fontana, Citigroup, *et al*. (June 17, 2008) [CITI-LBHI-EXAM 00073791]; e-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (July 2, 2008) [CITI-LBHI-EXAM 00073015] (Mauerstein wrote that "[w]e should remind [people] in our organization that Lehman has $50 billion of holding company cash/liquidity (including the $2B with us) and access to the Fed discount window"); Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 5.

[5508] Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 6.

[5509] Examiner's Interview of Christopher M. Foskett, Sept. 24, 2009, at p. 5; Examiner's Interview of Michael Mauerstein, Sept. 16, 2009, at p. 6; Examiner's Interview of Thomas Fontana, Aug. 19, 2009, at p. 5 (Fontana distinguished the deposit from a "pledge" but noted that Citi believed it had a right of offset against the deposit).

[5510] Examiner's Interview of SEC staff, Aug. 24, 2009, at p. 11. The SEC's Matthew Eichner stated that he was not aware that Lehman included the $2 billion deposit at Citi in its liquidity pool and said that such a deposit would not have "raised eyebrows" in February of 2008, but that, by September 2008, people were focused on how much was on deposit at the various banks. Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at p. 8.

funds from its internal calculation of Lehman's liquidity pool.[5511] Notably, the FRBNY also discounted Lehman's liquidity pool by the amount of the deposit with Citi; the FRBNY did not find the inclusion of the deposit prudent because it was not freely available for other uses, particularly in August and September 2008 when companies were becoming increasingly anxious about liquidity.[5512] FRBNY Senior Vice President Art Angulo said there was a "real question" whether the $2 billion deposit should have been included in the pool at all given that it had to be returned to Citi every morning to support Lehman's clearing.[5513]

Additionally, rating agency analysts whom the Examiner interviewed stated they were not aware of the $2 billion deposit Lehman placed with Citi, but that they would have wanted to know about it for purposes of their rating analysis of Lehman.[5514] Further, two rating agency analysts stated that it would not have been appropriate to include a deposit in the liquidity pool like the one Lehman provided Citi beginning June 12 because the funds could not be used for any other purpose.[5515]

[5511] Examiner's Interview of SEC staff, Aug. 24, 2009, at p. 11.

[5512] Examiner's Interview of Arthur G. Angulo, Oct. 1, 2009, at p. 4; Examiner's Interview of Jan H. Voigts, Oct. 1, 2009, at pp. 3-4.

[5513] Examiner's Interview of Arthur G. Angulo, Oct. 1, 2009, at p. 4.

[5514] Examiner's Interview of Eileen A. Fahey, Sept. 17, 2009, at p. 5; Examiner's Interview of Diane Hinton, Sept. 22, 2009, at p. 4; Examiner's Interview of Peter E. Nerby, Oct. 8, 2009, at p. 4.

[5515] Examiner's Interview of Eileen A. Fahey, Sept. 17, 2009, at p. 5; Examiner's Interview of Diane Hinton, Sept. 22, 2009, at pp. 4-5.

(e) On August 25, 2008, Lehman Executed a Security Agreement with Bank of America, Granting the Bank a Security Interest in a $500 Million Deposit

Bank of America ("BofA") was one of Lehman's clearing banks for transactions in Asia.[5516] BofA was viewed by Lehman as critical for Lehman Brothers Japan ("LBJ") operations, as well as for FX clearing for Japanese Yen.[5517] Lehman moved over $10 billion a day through BofA's clearing function, via several Lehman entities.[5518] Moreover, as the global business day opened with trading activity in Asia, Lehman was dependent on reliable clearing operations in that region to finance its positions elsewhere around the world later in the day.[5519]

As with JPMorgan and Citibank, BofA approached Lehman in the summer of 2008 with concerns regarding risk exposures incurred through its provision of intraday credit. Thus, on the evening of August 20, 2008, BofA's James Dever placed a call to Lehman's Emil Cornejo and Tonucci, informing them that BofA would drop Lehman's $1 billion intraday line of credit to zero the coming Monday if Lehman did not place a

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[5516] *See* Section III.A.5.e and Appendix 19 of this Report, which discuss Lehman's dealings with Bank of America.

[5517] *See* E-mail from Gregory Ito, Lehman, to Carlo Pellerani, Lehman, *et al*. (Aug. 21, 2008), at p. 2 [LBHI_SEC07940_547285].

[5518] E-mail from Stirling Fielding, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (Aug. 21, 2008), at p. 1 [LBHI_SEC07940_547285].

[5519] E-mail from Gregory Ito, Lehman, to Carlo Pellerani, Lehman, *et al*. (Aug. 21, 2008), at p. 2 [LBHI_SEC07940_547285] ("Without their [BofA] support we are unable to borrow from the O/N [overnight] call market in a reliable way.").

deposit with BofA.[5520] Tonucci raised the issue with the FRBNY, informing his FRBNY contacts of the consequences of BofA's actions, namely that Lehman would lose intraday credit from BofA and would be required to prefund all clearing through the bank.[5521] In an internal Lehman e-mail, he characterized the FRBNY as "suitably concerned" about BofA's actions.[5522] Tonucci contacted Government officials the next day as well to inform them that BofA still had not forwarded the draft documentation to establish "the intraday collateralisation that [would] replace the 'intraday credit.'"[5523] The SEC's Matthew Eichner asked that Tonucci keep him "in the loop" on his discussions with BofA.[5524] Recognizing the importance of the relationship, Lehman mobilized to place a deposit with BofA to induce the bank to continue clearance operations. Initially, Tonucci approved placing a $200 million deposit with the bank.[5525] Stirling Fielding, head of Cash, Collateral, and Network Management in Lehman's International Treasury, reported back that BofA was reducing all of Lehman's credit

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[5520] E-mail from Emil F. Cornejo, Lehman, to Daniel J. Fleming, Lehman *et al*. (Aug. 20, 2008) [LBHI_SEC07940_547120].

[5521] E-mail from Paolo R. Tonucci, Lehman, to William Brodows, FRBNY, *et al*. (Aug. 20, 2008) [LBEX-AM 055584].

[5522] E-mail from Paolo R. Tonucci, Lehman, to Julie Boyle, Lehman (Aug. 21, 2008) [LBHI_SEC07940_547284].

[5523] E-mail from Paolo R. Tonucci, Lehman, to Matthew Eichner, SEC, *et al*. (Aug. 21, 2008) [LBEX-AM 055372].

[5524] E-mail from Matthew Eichner, SEC, to Paolo R. Tonucci, Lehman, *et al*. (Aug. 21, 2008) [LBEX-AM 055372].

[5525] E-mail from Paolo R. Tonucci, Lehman, to Gregory Ito, Lehman, *et al.* (Aug. 21, 2008) LBHI_SEC07970_547284].

lines, and that Lehman would need to post a $500 million deposit.[5526] Further, BofA sought a lien granting a security interest in the deposit.[5527] Tonucci elevated the issue to COO Bart McDade, and requested that McDade elevate it to Richard Fuld to discuss with BofA CEO Kenneth Lewis.[5528]

In considering the proper amount to deposit with BofA, Fielding suggested an amount larger than the $500 million. In that same exchange, Fielding wrote Tonucci:

> Paolo, if you are going to include this deposit as part of the liquidity profile and it doesn't impact other models[,] we should consider being prudent and starting with a larger deposit. The main risk is that it becomes evident to the market that we have liquidity issues. Without intraday liquidity[,] our clients, counterparts and agent banks will all be receiving payments much later than usual. Many of them an hour before cut-off. It also increases the risk that some large payments are released too late in the day and fail, either to an agent bank or to a client.[5529]

Thus, while Tonucci was inclined to transfer as small an amount as possible, Fielding, in advocating for a larger deposit, noted the importance of intraday liquidity, and the role of clearing banks in providing that liquidity. He also noted that so long as Lehman would include this deposit in its liquidity pool, there would be no harm in making a larger deposit.

[5526] E-mail from Stirling Fielding, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (Aug. 21, 2008) [LBHI_SEC07940_547284].

[5527] *See* e-mail from Andrew Yeung, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (Aug. 23, 2008) [LBEX-SIPA 003280] (recounting Lehman's efforts to negotiate terms of the security agreement initially advanced by BofA and noting "[t]he security agreement will only secure overdraft obligations[; t]he initial draft . . . could have been interpreted to secure other debt obligations to BofA").

[5528] *See* e-mail from Paolo R. Tonucci, Lehman, to Heidimarie Echtermann, Lehman (Aug. 21, 2008) [LBHI_SEC07940_547415].

[5529] E-mail from Stirling Fielding, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (Aug. 21, 2008) [LBEX-SIPA 003306].

Ultimately, Lehman acceded to BofA's demand for the $500 million and documentation establishing a lien over the deposit via a security agreement dated August 25, 2008.[5530] The agreement provided that the $500 million collateral was transferable outside BofA only upon three-days' written notice from Lehman, and only to the extent that doing so would leave sufficient collateral to cover the aggregate amount of overdrafts Lehman incurred against BofA.[5531] With the $500 million deposit in place, encumbered by the August 25, 2008 Security Agreement, BofA continued to clear for Lehman.

The $500 million Bank of America deposit, subject to the August 25, 2008 Security Agreement, was included in Lehman's liquidity pool.[5532]

(f) LBHI and JPMorgan Executed an Amendment to the June 2000 Clearance Agreement, a Security Agreement and a Holding Company Guaranty, all Dated August 26, 2008

JPMorgan and Lehman executed an amendment to their standing Clearance Agreement (the "August Amendment"), a security agreement (the "August Security Agreement"), and a guaranty by LBHI for clearing obligations of certain of its

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[5530] *See* Security Agreement (Aug. 25, 2008) [LBEX-DOCID 000584].

[5531] *See id.* at p. 2.

[5532] *See, e.g.*, e-mail from Robert Azerad, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (Sept. 9, 2008) [LBHI_SEC07940_557814]; Lehman, Liquidity Pool Summary (Sept. 9, 2008), at pp. 2, 4 [LBHI_SEC07940_557815] (showing the $500 million BofA deposit in the liquidity pool).

subsidiaries (the "August Guaranty") on August 29, 2008 (back-dated to August 26, 2008).[5533]

The August Amendment added LBHI, LBIE, Lehman Brothers OTC Derivatives and LBJ to the standing Clearance Agreement, to which LBI, LCPI, and JPMorgan were already parties.[5534]

The August Guaranty bound LBHI to guarantee the clearing obligations of its affiliates that were parties to the Clearance Agreement, incurred under the terms of the Clearance Agreement.[5535] Under the Clearance Agreement, the Lehman borrowers were obligated to repay JPMorgan's discretionary credit advances.[5536]

The August Security Agreement established a JPMorgan lien on two specific accounts to secure obligations under the Clearance Agreement: 1) an "LCE" "Securities Account" and 2) a "DDA 066-141-605" "Cash Account."[5537] The August Security Agreement also established a lien on certain related accounts.[5538] The August Security Agreement notably provided for an "Overnight Account" into which "at the end of a business day" LBHI could transfer amounts from the liened accounts provided that it

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[5533] *See* Section III.A.5.b.1 of this Report, which discusses Lehman's dealings with JPMorgan; *see also* Amendment to Clearance Agreement (Aug. 26, 2008), at pp. 1-2 [JPM-2004 0005856]; Security Agreement (Aug. 26, 2008), at p. 6 [JPM-2004 0005867]; Guaranty (Aug. 26, 2008), at p. 6 [JPM-2004 0005879].
[5534] Amendment to Clearance Agreement (Aug. 26, 2008), at p. 1 [JPM-2004 0005856].
[5535] Guaranty (Aug. 26, 2008), at p. 1 [JPM-2004 0005879].
[5536] Clearance Agreement (June 15, 2000), at p. 4 [JPM-2004 0031786].
[5537] Security Agreement (Aug. 26, 2008), at pp. 1-2 [JPM-2004 0005867].
[5538] *Id*.

owed no outstanding obligations to JPMorgan as defined under the Clearance Agreement.[5539]

In early August, JPMorgan sought a "continuing" as opposed to an "intraday" lien on Lehman collateral.[5540] As executed, however, the August Agreements provided that Lehman's collateral was only meant to cover intraday obligations.[5541]

Lehman structured the lien provisions of the August Security Agreement, limiting the lien to its intraday clearing exposure, so that Lehman could claim the collateral as lien-free overnight for the purpose of reporting it as part of LBHI's liquidity pool.[5542] Andrew Yeung acknowledged that he received an e-mail from Dan Fleming providing this specific guidance.[5543] JPMorgan risk manager Donna Dellosso and JPMorgan's Doctoroff stated that Lehman structured the "Overnight Account" provision of the August Agreements such that Lehman could include collateral pledged

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[5539] *Id.* at p. 3; *see* Section III.A.5.b.1.f of this Report, which discusses Lehman's dealings with JPMorgan and provides greater detail on the Overnight Account.

[5540] *See* Section III.A.5.b.1.f of this Report, which discusses Lehman's dealings with JPMorgan; Examiner's Interview of Craig L. Jones, Sept. 28, 2009, at p. 13; e-mail from Craig L. Jones, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Aug. 8, 2008) [LBEX-DOCID 457557] (relaying "an urgent call from a group at Chase" in which JPMorgan "stated they want[ed] to ensure the assets have a continuing lien and not just an intraday lien").

[5541] *See* e-mail from Craig L. Jones, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (Aug. 14, 2008) [LBEX-AM 001764] ("Mark Doctoroff [of JPMorgan] called from Singapore to apologize for the issues raised when Chase requested the continuing lien acknowledging he was well aware it was only intended to be an intraday lien.").

[5542] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at pp. 9-10.

[5543] Examiner's Interview of Andrew Yeung, May 14, 2009, at p. 8 (Yeung recalled an e-mail exchange with Dan Fleming in which Fleming instructed him that Lehman had to be able to claim collateral pledged with JPMorgan was lien-free for liquidity reporting).

to JPMorgan intraday in its liquidity pool.[5544] Doctoroff was most explicit on this point, specifically stating that it was Tonucci who insisted that JPMorgan's intraday lien not extend overnight so that Lehman could include the collateral subject to the August Security Agreement in its liquidity pool.[5545]

(g) Lehman Assets Subject to the August Security Agreement Were Included in Lehman's Liquidity Pool

At least some of the assets subject to the intraday lien, memorialized in the August Security Agreement with JPMorgan, were included in the liquidity pool. Tonucci confirmed this fact in his interview with the Examiner.[5546] Doctoroff explained that he understood from Lehman that assets subject to the August Security Agreement were included in Lehman's liquidity pool.[5547] The documentary evidence confirms this point. The August Security Agreement encumbered assets in LBHI's LCE and DDA 066-141-605 accounts at JPMorgan. A snapshot of the LCE account distributed within Lehman on August 26, 2008 shows that CLOs and ABCP pledged to meet JPMorgan's margin requirements, namely Fenway, Pine, Spruce, Kingfisher and Verano, were

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[5544] Examiner's Interview of Donna Dellosso, Feb. 27, 2009, at p. 3 (Lehman informed JPMorgan that it wanted overnight access to the collateral, presumably for its overnight liquidity pool); Examiner's Interview of Mark G. Doctoroff, Apr. 29, 2009, at p. 12 (recalling that Paolo Tonucci represented that the purpose of the overnight-account provision was to preserve Lehman's ability to include in Lehman's liquidity pool collateral pledged to cover JPMorgan's intraday risk).

[5545] Examiner's Interview of Mark G. Doctoroff, Apr. 29, 2009, at p. 12. For his part Doctoroff said he was not concerned with Lehman's inclusion of JPMorgan intraday collateral in its liquidity pool because JPMorgan did not face clearing exposure to Lehman at the end of the day. *Id.* at p. 14. Further, Doctoroff was comforted by the inclusion of the collateral in the pool because of the implied liquidity of the collateral. *Id.* at p. 13.

[5546] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 19.

[5547] Examiner's Interview of Mark G. Doctoroff, Apr. 29, 2009, at pp. 17, 22-23.

located in that encumbered account.[5548] The collateral in the LCE box as shown on this chart was worth about $7.2 billion.[5549] All of these securities were included in Lehman's liquidity pool in late August as well.[5550] As of September 2008, the Pine, Spruce, Kingfisher, and Verano funds were still in the liquidity pool.[5551] As of that date, those funds were simultaneously held as collateral by JPMorgan.[5552] A JPMorgan-drafted agenda for the September 4 meeting with Lehman also makes plain that collateral placed to cover JPMorgan's margin requirements was included in the liquidity pool.[5553]

Tonucci stated that, had Lehman attempted to remove collateral posted at JPMorgan, there were "steps short of not clearing" that the bank might have taken. Perhaps, Tonucci suggested, JPMorgan would have agreed to reduce the volume of clearing in exchange for the return of some collateral.[5554] Had Lehman contracted its

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[5548] E-mail from Kristen Coletta, Lehman, to Craig L. Jones, Lehman (Aug. 26, 2008) [LBEX-DOCID 055369]; Lehman, Spreadsheet (Aug. 26, 2008) [LBEX-DOCID 046640] (showing LCE box as of August 20, 2008).

[5549] Lehman, Spreadsheet (Aug. 26, 2008) [LBEX-DOCID 046640] (showing par values for collateral in the LCE box as of August 20, 2008).

[5550] *See* Lehman, Detailed Liquidity Pool Composition, (Aug. 21, 2008), at pp. 19-20 [BARLQP0003950] (showing Spruce, Pine, Fenway, Kingfisher, and Verano securities in the liquidity pool).

[5551] Lehman, Liquidity Update (Sept. 10, 2008), at p. 3 [LBEX-WGM 725919] (showing the "[a]bility to [m]onetize" assets in the liquidity pool and listing Pine and Verano as "low" ability to monetize; Spruce is given a "mid" level ability to monetize because it is "PDCF [e]ligible"). Note that the Kingfisher securities were in the LCD, not LCE, account by this point. Thus, Kingfisher was subject to the lien provisions of Section 11 of the Clearance Agreement, rather than the lien provision of the August Security Agreement.

[5552] *See* Lehman, Collateral Pledged to JPM for Intraday As of 9/10/2008 COB [LBEX-DOCID 046681] (showing Pine, Spruce, Kingfisher and Verano funds, among others, as collateral pledged to JPMorgan).

[5553] E-mail from Emil F. Cornejo, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (Sept. 3, 2008) [LBEX-AM 000862], attaching JPMorgan Agenda (Sept. 3, 2008), at p. 2 [LBEX-AM 000863] (noting that the collateral placed as margin consisted of assets that Lehman included in its liquidity pool).

[5554] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 10.

triparty-repo book, for example, presumably less triparty-investor margin would have been required by investors overnight and retained by JPMorgan the next morning. This action arguably could have resulted in JPMorgan requiring less collateral.[5555] Moreover, through counsel, JPMorgan confirmed that Lehman could remove collateral from LCE to the extent the total value of that account did not drop below $5 billion.[5556] Although there would be no operational barrier to such a transaction, JPMorgan's counsel could not address what "alarms" would have gone off within JPMorgan had Lehman given such an instruction.[5557] Indeed, it appears that Lehman effected two such transfers: Lehman removed Freedom from LCE on August 15 and moved Kingfisher from LCE to LCD on September 2.[5558]

(h) September 2, 2008: Lehman Transferred Just Under $1 Billion to HSBC to Continue Clearing Operations, and Encumbered This with "Cash Deeds" Executed on September 9 and September 12

HSBC cleared and settled sterling-denominated securities trades for Lehman via the "CREST" system.[5559] CREST is a network of servers on which CREST members, such

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[5555] Contraction of collateral required by triparty investors overnight (and thus required by JPMorgan intraday) would have affected the amount of collateral Lehman was required to maintain in the LCD account or other LBI clearing account. *See* Section III.A.5.b.1 of this Report, which discusses Lehman's dealings with JPMorgan (Lehman posted securities to the LCD account to mitigate the effect of the margin retained by JPMorgan intraday).

[5556] Jenner & Block, Memorandum re November 16, 2009 Teleconference with JPMorgan Counsel (Nov. 16, 2009), at p. 2.

[5557] *Id*.

[5558] JPMorgan Second Written Responses, at p. 7; Jenner & Block, Memorandum re November 18, 2009 Teleconference with JPMorgan Counsel (Nov. 19, 2009), at p. 2.

[5559] *See* Section III.A.5.d.1 of this Report, which discusses Lehman's dealings with HSBC.

as LBIE, trade, using the services of a "CREST Settlement Bank" to execute those trades. HSBC was Lehman's CREST Settlement Bank. As with a bank clearing triparty repos (JPMorgan), or FX trades on the CLS system (Citi), HSBC intermediated between Lehman and counterparties seeking to make securities trades. As with other clearing and settlement banks, HSBC extended intraday credit to facilitate this function.

As set forth in further detail in Section III.A.5.d of this Report, beginning in mid-to-late 2006, HSBC began reducing its credit exposure industry-wide and to Lehman in particular. After the near collapse of Bear Stearns, those efforts were increased. By August 18, 2008, HSBC decided to exit its relationship with Lehman entirely. This decision was driven by macro-level and Lehman-specific concerns:

> The decision to withdraw is on the basis of deteriorating risk and business fundamentals, continuing performance/valuation uncertainty, capital erosion and significant Group exposure to Lehman in particular and the sector as a whole. . . . On balance, Lehman is the weakest with less diversification and relatively more exposure to troubled fixed income classes. Also, arguably, with its business model terminally damaged, it is perhaps the least likely to be saved. . . . It has $50bn of risky real estate/mortgage assets including $10bn of Alt A. It also retains $11bn of leveraged loans. Many now predict further write downs and a consequent fiscal Q3 loss (ending August) c$2bn instead of the $250m profit previously expected.[5560]

[5560] Nicholas J. Taylor, HSBC, Briefing Note – Project Milan (Aug. 18, 2008), at p. 2 [HBUS 90]. "Project Milan" was the name given by HSBC to its efforts to minimize its exposure to Lehman Brothers, and ultimately, withdraw from the relationship. Memorandum from HSBC Financial Institutions Group, re Project Milan (Aug. 2008), at p. 1 [HBUS 17459]; Examiner's Interview of Nicholas Taylor, Oct. 15, 2009, at p. 5; *see* Section III.A.5.d.1 of this Report, which discusses Lehman's dealings with HSBC.

HSBC Financial Institutions Group head Nicholas Taylor relayed this decision to Tonucci in New York on August 18.[5561] According to internal HSBC documents, Tonucci expressed surprise at Taylor's announcement, and concern over Lehman's ability to replace HSBC as a core clearing bank in markets such as the U.K. and India.[5562] Tonucci urged Taylor to discuss HSBC's concerns with Pellerani, while indicating that Lehman would "look into this and how we can reduce your risk quickly."[5563] In August, HSBC continued drawing down credit lines, working with Pellerani to determine which lines were under-utilized by Lehman.[5564]

On August 22, HSBC's Guy Bridge informed Pellerani that the bank would seek collateralization of HSBC's credit lines, formalized by a "cash deed [that] can be executed very quickly."[5565] On Wednesday, August 27, Pellerani informed Tonucci that HSBC would require Lehman to post roughly "$1 bn of deposit by Friday, with a legal right to set off, non-negotiable, or they will not settle for us."[5566] Pellerani recommended to Tonucci that Lehman "[i]nform FSA," "[i]nform FED and SEC," and "[f]ind out if

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[5561] Nicholas J. Taylor, HSBC, Briefing Note – Project Milan (Aug. 18, 2008), at p. 1 [HBUS 90].

[5562] *Id*.

[5563] *See* e-mail from Carlo Pellerani, Lehman, to Guy Bridge, HSBC, *et al.* (Aug. 27, 2008) [HBUS 3]; Lehman, Spreadsheet of Credit Lines Subject to Examination by HSBC and LBHI (Aug. 28, 2008) [HBUS 237] (created in concert with Lehman to determine utilization of lines for further reductions).

[5564] *See* e-mail from Carlo Pellerani, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (Aug. 22, 2008) [LBEX-AM 008959] ("Spoke at length yesterday and today with HSBC. They are bringing to zero all lines they see as unutilised and work on reducing exposure for the settlement lines. . . . I was unsuccessful in convincing them to be measured on [the credit lines that HSBC brought to zero].").

[5565] E-mail from Guy Bridge, HSBC, to Carlo Pellerani, Lehman, *et al*. (Aug. 22, 2008) [LBEX-AM 008906].

[5566] E-mail from Carlo Pellerani, Lehman, to Paolo R. Tonucci, Lehman (Aug. 27, 2008) [LBEX-AM 008916].

legally we can stop them from doing this."[5567] Tonucci, in turn, elevated the issue to Lowitt, communicating that a deposit by Friday was essential "if they [HSBC] are to continue clearing for us."[5568] Similarly, in enlisting in-house counsel Yeung's assistance, Lehman's Huw Rees remarked "there is a possibility that, without an agreement, our UK clearing operations will be impacted."[5569]

Subsequently, Lehman deposited GBP 435 million (nearly $800 million at the time) with HSBC in the U.K. on the morning of August 28.[5570] Following conversations between Lowitt and HSBC's Chief Risk Officer, however, on August 28 HSBC agreed to allow Lehman to temporarily retrieve the deposit and hold it until after the end of the quarter, in order "to help with [Lehman's] quarter end [balance sheet] targets."[5571]

Lehman returned GBP 435 million to HSBC in the U.K. on September 1 for value on September 2.[5572] In addition, on September 2, Lehman deposited the equivalent of approximately $180 million in a Hong Kong account.[5573]

[5567] *Id*.

[5568] E-mail from Paolo R. Tonucci, Lehman, to Ian T. Lowitt, Lehman, *et al*. (Aug. 27, 2008) [LBEX-AM 008918].

[5569] E-mail from Huw Rees, Lehman, to Andrew Yeung, Lehman, *et al*. (Aug. 28, 2008) [LBEX-AM 008941].

[5570] E-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al*. (Aug. 28, 2008) [HBUS 9250].

[5571] E-mail from Carlo Pellerani, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Aug. 28, 2008) [LBEX-AM 008853]; e-mail from Craig Goldband, Lehman, to Huw Rees, Lehman, *et al*. (Aug. 28, 2008) [LBEX-AM 008853]; *see also* e-mail from Ian T. Lowitt, Lehman, to Jeremy Isaacs, Lehman (Aug. 28, 2008) [LBEX-AM 008940].

[5572] E-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al*. (Sept. 1, 2008) [HBUS 401].

[5573] E-mail from Patricia Gomes, HSBC, to Guy Bridge, HSBC, *et al.* (Sept. 1, 2008) [HBUS 397] (stating that Hong Kong deposit is equivalent to $180 million). *But see* e-mail from Stirling Fielding, Lehman, to Carlo Pellerani, Lehman, *et al.* (Sept. 1, 2008) [LBEX-AM 008963-64] (recording instant message conference stating that Hong Kong deposit is equivalent to $192 million with unspecified credit due to Lehman).

The HSBC deposits in the U.K. were encumbered by two "Cash Deeds" executed on September 9, 2008 by LBHI(U.K.) and LBIE (the "U.K. Cash Deeds").[5574] One Cash Deed provided that LBHI(U.K.) was required to maintain a deposit with HSBC equal to the amount that HSBC estimated, in its good faith, was required to cover aggregate intraday exposures to LBHI(U.K.), LBIE, and Lehman Brothers Limited.[5575] The deposit was only available to Lehman provided that HSBC was satisfied that none of these specified Lehman entities owed any outstanding debt to HSBC.[5576] HSBC had the right to setoff against the deposit.[5577] The LBHI(U.K.) Cash Deed formally recognized that any extension of credit by HSBC to the same three Lehman entities was left to HSBC's discretion.[5578]

A third Cash Deed was to be executed between HSBC and Lehman Brothers Asia Holdings Limited ("LBAH") to secure the Hong Kong deposit (the "Hong Kong Cash Deed").[5579] The funds, however, were not moved into a collateral account until after the petition date. At Lehman's request, the funds were moved back into a cash account on

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The Examiner's investigation has not revealed any other references to a Hong Kong deposit equivalent to $192 million. The Examiner's financial advisors identified a September 1 transfer equivalent to $192 million from a Lehman Brothers Asia Holdings money market account, but were not able to determine if all of these funds were used for a deposit. Duff & Phelps, Preliminary Findings re: HSBC Deposits (Dec. 2, 2009), at p. 2.

[5574] Cash Deed between HSBC and LBHI(U.K.) (Sept. 9, 2008) [HBUS 1190]; Cash Deed between HSBC and LBIE (Sept. 9, 2008) [HBUS 1180].

[5575] Cash Deed between HSBC and LBHI(U.K.) (Sept. 9, 2008), ¶ 5 [HBUS 1190].

[5576] *Id.* ¶ 6.

[5577] *Id.* ¶ 4.

[5578] *Id.* ¶ 10.

[5579] E-mail from Patricia Gomes, HSBC, to Nicholas Taylor, HSBC, *et al*. (Sept. 12, 2008) [HBUS 1760].

September 16, 2008 (that was subsequently frozen on September 19 by KPMG, the provisional liquidators for LBAH).[5580]

(i) The HSBC Deposit Was Represented as "Liquid" and Was Included in LBHI's Liquidity Pool

Tonucci confirmed that the total HSBC deposit, valued at almost $1 billion, was included in LBHI's liquidity pool.[5581] Documents, including liquidity presentations and "ability to monetize" tables prepared during Lehman's final week before bankruptcy, reveal that approximately $1 billion of Lehman's liquidity pool was earmarked "HSBC," and assigned a "low" ability to monetize.[5582] The deposit was maintained in the liquidity pool despite the fact that it was placed with HSBC as a precondition for HSBC's clearance of trades in vital markets, that the deposit could not be removed unless Lehman zeroed its exposure with HSBC, and that HSBC held a clear right of setoff against the deposit.

(j) Lehman and JPMorgan Executed Another Round of Security Documentation Dated September 9, 2008; Lehman Made $3.6 Billion and $5 Billion Pledges to JPMorgan Subject to the Terms of These Agreements

On the eve of Lehman's accelerated earnings announcement, scheduled to be delivered September 10, 2008, JPMorgan engaged various senior officials at Lehman and advised that they were seeking a new round of security documentation. JPMorgan

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[5580] *Id.*

[5581] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 19.

[5582] *See, e.g.*, Lehman, Liquidity Update (Sept. 10, 2008), at p. 3 [LBEX-WGM 725919]; Lehman, Ability to Monetize Table (Sept. 12, 2008) [LBEX-WGM 784607].

insisted that Lehman execute the documents before the commencement of the next morning's earnings call.[5583]

The new agreements consisted of a revised Security Agreement, a revised Guaranty, and a new Amendment to the Clearance Agreement. The new documentation expanded JPMorgan's rights over Lehman collateral. For instance, the new Security Agreement and Guaranty gave JPMorgan a security interest in all Lehman accounts (save the "Overnight Account") to secure all Lehman obligations to JPMorgan – not simply clearance-related obligations.[5584] Unlike the August Security Agreement, under the September Security Agreement collateral was returnable to Lehman only upon three-days written notice to JPMorgan,[5585] a provision inserted at Lehman's request for liquidity reporting purposes.[5586]

On September 9, JPMorgan requested $5 billion of additional collateral from Lehman and Lehman agreed to post $3 billion immediately. Lehman posted $1 billion in cash and $1.7 billion in money market funds on September 9. Lehman then posted

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[5583] Examiner's Interview of Andrew Yeung, March 13, 2009, at p. 4; Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 13.

[5584] *See* Guaranty (Sept. 9, 2008), at p. 1 [JPM-2004 0005813]; Security Agreement (Sept. 9, 2008), at p. 1 [JPM-2004 0005873].

[5585] Security Agreement (Sept. 9, 2008), at p. 3 [JPM-2004 0005873].

[5586] E-mail from Mark G. Doctoroff, JPMorgan, to Jane Buyers-Russo, JPMorgan, *et al*. (Sept. 9, 2008) [JPM-EXAMINER00005933] (noting that Doctoroff "[j]ust spoke to Dan Fleming. The one condition they [Lehman] want in giving us [a] lien against [the collateral] is that they have a 3-day notice period to call the cash [collateral] back -- this will allow them to count the cash as part of their liquidity pool. . . . If not able to provide this, then . . . there is the public issue of their liquidity pool having to drop . . . .").

$300 million in cash the following day. On September 11, Lehman delivered an additional $600 million in cash to JPMorgan.[5587]

JPMorgan demanded $5 billion more in cash collateral on September 11, 2008, which Lehman provided by the afternoon of September 12.[5588] Although the collateral was posted pursuant to the September Agreements, which covered all Lehman obligations to JPMorgan – not just intraday exposures – Lehman believed that JPMorgan's demand for $5 billion was solely for intraday purposes.[5589] An e-mail sent by JPMorgan to Lehman memorializing the transaction, however, contains no mention of returning the collateral to Lehman at the end of the day.[5590]

(k) Lehman Made a Deposit to Bank of New York Mellon to Cover Intraday Exposure, and Included That Deposit in Its Liquidity Pool

On September 1, 2008, Lehman's Graham Kettle informed Pellerani that Bank of New York Mellon ("BNYM"), one of Lehman's clearance and settlement banks, was seeking to "eliminate any intraday exposure."[5591] In response, on September 11, 2008, LBHI and BNYM's London branch executed an agreement that required Lehman to deposit $125 million initially and thereafter maintain a collateral account with at least

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[5587] *See* Section III.A.5.b.1.g of this Report, which discusses Lehman's dealings with JPMorgan.
[5588] *See id*.
[5589] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 16.
[5590] E-mail from Jane Buyers-Russo, JPMorgan, to Paolo R. Tonucci, Lehman, *et al.* (Sept. 11, 2008) [JPM-2004 0005411].
[5591] E-mail from Graham Kettle, Lehman, to Carlo Pellerani, Lehman, *et al.* (Sept. 1, 2008) [LBEX-DOCID 065890].

$50 million – with more required if BNYM forecasted greater intraday exposure.[5592] The funds were transferred to BNYM's London branch by LBHI(U.K.).[5593]

There is evidence that Lehman included this deposit in its liquidity pool.[5594] While the deposit was subject to BNYM's contractual right of setoff and was placed to cover the bank's intraday exposure to Lehman, thus facilitating BNYM's settlement activity, Kettle relayed to Pellerani that the deposit would "not [a]ffect the liquidity pool."[5595] Pellerani responded: "Disagree with that view. If we need to have this locked up then there is an argument for this not to be available liquidity."[5596] Lehman's Emil

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[5592] E-mail from Gerry Barber, BNYM, to Carlo Pellerani, Lehman, *et al*. (Sept. 11, 2008) [LBEX-DOCID 1065087] (attaching "Final Version" of collateral deposit agreement); Collateral Deposit Agreement between Lehman Brothers Holdings, Inc. and the Bank of New York Mellon, London Branch (Sept. 11, 2008), §§ 1.1, 2.3 [LBEX-DOCID 1031225] (setting minimum deposit at $50 million). The agreement allowed BNYM to set off "all present and future monies, obligations and liabilities" LBHI or other specified Lehman entities owed under any "legal documentation . . . related to the issuance of securities." *Id.* §§ 1.1, 4. If any of BNYM's agreements with Lehman required BNYM to make a payment on Lehman's behalf, Lehman had three business days to repay BNYM, after which BNYM could withdraw an equivalent amount from the collateral deposit. *Id.* § 3. Lehman was entitled to direct BNYM to transfer any excess collateral out of the account. *Id.* § 3.1.5. Further, BNYM could, in its "absolute discretion," allow Lehman to withdraw funds from the collateral account even though Lehman was not otherwise entitled to do so under the agreement. *Id.* § 5.3.

[5593] *See* e-mail from Graham Kettle, Lehman, to Huw Rees, Lehman, *et al.* (Sept. 12, 2008) [LBEX-DOCID 65923] (announcing successful payment of $120 million to BNYM by LBHI(U.K.), per the agreement).

[5594] *See* e-mail from Emil F. Cornejo, Lehman, to Daniel J. Fleming, Lehman *et al*. (Sept. 8, 2008) [LBEX-DOCID 065890] (indicating that Lehman would include the collateral in its liquidity pool after the collateral deposit agreement was executed). Lehman authorized BNYM to invest the "Collateral Account" in a "Dreyfus Cash Management Plus" money fund. Collateral Deposit Agreement between Lehman Brothers Holdings, Inc. and the Bank of New York Mellon, London Branch (Sept. 11, 2008), at p. 20 (Schedule 3) [LBEX-DOCID 1031225]. Lehman directed that the $125 million BNYM deposit be invested in that Dreyfus fund. E-mail from Graham Kettle, Lehman, to Scott Alvey, Lehman, *et al.* (Sept. 10, 2008) [LBEX-DOCID 1065130]; Lehman included this money fund in its liquidity pool. Lehman, Detailed Liquidity Pool Composition (Sept. 11, 2008) at pp. 7, 9 [LBEX-BARLQP 0003839].

[5595] E-mail from Graham Kettle, Lehman, to Carlo Pellerani, Lehman, *et al.* (Sept. 8, 2008) [LBEX-DOCID 065890].

[5596] E-mail from Carlo Pellerani, Lehman, to Graham Kettle, Lehman, *et al.* (Sept. 8, 2008) [LBEX-DOCID 065890].

Cornejo, in turn, responded that the deposit was not structured as a formal "pledge" and was instead only in a "Lehman account, with some right of offset," implying that it could be counted in the liquidity pool.[5597] In his interview with the Examiner, Pellerani rejected the "pledge" versus "deposit" distinction, and expressed his view that the BNYM deposit was not appropriate for the liquidity pool.[5598] Pellerani, however, said he did not know that the BNYM – or any other – clearing-bank collateral was included in Lehman's liquidity profile.[5599]

(l) The Cumulative Impact of Lehman's Inclusion of Clearing-Bank Collateral and Deposits in Its Liquidity Pool

Tonucci confirmed that by the second week of September 2008, a material portion of LBHI's liquidity pool had become locked up as assets that were transferred to Lehman's clearing banks.[5600] This trend began in June 2008 as Lehman attempted to navigate the competing demands of providing clearing banks with adequate security and preserving Lehman's public liquidity pool numbers. In its attempts to strike a balance between these demands, Lehman included both the billions of dollars in collateral for JPMorgan's margin requirements and the $2 billion Citibank comfort deposit in its liquidity pool. In addition to the JPMorgan and Citibank amounts, by late

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[5597] E-mail from Emil F. Cornejo, Lehman, to Daniel J. Fleming, Lehman *et al*. (Sept. 8, 2008) [LBEX-DOCID 065890].

[5598] Examiner's Interview of Carlo Pellerani, Jan. 13, 2010, at pp. 4-5.

[5599] *Id.* at p. 4.

[5600] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 19.

summer Lehman was also including in its liquidity pool $500 million in Bank of America collateral, and nearly $1 billion in HSBC collateral. Lehman's liquidity pool was further encumbered in the second week of September 2008, when Lehman pledged more than $8 billion of additional collateral to JPMorgan under the September Agreements, and when Citibank and HSBC obtained formal rights of setoff and security interests in Lehman's deposits.

These collateral calls and intraday credit usages were satisfied from Lehman's liquidity pool, without that fact being disclosed to the market or to significant market participants such as rating agencies. The lack of disclosure is particularly evident when the "liquidity updates" and "ability to monetize" charts produced by Lehman during the week of September 8 are compared to Lehman's public disclosures.[5601] For example, the "Liquidity Summary as of 9/13"[5602] deck circulated within Lehman, and distributed to the SEC and FRBNY (the first time Lehman had circulated such data), described Lehman's "[r]eportable [l]iquidity" in the context of the "[a]bility to [m]onetize" that putative liquidity.[5603] Lehman ended the prior week with a reportable pool of $42.1

[5601] *See, e.g.*, Lehman, Liquidity Update (Sept. 11, 2008), at p. 2 [LBEX-WGM 784543].

[5602] Lehman, Liquidity Summary (Sept. 13, 2008) [LBEX-DOCID 647325] (attachment containing "ability to monetize" chart); e-mail from Robert Azerad, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Sept. 13, 2008) [LBEX-DOCID 717430] (attaching same).

[5603] Lehman, Liquidity Summary (Sept. 13, 2008) [LBEX-DOCID 647325] (attachment containing "ability to monetize" chart); e-mail from Robert Azerad, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Sept. 13, 2008) [LBEX-DOCID 717430] (attaching chart); e-mail from Laura M. Vecchio, Lehman, to Michael A. Macchiaroli, SEC, *et al*. (Sept. 14, 2008) [LBEX-DOCID 69577] (distributing same to the SEC); e-mail from Laura M. Vecchio, Lehman, to Jan H. Voigts, FRBNY (Sept. 14, 2008) [LBEX-DOCID 731444] (distributing

billion, and a highly monetizable portion of that pool of $33.8 billion.[5604] On September 10, as the effects of the security documentation demanded by Lehman's clearing banks and JPMorgan's September 9 cash collateral pledge took hold, Lehman's reportable liquidity declined to $37.6 billion, while the "low" ability to monetize portion jumped to $27.3 billion.[5605] Finally, by Friday, September 12, Lehman's last day operating as a going concern, the firm's reportable liquidity dropped and, reflecting the impact of JPMorgan's $5 billion collateral call, $30.1 billion of $32.5 billion reportable liquidity was classified as assets with a "low" ability to monetize.[5606] In other words, only $2.4 billion of Lehman's $32.5 billion liquidity pool was readily convertible to cash on September 12. Another internal Lehman document succinctly captures the impact of including the clearing-bank collateral in the liquidity pool on Lehman's ability to monetize that pool; as of September 12, 2008:[5607]

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same to FRBNY). The September 13 deck is the first instance of which the Examiner is aware of any disclosure to Lehman's regulators of the firm's "ability to monetize" the liquidity pool.

[5604] Lehman, Liquidity Summary (Sept. 13, 2008) [LBEX-DOCID 647325].

[5605] *Id.*

[5606] *Id.*

[5607] Lehman, Ability to Monetize Table (Sept. 12, 2008) [LBEX-WGM 784607] (handwriting in the original).

Ability to Monetize	Collateral Type	12-Sep	Comment
High	UK Deposit	216	
	US Deposit	560	Citi, JPM (on top of prefunding)
	US Money Funds	96	
	Boxed assets	562	Boxed Inventory in LBIE
Total		**1,434**	
Mid	US CLO	734	Spruce - PDCF Eligible
	US Money Funds	200	LOTC upstreamable bal.
Total		**934**	
Low	US CLO	2,490	Sasco, Kingfisher, Verano
	UK Bond Funds	522	Pioneer
	US Deposit	9,400	Citi, BOA, JPM
	UK Deposit	947	HSBC, etc
	UK Money Funds	904	JPM
	US Money Funds	750	JPM, Dreyfus
	Cash at Banks	360	various entities in Asia
	Boxed assets	4,709	LBI box lock up
	Boxed assets	10,039	LBIE box lock up
Total		**30,121**	
Total Liquidity Pool		**32,489**	

SEC analyst Michael Hsu, realized, albeit on September 12, 2008, that Lehman's pool of purportedly liquid assets was mostly composed of assets placed to secure clearing-bank risk. His reaction presaged LBHI's liquidity reckoning, due the coming Monday. "Key point," Hsu wrote: "[L]ehman's liquidity pool is almost totally locked up with clearing banks to cover intraday credit ($15bn with jpm, $10bn with others like citi and bofa). This is a really big problem."[5608]

Lehman's own post-mortem analysis (prepared by Tonucci and Azerad) reflects the fact that Lehman's liquidity crisis was traceable to the inclusion of clearing-bank deposits and pledges in the pool. Four slides throughout the deck, "Liquidity of Lehman Brothers," implicate the usage of intraday liquidity as clearing-bank collateral

[5608] E-mail from Michael Hsu, SEC, to Til Schuermann, FRBNY (Sept. 12, 2008) [FRBNY to Exam. 014851].

as a significant factor in LBHI's bankruptcy filing.[5609] Indeed, according to the Tonucci-Azerad analysis, the depletion of the liquidity pool appears to have been the immediate cause of LBHI's bankruptcy filing. That analysis concludes:

> Post earnings announcement on September 9[, 2008], Holdings' liquidity decreased . . . from $41 billion to $25 billion – $16 billion of which was required by clearing banks at the start of the day and approximately $7 billion of which was in liquid securities that became near impossible to monetize immediately in this extremely stressed market environment – primarily because of a loss of repo capacity.
>
> As a result, . . . "free cash" available intra day was less than $2 billion. With LBIE facing a projected cash shortage of $4.5 billion on September 15, Lehman had no choice but to place LBIE into administration because of potential director liability. This resulted in a cross-default of and triggered the filing [of LBHI] on September 15.[5610]

(5) Disclosures Concerning the Inclusion of Clearing-Bank Collateral in Lehman's Liquidity Pool

(a) Lehman Did Not Disclose on Its June 16, 2008 Second Quarter Earnings Call That It Was Including the $2 Billion Citi "Comfort Deposit" in Its Liquidity Pool

Lowitt led the portion of Lehman's June 16, 2008 second quarter earnings call concerning Lehman's liquidity position. He stated: "we have significantly increased . . . our liquidity pool to $45 billion from $34 billion."[5611] Lowitt did not disclose that between the end of the quarter (May 31, 2008) and the June 16 call that Lehman had

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[5609] *See* Lehman, Liquidity of Lehman Brothers (Oct. 7, 2008), at pp. 4, 7, 9, 15 [LBEX-WGM 787681]. Tonucci said that he directed Azerad to prepare the deck and that it reflects Tonucci's analysis. Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 20.

[5610] Lehman, Liquidity of Lehman Brothers (Oct. 7, 2008), at p. 9 [LBEX-WGM 787681]. Note that while the presentation states that the earnings announcement occurred on September 9, it in fact occurred on September 10.

[5611] Final Transcript of Lehman Brothers Holdings Inc., Second Quarter 2008 Earnings Call (June 16, 2008), at p. 10 (statement of Ian T. Lowitt).

placed a $2 billion "comfort deposit" (on June 12) with Citigroup to allay Citigroup's intraday risk concerns.

A number of factors militate against the potential impropriety, or materiality, of such a non-disclosure of the Citi deposit: (1) Lehman believed the deposit to be "lien-free" and did not grant Citi the right to setoff;[5612] (2) the deposit was understood to simply cover intraday risk and was callable by Lehman daily;[5613] and (3) market conditions were probably not yet such that Citi would have refused to return the deposit. The Examiner is aware, for example, that Lehman requested, and Citibank granted, the return of $210 million of this deposit on June 30, 2008.[5614]

(b) Lehman Did Not Disclose in Its Second Quarter 2008 10-Q, Filed July 10, 2008, That It Was Including Both the $2 Billion Citibank "Comfort Deposit" and Approximately $5.5 Billion of Securities Collateral Pledged to JPMorgan in Its Liquidity Pool

Lehman filed its 10-Q for the second quarter of 2008 on July 10, 2008. Lowitt signed the certification. The 10-Q disclosed the following regarding Lehman's liquidity and liquidity pool:

> The funding market environment became very challenging during the second quarter of 2008 as a series of credit and liquidity events . . . resulted in a sharp decrease in the supply of liquidity in March, which was partially reversed in April and May. Despite this difficult

[5612] *See* e-mail from Daniel J. Fleming, Lehman to Ian T. Lowitt, Lehman, *et al.* (June 12, 2008) [LBEX-AM 008608].

[5613] Lehman, Citigroup Agenda (June 17, 2008), at p. 2 [LBEX-AM 008597].

[5614] *See, e.g.*, e-mail from Michael Mauerstein, Citigroup, to Christopher M. Foskett, Citigroup (June 30, 2008) [CITI-LBHI-EXAM 00074989]. Lehman replenished the deposit the morning of the next business day. *Id.*

> environment, the Company strengthened its liquidity position, finishing the quarter with record levels of liquidity. . . . The Company's liquidity pool at May 31, 2008 was approximately $45 billion, up from approximately $34 billion at February 29, 2008 and $35 billion at November 30, 2007.[5615]

The 10-Q further characterized Lehman's liquidity pool as "unencumbered." Recounting the "[e]stimated values of the liquidity pool," the 10-Q referred to "the liquidity pool and other unencumbered (*i.e.*, unpledged) asset portfolios . . . ."[5616]

While the data in the 10-Q represented data for the second quarter of 2008, which ended May 31, 2008, the 10-Q itself was filed July 10, 2008. Between the end of the reporting period and the filing date:

- Lehman made its $2 billion Citibank "comfort deposit" (June 12, 2008) that was simultaneously included in Lehman's liquidity pool;[5617] and
- Lehman began pledging securities collateral to JPMorgan to mitigate the effects of JPMorgan's margin requirements for triparty collateral (June 19, 2008 and dates following). The securities collateral was apparently owned initially by LCPI and placed in an LBI collateral account at JPMorgan. Pursuant to a June 2000 Clearance Agreement between JPMorgan and LBI, JPMorgan had a lien on collateral in such accounts.[5618] As of the 10-Q filing date, Lehman simultaneously counted Spruce, Pine, SASCO, Kingfisher and Fenway securities in both its liquidity pool and clearing accounts maintained

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[5615] LBHI 10-Q (July 10, 2008), at p. 80.

[5616] *Id.* at p. 81.

[5617] Lehman Brothers, Detailed Liquidity Pool Composition (July 10, 2008), at p. 7 [LBEX-BARLQP 0002443] (showing $2 billion Citibank deposit in the liquidity pool).

[5618] *See* Clearance Agreement (June 15, 2000), at pp. 11-12 [JPM-2004 0031786] amended by Amendment to Clearance Agreement (May 30, 2008), at p. 1 [JPM-2004 0085662] (establishing a "lien upon . . . every account" maintained by a party to the Clearance Agreement with JPMorgan). At least as of late July 2008, Lehman personnel acknowledged in internal e-mails that JPMorgan had a lien over some of the collateral placed to mitigate margin requirements. *See* e-mail from Craig L. Jones, Lehman, to James W. Hraska, Lehman (July 31, 2008) [LBEX-DOCID 077621] (noting that "Chase has taken an official lien over $5 bn [of collateral]").

with JPMorgan.[5619] Lehman included approximately $5.5 billion of JPMorgan margin collateral in its liquidity pool as of the filing date.[5620]

(c) Lehman Did Not Disclose On Its September 10, 2008 Earnings Call That a Substantial Portion of Its Liquidity Pool Was Encumbered by Clearing-Bank Pledges

On September 10, 2008, Lehman held its third quarter 2008 earnings announcement via conference call. Lowitt led the portion of the call updating investors on Lehman's liquidity position. Lowitt's remarks on Lehman's liquidity pool were as follows:

> I will now provide an update on our liquidity position, which remains very strong. We maintained our cash capital surplus at $15 billion at the end of the third quarter. Our liquidity pool also remains strong at $42 billion, versus a record $45 billion at May 31. The decline in this figure versus the end of the second quarter is strictly attributable to our managing down our commercial paper outstandings, which ended the quarter at $4 billion versus $8 billion at the end of the second quarter . . . . Through last night, our liquidity pool remained essentially unchanged at $41 billion.[5621]

Lowitt did not disclose that Lehman, as of the night before the earnings call, included in its liquidity pool:

[5619] *Compare* Lehman, Detailed Liquidity Pool Composition (July 10, 2008), at pp. 20-21 [LBEX-BARLQP 0002443] (showing Spruce, Pine, SASCO, Kingfisher, and Fenway securities in the liquidity pool), *with* Duff & Phelps, JPMC Collateral Account "LCD" Position Summary, showing the contents of the LCD account as of July 10, 2008 (Jan. 3, 2010) (showing Fenway, Kingfisher, Pine, SASCO and Spruce in the LCD account).

[5620] Duff & Phelps, JPMC Collateral Account "LCD" Position Summary, showing the contents of the LCD account as of July 10, 2008 (Jan. 3, 2010) (the combined trade value of the Fenway, Kingfisher, Pine, SASCO, and Spruce securities in both the encumbered LCD account and in the liquidity pool was $5,457,847,089).

[5621] Final Transcript of Lehman Brothers Holdings Inc., Third Quarter 2008 Earnings Call (Sept. 10, 2008), at p. 11.

- Roughly $4 billion of CLOs pledged to JPMorgan (Spruce, SASCO, Pine, Kingfisher, and Verano);[5622]
- $2.7 billion in cash and money market funds pledged to JPMorgan on September 9, 2008;[5623]
- The $2 billion Citibank cash deposit, subject to a right of setoff formalized in a Guaranty Amendment executed between Citi and Lehman the evening of September 9, 2008;[5624]
- The $500 million Bank of America cash deposit, subject to a Security Agreement executed between Bank of America and Lehman on August 25, 2008; and[5625]
- The nearly $1 billion collateral deposit with HSBC, subject to a right of setoff formalized against the U.K. deposit by the U.K. Cash Deeds executed between HSBC and LBHI(U.K.) and LBIE on September 9, 2008.[5626]

Lowitt also did not disclose that Lehman and JPMorgan executed expanded security documentation on the morning of September 10, before the earnings call. This documentation granted JPMorgan a security interest in practically all Lehman accounts

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[5622] *Compare* Duff & Phelps, JPMC Collateral Account "LCE" – Position Summary for Sept. 9, 2008 (Jan. 3, 2010) (showing Spruce, Pine and Verano located in the LCE account), *and* Duff & Phelps, JPMC Collateral Account "LCD" - Position Summary for Sept. 9, 2008 (Jan. 3, 2010) (showing SASCO and Kingfisher in the LCD), *with* Lehman, Liquidity Pool Summary (Sept. 9, 2008), at pp. 1-2 [LBHI_SEC07940_557815] (showing Spruce, Pine, Verano, SASCO and Kingfisher securities in the liquidity pool) (attached to e-mail from Robert Azerad, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (Sept. 9, 2008) [LBHI_SEC07940_557814]) (the total value of the securities depends on whether one aggregates the values in the LCD and LCE position summaries, or whether one aggregates those in the liquidity pool summary; in the former the combined value of the securities is $4,668,490,656, for the latter the combined value is $3,994,841,869).

[5623] *See* Section III.A.5.b.1.g of this Report, which discusses Lehman's dealings with JPMorgan, and its pledges to JPMorgan in particular; JPMorgan Second Written Responses, at p. 9; Lehman, Collateral Pledged to JPM for Intraday As of 9/12/2008 COB [LBEX-AM 047008]; *see also* e-mail from Mark G. Doctoroff, JPMorgan, to Jane Buyers-Russo, JPMorgan, *et al.* (Sept. 9, 2008) [JPM-2004 0032520]; e-mail from Daniel J. Fleming, Lehman, to Paolo R. Tonucci, Lehman (Sept. 9, 2008) [LBEX-DOCID 0073380].

[5624] Lehman, Liquidity Pool Summary (Sept. 9, 2008), at pp. 2, 4 [LBHI_SEC07940_557815] (attached to e-mail from Robert Azerad, Lehman, to Paolo R. Tonucci, Lehman, *et al*. (Sept. 9, 2008) [LBHI_SEC07940_557814]).

[5625] Lehman, Liquidity Pool Summary (Sept. 9, 2008), at pp. 2, 4 [LBHI_SEC07940_557815].

[5626] *Id*.

at JPMorgan for all Lehman exposures to JPMorgan – beyond those exposures related to triparty clearance.

Reproduced below is a snapshot of Lehman's liquidity pool, on the evening of September 9, 2008, extracted from one of Lehman's internal documents. It reflects that the collateral pledges itemized above were included in the pool, reducing Lehman's "ability to monetize" that reserve:[5627]

	A	B	C	D
1				
2	**Ability to Monetize**	**Collateral Type**	**Pledge Value**	**Comment**
3	High	UK EMF	941	ECB Eligible
4		US Deposit	740	Citi, JPM (on top of prefunding)
5		UK Money Funds	3,833	
6		US Money Funds	14,916	
7		Agencies	1,250	Boxed Inventory in LBHINY
8		Various securities	2,979	Boxed Inventory in LBIE
9	**Total**		**24,659**	
10	Mid	US CLO	734	Spruce - PDCF Eligible
11		US Money Funds	200	LOTC upstreamable bal.
12	**Total**		**934**	
13	Low	US CLO	3,231	Sasco, Pine, Kingfisher, Verano
14		UK Bond Funds	533	Pioneer
15		US Deposit	3,500	Citi, BOA, JPM
16		UK Deposit	970	HSBC, etc
17		UK Money Funds	924	JPM
18		US Money Funds	1,220	JPM, Dreyfus
19		US Trust Investment	408	JPM
20		Cash at Banks	360	various entities in Asia
21		Various securities	2,148	LBI box lock up / Pending
22		Various securities	1,697	LBIE box lock up
23	**Total**		**14,991**	
24				
25	**Total Liquidity Pool**		**40,584**	

While the total size of the pool was approximately $40.6 billion, Lehman managers had determined that they had a "high" ability to monetize approximately $25 billion of the pool, a "mid" ability to monetize approximately $1 billion of the pool, and only a "low" ability to monetize approximately $15 billion, or 37%, of the total pool.

[5627] *Id.* at p. 4.

(d) Senior Executives Did Not Disclose to the Board of Directors at the September 9, 2008 Finance Committee Meeting the Fact That a Substantial Portion of Its Liquidity Pool Was Encumbered by Clearing-Bank Pledges

The Finance and Risk Committee of the Board of Directors for LBHI met at 10:00 a.m. on September 9, 2008.[5628] Present for the Board were Henry Kaufman, John Akers, Roger Berlind, Marsha Johnson Evans and Roland Hernandez.[5629] Lehman officers present by invitation were Lowitt, O'Meara, Tonucci, and Jeffrey Welikson.[5630]

According to Committee minutes, Tonucci updated the Committee on LBHI's liquidity and capital, as well as general market conditions, over the third quarter of 2008.[5631] Board minutes, as well as a deck prepared to guide Tonucci's presentation, show that Tonucci debriefed the Committee on the status of Lehman's liquidity pool, cash capital, commercial paper, and secured funding, among other topics related to liquidity.[5632] The deck accompanying Tonucci's presentation states: "Despite [the] challenging market environment, Lehman Brothers was able to broadly maintain the status quo in terms of liquidity[.]"[5633]

[5628] Lehman Brothers Holdings Inc., Minutes of Meeting of Finance and Risk Committee (Sept. 9, 2008), at p. 1 [LBEX-AM 059210].

[5629] *Id*.

[5630] *Id*.

[5631] *Id.* at pp. 1-2.

[5632] *Id.* at p. 2.

[5633] Lehman, Finance & Risk Committee of the Board, Risk, Liquidity, Capital And Balance Sheet (Sept. 9, 2008), at p. 2 [LBEX-AM 067342].

Absent from either the Committee minutes, or the deck guiding Tonucci's presentation, is any disclosure of significant events affecting the liquidity pool over the course of the third quarter,[5634] including:

- On June 12, 2008, Lehman provided Citi with a $2 billion cash deposit to allay Citi's intraday risk concerns, and that this deposit was simultaneously included in the liquidity pool;
- On or about June 19, 2008, Lehman began pledging more than $5 billion in securities to JPMorgan to mitigate the effects of its margin requirements for triparty repo, and that many of the securities pledged were included in Lehman's liquidity pool;
- LBHI and BofA executed a security agreement dated August 25, 2008 that granted BofA a security interest in a $500 million collateral deposit, which was also included in Lehman's liquidity pool;
- LBHI and JPMorgan executed a security agreement dated August 26, 2008 that granted JPMorgan a security interest in the LCE account. Collateral in this account was included in Lehman's liquidity pool, on the rationale that it was lien-free at night. JPMorgan required almost all of that collateral to be returned to the encumbered accounts every morning, however, to facilitate the daily unwind of triparty repos; and
- On August 28, 2008, Lehman transferred at HSBC's request approximately $1 billion in collateral to HSBC to secure the intraday clearing and settlement risk. HSBC returned that collateral to Lehman the same day to assist Lehman with month-end reporting. Lehman returned the collateral to HSBC on September 1, 2008. This collateral was simultaneously counted in Lehman's liquidity pool.

In his interview with the Examiner, the Chairman for the Board's Finance and Risk Committee, Dr. Henry Kaufman, stated that he was never told that Lehman

[5634] Tonucci did not disclose that Lehman executed documentation on September 9, 2008 with Citibank and HSBC, strengthening the claim of those banks on Lehman collateral, although it should be noted that those documents were executed *after* the 10:00 am Committee meeting. Likewise, the September Agreements between LBHI and JPMorgan, which also strengthened JPMorgan's claim on Lehman collateral, were executed the morning of September 10 (*i.e.*, after the Committee meeting).

included clearing-bank collateral in its liquidity pool.[5635] However, Kaufman did not think it was improper to include this collateral in the pool, from a reporting sense.[5636] Under the circumstances such as Lehman faced the week of September 8, Kaufman thought it would have been impossible for Lehman to obtain and maintain adequate liquidity to save itself.[5637]

Other Directors, with one exception, made statements similar to Kaufman's view. Director Roger Berlind said he did not recall much discussion over the effect of collateral calls on Lehman's liquidity; indeed he was not concerned about collateral demands because of Lehman's "record levels" of liquidity.[5638] He said he assumed that funds pledged intraday were included in the liquidity pool.[5639] Director Thomas Cruikshank said he had no knowledge as to whether Lehman included clearing-bank collateral, or difficult-to-monetize assets in its liquidity pool.[5640] Neither the Board nor the Audit Committee reviewed the liquidity pool in that level of detail, he said.[5641] Director Sir Christopher Gent said he did not recall any discussion over pledged assets being included in Lehman's liquidity pool;[5642] Gent said that Lehman's management repeatedly assured the Board that assets in the liquidity pool were appropriate for the

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[5635] Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at pp. 3, 12.
[5636] *Id*.
[5637] *Id*. at p. 20.
[5638] Examiner's Interview of Roger Berlind, May 8, 2009, at p. 2.
[5639] *Id*.
[5640] Examiner's Interview of Thomas Cruikshank, Oct. 8, 2009, at p. 9.
[5641] *Id*.
[5642] Examiner's Interview of Sir Christopher Gent, Oct. 21, 2009, at p. 13.

pool.[5643] Director Jerry Grundhofer said he could not recall whether Lehman's management disclosed that intraday clearing-bank collateral was included in the liquidity pool;[5644] but stated that the inclusion of intraday collateral would not concern him because Lehman had other sources of liquidity and that it could negotiate with counterparties to effect the return of intraday collateral.[5645] Grundhofer said the issue to him was what percentage of Lehman's total liquidity consisted of intraday collateral.[5646] When pressed for what percentage of the liquidity pool would have been "significant" to him, Grundhofer said that ultimately it did not matter whether Lehman had $30 billion or $50 billion in its liquidity pool, because a run on the bank would have depleted all liquidity.[5647] Grundhofer also had confidence that if Lehman's inclusion of intraday collateral in its liquidity pool were an issue, that Lehman's management would have informed the Board.[5648]

Director Marsha Johnson Evans, however, stated that she did not focus on whether funds pledged to clearing banks were included in Lehman's liquidity pool, but said that her impression was that such assets should not be included in the pool.[5649]

[5643] *Id*. at p. 3.
[5644] Examiner's Interview of Jerry A. Grundhofer, Oct. 15, 2009, at p. 6.
[5645] *Id*.
[5646] *Id.*
[5647] *Id*.
[5648] *Id*. at p. 2.
[5649] Examiner's Interview of Marsha Johnson Evans, May 22, 2009, at p. 3.

(e) Lehman Officers Did Not Disclose to the Board of Directors That Its Liquidity Position Was Substantially Impaired by Collateral Held at Clearing Banks Until the Evening of September 14, 2008

The Board of Directors convened the evening of September 14, 2008, to discuss, among other things, the status of its prospective deal for a sale to Barclays, the deterioration of the firm's financial condition and the possibility of filing bankruptcy and winding down the firm.[5650] The Board voted to file for Chapter 11 bankruptcy at the conclusion of the meeting.[5651]

It was only at this meeting that Lehman officers, namely Chief Legal Officer Thomas Russo and Lowitt, disclosed to the Board that Lehman's liquidity position had been compromised by pledges and deposits with the firm's clearing banks. According to the minutes of that meeting: "Mr. Russo reported that the Firm [LBHI] had a liquidity problem, with much of its liquidity tied up at clearing banks (primarily JPMorgan Chase Bank) . . . ."[5652] After the meeting adjourned at 6:10 p.m. and reconvened at 7:55 p.m., Lowitt:

> reported that cash and collateral were being tied up by the Firm's clearing banks, with Chase holding approximately $17 billion of collateral (half in collateral and half in cash). . . . Mr. Lowitt reported that cash had drained very quickly over the last three days of the previous week and that Chase had demanded an additional $5 billion on Friday.[5653]

[5650] *See generally* Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 14, 2008) [LBEX-AM 003932].

[5651] *Id*. at p. 5.

[5652] *Id.* at p. 2.

[5653] *Id*. at p. 4.

According to the Board minutes and supplemental Board materials, this was the first time that the qualifications on Lehman's reported liquidity position were disclosed to the Board of Directors. Lowitt was accurate in his disclosure that cash had drained "very quickly" over the previous week, as JPMorgan received over $3 billion in cash and money market collateral on September 9, 10, and 11, 2008, and an additional $5 billion in cash collateral on September 12, 2008. Despite being transferred as collateral to JPMorgan, and subject to a security interest granted by the September 9, 2008 LBHI-JPMorgan Security Agreement, these assets remained in the firm's liquidity pool.[5654]

Lowitt did not disclose, in the September 14 Board meeting or any other, that Lehman had begun including clearing-bank deposits (and eventually collateral) in its liquidity pool on or about June 12, 2008, and continued to do so in increasing amounts throughout the quarter.

[5654] *Compare* Lehman, Liquidity Update (Sept. 11, 2008), at p. 3 [LBEX-WGM 784543], *with* Lehman, Ability to Monetize Table (Sept. 12, 2008) [LBEX-WGM 784607] (showing that between September 11, 2008 and September 12, 2008 the low ability to monetize "US Deposit" held by clearing banks including JPMorgan increased exactly $5 billion, confirming that Lehman included the $5 billion JPMorgan pledge on September 12, 2008 in its liquidity pool). Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 19 (confirming that the $3 billion in collateral pledged to JPMorgan the week of September 8, 2008, prior to the September 12, 2008 pledge, was included in the liquidity pool).

(f) Lowitt's Views on Including Clearing-Bank Collateral in the Liquidity Pool[5655]

According to Lowitt, Treasury (headed by Tonucci) was responsible for monitoring the liquidity pool,[5656] and Lowitt himself was "not . . . very attentive to what was in the liquidity pool."[5657] While Lowitt said he did not know what the rationale was for including clearing-bank collateral in the liquidity pool at the time Lehman did so, he said he later learned that Lehman considered the collateral transferred to banks to be Lehman's and that Lehman could recall the collateral if it wished, although doing so would entail conversations with the entities with which collateral was placed.[5658] Lowitt also said that he did not recall anyone at Lehman suggesting that Lehman disclose the firm's "ability to monetize" assets in the liquidity pool on the September 10, 2008 third-quarter earnings call.[5659]

Nevertheless, the Clearance Agreement (as amended), Security Agreements, and Guaranties granted JPMorgan liens over collateral that was simultaneously reported as part of Lehman's liquidity pool. By September 9, 2008, Citibank, HSBC and BofA had executed documentation granting security interests and/or rights of setoff against

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[5655] The views of additional former senior members of Lehman management on the inclusion of clearing-bank collateral in the liquidity pool can be found in the appendix. *See* Appendix 20 of this Report. Tonucci defended including the collateral in the liquidity pool. Lehman International Treasurer Carlo Pellerani was unaware that Lehman included the collateral in its liquidity pool, and stated that it would have been improper for Lehman to have done so.

[5656] Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 24.

[5657] *Id.* at p. 23.

[5658] *Id.* at pp. 23-24.

[5659] *Id*. at p. 26.

collateral Lehman placed with them as well. Pulling collateral from the clearing banks likely would have affected Lehman's ability to clear through those banks.

(6) Rating Agencies Were Unaware That Lehman Was Including Clearing-Bank Collateral in Its Liquidity Pool

(a) Fitch

Eileen Fahey, a managing director at Fitch, was involved in rating broker-dealers, such as Lehman's U.S. broker-dealer, LBI.[5660] Fahey's primary contact at Lehman was Tonucci.[5661] Fahey said she was not aware of any restricted cash or pledged securities being included in Lehman's liquidity pool.[5662] Fahey said it would have been "completely inappropriate" to include encumbered assets in Lehman's liquidity pool.[5663] In her opinion, cash deposits that were not formally pledged would be inappropriate for a firm's liquidity pool if that firm's clearing bank demanded the deposit due to deteriorating market conditions.[5664] Fahey said Lehman did not inform Fitch that it made any collateral pledges or deposits to its clearing banks, and that she considered such information "material" to her analysis of Lehman.[5665]

[5660] Examiner's Interview of Eileen A. Fahey, Sept. 17, 2009, at pp. 1-2.
[5661] *Id.* at p. 2.
[5662] *Id.* at p. 5.
[5663] *Id.*
[5664] *Id.*
[5665] *Id.*

(b) Standard & Poor's

Diane Hinton of Standard & Poor's, or S&P, was the primary analyst assigned to Lehman at S&P through July 2008.[5666] Hinton stated that S&P did not render opinions about the appropriateness of the contents of Lehman's liquidity pool, nor did S&P audit the contents of the pool.[5667] Hinton said she was not aware that Lehman included encumbered assets in its liquidity pool.[5668] When asked by the Examiner if the inclusion of a hypothetical $5 billion pledge to a clearing bank in a firm's liquidity pool would have been relevant to her analysis of that firm's liquidity pool, Hinton replied that it would have been.[5669] Hinton said that S&P does not include pledged assets in its assessment of liquidity, and that S&P would likely subtract the value of any pledged assets from a firm's liquidity pool; thus if a $40 billion liquidity pool contained $5 billion in pledged assets, S&P would consider the pool to actually contain $35 billion.[5670] Hinton's answer did not change when the Examiner asked that she assume that the assets were encumbered by a lien intraday, but were lien-free overnight – she would have subtracted any intraday collateral as well.[5671] Hinton further stated that if she had

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[5666] Examiner's Interview of Diane Hinton, Sept. 22, 2009, at p. 1.
[5667] *Id.* at p. 4.
[5668] *Id.* at p. 5.
[5669] *Id.* at p. 4.
[5670] *Id.*
[5671] *Id.*

known that Lehman was including deposits held by third parties in its liquidity pool that she would likely have communicated this to others at S&P.[5672]

(c) Moody's

Peter Nerby was Moody's lead analyst assigned to Lehman from 1998 to 2003, and its back-up analyst from 2004 to 2008.[5673] Nerby did not recall ever being told that Lehman included pledged assets, intraday or otherwise, in its liquidity pool.[5674] Nerby said that he would have wanted to know if Lehman had been including a $2 billion clearing bank cash deposit in its liquidity pool.[5675] Likewise, he said he would have wanted to know if Lehman had been including in its liquidity pool collateral that was encumbered by a lien intraday, but which was swept to a lien-free account overnight.[5676] Nerby said that Lehman represented to Moody's that liquidity pool assets were unencumbered.[5677]

(7) The FRBNY Did Not View the Clearing-Bank Collateral in the Liquidity Pool as "Unencumbered"

The FRBNY monitored Lehman's liquidity position continuously, and embedded several FRBNY analysts on-site at Lehman toward this end.[5678] The FRBNY was aware that as of late August 2008, Lehman had posted, or was planning to post, collateral to

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[5672] *Id.* at p. 5.
[5673] Examiner's Interview of Peter E. Nerby, Oct. 8, 2009, at p. 1.
[5674] *Id.* at p. 4.
[5675] *Id.* Nerby did not express an opinion as to whether Moody's would have deducted the clearing-bank collateral from the liquidity pool if Moody's had known about the issue.
[5676] *Id.*
[5677] *Id.* at pp. 4-5.
[5678] Examiner's Interview of Jan H. Voigts, Aug. 25, 2009, at pp. 2, 5.

JPMorgan, Citigroup, BofA and BNYM. Lehman's Paolo Tonucci told the FRBNY that "none of these [collateral] requirements will affect the liquidity pool."[5679]

On August 20, 2008, in his daily "Lehman update" e-mail, FRBNY on-site Lehman liquidity monitor Jan Voigts summarized recent clearing-bank collateral requests, and Lehman's posting of collateral to satisfy some of those requests.[5680] In response to Voigts' update, Angulo noted that Lehman was apparently including in the liquidity pool its $2 billion Citibank cash deposit and $5 billion of collateral posted with JPMorgan.[5681] Angulo wrote, "seems like LEH has $7B (and perhaps soon to be $8B+) less in available liquidity than reported . . . [.]"[5682] Voigts replied: "The liquidity pool looks largely unchanged - which leads me to want to look more closely at the three card monte routine we see in intercompany funding."[5683] Angulo responded:

> Conceptually, I can see an argument for including the $7B in the liquidity pool if JPM and C[itigroup] release the collateral to LEH every night – if triparty investors decline to roll at the end of the day, LEH can repo the $7B to replace the funding for the assets not financed by the triparty

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[5679] FRBNY, Lehman IB Update (Aug. 26, 2008) [FRBNY to Exam. 007969] (summarizing Lehman's collateral postings securing intraday funding with BofA, BNYM, JPMorgan and Citi, and prefacing that summary with the statement: "The Treasurer [Paolo Tonucci] provided the following recap and noted that none of these requirements will affect Lehman's liquidity pool.").

[5680] E-mail from Jan H. Voigts, FRBNY, to Arthur G. Angulo, FRBNY, *et al.* (Aug. 20, 2008) [FRBNY to Exam. 033297].

[5681] *Id*.

[5682] E-mail from Arthur G. Angulo, FRBNY, to Jan H. Voigts, FRBNY, *et al.* (Aug. 20, 2008) [FRBNY to Exam. 033297].

[5683] E-mail from Jan H. Voigts, FRBNY, to Arthur G. Angulo, FRBNY (Aug. 20, 2008) [FRBNY to Exam. 033297]. In an interview with the Examiner, Voigts explained that his "three card monte in intercompany funding" remark alluded to the fact that daily transfers of assets between LBIE, LBHI, LBI, and Lehman Brothers Bankhaus, AG all affected Lehman's liquidity pool. Examiner's Interview of Jan H. Voigts, Oct. 1, 2009, at p. 8. Voigts stated that the FRBNY tried, but was never able to gain an adequate understanding of the funding effects of Lehman's intercompany transactions. *Id.*

> investors[.] *On the other hand, doesn't feel quite right to view the $7B as 'unencumbered[.]'*[5684]

Voigts replied: "Agreed."[5685]

Angulo explained to the Examiner that collateral posted to Lehman's clearing banks, which was simultaneously included in Lehman's liquidity pool, "doesn't seem liquid" and could only be considered liquid in the limited event that counterparties were to stop rolling their repos and the collateral would therefore no longer be needed to support the intraday clearing risk associated with clearing those repos.[5686] Absent such a "narrow situation," Angulo said, it "would've been very difficult" to monetize this collateral for other liquidity purposes.[5687] Angulo further noted that in the period immediately preceding LBHI's bankruptcy, the FRBNY discounted the value of Lehman's liquidity pool to subtract out the value of the clearing-bank collateral that Lehman was including in the pool.[5688] "At some point," Angulo said, the FRBNY came to the conclusion that "the liquidity pool isn't 'X;' it's 'X minus something,'" where that "something" was the clearing-bank collateral.[5689]

[5684] E-mail from Arthur G. Angulo, FRBNY, to Jan H. Voigts, FRBNY (Aug. 20, 2008) [FRBNY to Exam. 033297] (emphasis added).

[5685] E-mail from Jan H. Voigts, FRBNY, to Arthur G. Angulo, FRBNY (Aug. 21, 2008) [FRBNY to Exam. 033297].

[5686] Examiner's Interview of Arthur G. Angulo, Oct. 1, 2009, at p. 4.

[5687] *Id.*

[5688] *Id.*

[5689] *Id.*

The FRBNY discounted the value of Lehman's pool to account for these collateral transfers.[5690] However, the FRBNY did not request that Lehman exclude this collateral from its reported liquidity pool. In the words of one of the FRBNY's on-site monitors: "how Lehman reports its liquidity is between Lehman, the SEC, and the world."[5691] In the same vein, FRBNY witnesses repeatedly stated that they were mindful that the FRBNY was not Lehman's "primary regulator" under the CSE program, and that the FRBNY was not monitoring Lehman with an eye toward compliance or enforcement.[5692]

(8) The SEC, Lehman's Primary Regulator, Was Unaware of the Extent to Which Lehman Was Including Clearing-Bank Collateral in Its Liquidity Pool; to the Extent It Was Aware, the SEC Did Not View This Practice as Proper

SEC statements concerning its monitoring of Lehman's reported liquidity are somewhat contradictory. On the one hand, according to SEC personnel, the SEC did not monitor Lehman's liquidity pool from a "disclosure perspective;" instead, it monitored Lehman's liquidity internally by applying haircuts to assets in the liquidity pool that the SEC viewed as less than completely liquid in order to determine Lehman's

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[5690] *See, e.g.*, e-mail from Arthur G. Angulo, FRBNY, to Jan H. Voigts, FRBNY (Aug. 20, 2008) [FRBNY to Exam. 033297] (discounting Citibank and JPMorgan collateral from Lehman's liquidity pool); e-mail from Arthur G. Angulo, FRBNY, to Timothy F. Geithner, FRBNY, *et al*. (Sept. 12, 2008) [FRBNY to Exam. 014855] (discounting Citibank and JPMorgan collateral from Lehman's liquidity pool); e-mail from Jan H. Voigts, FRBNY, to Timothy F. Geithner, FRBNY, *et al.* (Sept. 13, 2008) [FRBNY to Exam. 000709] (discounting value of liquidity pool by subtracting amount of collateral allocated to clearing banks).

[5691] Examiner's Interview of Jan H. Voigts, Oct. 1, 2009, at p. 7.

[5692] Examiner's Interview of Treasury Secretary Timothy F. Geithner, Nov. 24, 2009, at p. 4 (repeatedly emphasizing that the SEC, not the FRBNY, was Lehman's primary "supervisor"); Examiner's Interview of Arthur G. Angulo, Aug. 12, 2009, at pp. 3-4.

overall capital position.[5693] Further, in meetings with the Examiner, the SEC stated it had little authority to regulate CSE behavior with respect to liquidity practices.[5694] Yet, an internal February 20, 2008 SEC memorandum defines the SEC's mandate to inspect Lehman's liquidity pool broadly. According to that memorandum:

> To verify the composition of assets that comprise parent company liquidity, the [SEC's Trading and Markets Division] staff will identify all components of liquidity held by, or available to, the parent company without any restrictions.
>
> . . .
>
> Once the pool of assets is defined, the staff will sample the pool to confirm, among other things, the existence of the assets, the legal entity with rights to the assets, that the assets are liquid, and that the assets are available to the parent without restriction.[5695]

The memorandum further states that the SEC's "primary focus will be to verify that [non-cash assets in the liquidity pool] may be monetized quickly and that the cash proceeds are available to the parent company immediately, usually within twenty-four

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[5693] Examiner's Interview of SEC staff, Aug. 24, 2009, at p. 10.

[5694] *Id.* at p. 12.

[5695] Memorandum from Phillip Minnick, SEC, *et al.*, to Erik Sirri, SEC, *et al.*, re: Parent Company Liquidity Inspections Scope Memorandum for the Consolidated Supervised Entities ("CSE") (Feb. 20, 2008), at p. 1 [LBEX-WGM 017294]. In his interview with the Examiner, former SEC Assistant Director of Trading and Markets, Matthew Eichner, shed additional light on this document. In early 2007, the SEC determined that it should hire staff whose sole responsibility was to examine CSE firms' liquidity. The SEC finished hiring staff in late 2007, and the program went live in early 2008. This memorandum defined procedures for the just-hired staff to follow for parent company liquidity inspections. Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at p. 5. The SEC later asserted that the memorandum does not "establish Commission guidelines or policy," rather, the SEC clarifies, it "defined the scope of the upcoming liquidity pool inspection to be performed at CSE firms." Letter from Samuel M. Forstein, SEC, to Robert L. Byman, Jenner & Block (Jan. 29, 2010) (on file with the Examiner). The SEC did confirm that "the CSE inspections staff was asked to verify (1) the composition of assets that comprise liquidity held by the parent company, [and] (2) the mechanism for immediate monetization of non-cash assets . . . ." *Id.*

hours."[5696] According to former SEC Assistant Director for Trading and Markets Matthew Eichner, the SEC conveyed this "twenty-four hours" standard to Lehman, although Eichner could not recall who at the SEC conveyed it, or when.[5697] That this standard was conveyed, however, is confirmed by the fact that the SEC's memo was produced to the Examiner by Weil, Gotshal & Manges, counsel for the Debtors, and therefore was in Lehman's custody.[5698]

The SEC acted upon its authority to verify the contents of the liquidity pool at certain times. The SEC analyzed Lehman's liquidity pool critically, identified assets in the pool that should not have been there, and directed Lehman to remove those assets. For example, in 2005 the SEC identified and objected to the inclusion of a certain $1.5 billion bank facility.[5699] Further, Tonucci told the Examiner that the SEC requested that Lehman remove a certain "Aegis" commercial paper (backstopped by Lloyds of London) from its liquidity pool in late 2007 or early 2008, and that Lehman did so.[5700]

[5696] Memorandum from Phillip Minnick, SEC, *et al*., to Erik Sirri, SEC, *et al*., re: Parent Company Liquidity Inspections Scope Memorandum for the Consolidated Supervised Entities ("CSE") (Feb. 20, 2008), at p. 2 [LBEX-WGM 017294].

[5697] Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at p. 6.

[5698] The "LBEX-WGM" Bates prefix indicates that the document was produced to the Examiner by Weil, Gotshal & Manges.

[5699] SEC, Lehman Brothers Holdings, Inc. Report on Liquidity & Funding Risk Management (July 26, 2005), at p. 7 [LBEX-SEC 010903].

[5700] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 25; *see* Lehman, Confidential Presentation To: U.S. Securities & Exchange Commission Liquidity & Funding 2007 Q4 Review (Jan. 18, 2008), at pp. 6-7 [LBHI_SEC07940_323589] (noting that Lehman agreed to remove a $1.5 billion committed facility from its liquidity pool in order to bring its definition of liquidity in line with that of the SEC, and noting that in the fourth quarter of 2007 that Lehman decided to remove the Aegis investments from its liquidity pool as well).

The SEC was aware that Lehman was including a cash deposit with Citibank in its liquidity pool. The SEC did not believe the deposit belonged in the pool, elevated the issue internally, and discounted the value of the deposit from its own calculations of Lehman's liquidity.[5701] Lehman, however, continued to include the Citi deposit in its reported liquidity pool.[5702] In August 2008, the SEC learned that JPMorgan wanted Lehman to post additional collateral, but was told by Tonucci that the posting would "not affect" the liquidity pool.[5703] The SEC was also aware of "grumblings" on September 12 that Lehman pledged an additional $5 billion to JPMorgan.[5704] The SEC was unaware of the August 26 and September 9, 2008 security agreements executed between LBHI and JPMorgan, however, which substantially expanded JPMorgan's power over collateral that Lehman simultaneously included in its liquidity pool.[5705]

Despite the SEC's knowledge of the inclusion of the Citi deposit and Lehman's September 12 pledge to JPMorgan, the SEC did not believe that there "were any strings attached" to Lehman's $34 billion liquidity pool as of September 12, 2008.[5706] Asked whether collateral pledged to clearing banks, even if putatively lien-free overnight, should have been included in the liquidity pool, the SEC stated that it would have been

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[5701] Examiner's Interview of SEC Staff, Aug. 24, 2009, at p. 11.
[5702] *Id.*
[5703] *Id.*
[5704] *Id.*
[5705] *Id.*
[5706] *Id.*

inappropriate to include such assets in the liquidity pool.[5707] Eichner, however, stated that he was "not sure" whether the SEC ever reached a "final view" concerning the propriety of intraday collateral in a firm's liquidity pool.[5708]

Moreover, Eichner stated, the SEC applied a "much different standard" to holding company liquidity pools than the companies themselves did.[5709] Eichner characterized the SEC's standard as "narrower" than the standard to which the holding companies held themselves in public disclosures.[5710] Additionally, he said that the SEC was "very comfortable living with a world where numbers in the public were the ones the firms worked out with their accountants," as opposed to the narrower numbers worked out by the SEC.[5711]

(9) Certain Lehman Counsel Were Aware That Agreements with Its Clearing Banks Were Structured to Include Clearing-Bank Collateral in Its Liquidity Pool, but Disclaimed Knowledge Concerning What Assets Were Appropriate or Inappropriate for the Liquidity Pool

Lehman in-house counsel Andrew Yeung was involved in drafting security documentation with both JPMorgan and Bank of America.[5712] Yeung recalled an exchange between himself and Fleming in which Fleming instructed Yeung to limit any lien in the August JPMorgan Security Agreement to the intraday period so that

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[5707] *Id.*
[5708] Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at p. 8.
[5709] *Id.* at p. 7.
[5710] *Id.*
[5711] *Id.*
[5712] Examiner's Interview of Andrew Yeung, May 14, 2009, at pp. 6-7.

Lehman would be able to characterize the collateral as lien-free for liquidity reporting purposes.[5713] Yeung was unable to recall further exchanges on this topic, however, and stated that the liquidity reporting issue was not given much attention in the negotiation of the August and September JPMorgan agreements.[5714] Yeung offered, however, that around the time that the August JPMorgan agreements were being documented, Lehman was negotiating agreements with other clearing banks with an eye toward preserving liquidity while simultaneously giving those banks increased security.[5715] In particular, Yeung said that concerns regarding the preservation of liquidity were more pronounced in the context of Lehman's negotiations with Bank of America, culminating in the August 25, 2008 Security Agreement.[5716] That security agreement, like the September 9, 2008 Security Agreement between Lehman and JPMorgan, included a provision allowing for the return of collateral upon three-days written notice.[5717]

Lehman Chief Legal Officer Thomas Russo was unaware that Lehman included clearing-bank collateral in its liquidity pool.[5718] To the extent that Lehman did include such collateral in its liquidity pool, Russo had no opinion regarding the propriety of

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[5713] *Id.* at p. 7.
[5714] *Id.*
[5715] *Id.*
[5716] *Id.*
[5717] *Id.* at pp. 7-8; *see* Security Agreement (Aug. 25, 2008) [LBEX-DOCID 000584] (containing three-day provision for the release of collateral).
[5718] Examiner's Interview of Thomas A. Russo, May 11, 2009, at p. 8.

Lehman's actions.[5719] He further stated that he did not know what collateral was appropriate or inappropriate for inclusion in the pool and that he had no role in advising Lehman on this issue.[5720]

Andrew Keller, a partner at Simpson, Thacher & Bartlett, served as Lehman's disclosure counsel. Mr. Keller recalled working on the liquidity portion of the September 10, 2008 earnings call.[5721] He was not aware, however, of any collateral pledges, deposits or agreements, aside from the $500 million Bank of America deposit.[5722] He was not aware that this deposit, or any other similar deposit or pledge, was included in Lehman's liquidity pool at the time of the earnings call, nor did he become aware at any point before his interview with the Examiner. Mr. Keller said he could not recall any "significant issues or debates" regarding how to disclose Lehman's liquidity pool.[5723]

(10) Lehman's Auditors Monitored Lehman's Liquidity Pool, but Viewed the Composition of the Pool as a Regulatory Issue

William Schlich, lead auditor for Ernst & Young's Lehman audit team, represented to the Examiner that he was highly involved in monitoring Lehman's

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[5719] *Id.*
[5720] *Id.*
[5721] Examiner's Interview of Andrew R. Keller, Jan. 6, 2010, at p. 2.
[5722] *Id.*
[5723] *Id.*

liquidity pool following Bear Stearns' near collapse in March 2008.[5724] Schlich said he wanted to know what Lehman was telling its regulators, specifically whether Lehman was rolling its repos or whether counterparties were backing away.[5725] Asked whether Ernst & Young was aware of or had concerns with Lehman's inclusion of certain assets, such as the Citibank deposit or JPMorgan's intraday collateral, in its liquidity pool, Schlich stated that the composition of the liquidity pool was a "regulatory issue."[5726] Rather, Ernst & Young's focus was whether Lehman could fund its balance sheet on a daily basis and, if not, whether the firm had a contingency plan.[5727]

(11) There Is Insufficient Evidence To Support a Determination That Any Officer or Director Breached a Fiduciary Duty in Connection With the Public Disclosure of Lehman's Liquidity Pool

It is not within the scope of his mandate and the Examiner expresses no view as to whether or not the disclosures made by Lehman about the size and composition of its liquidity pool might give rise to causes of action. The Examiner did consider whether any officer or director breached a fiduciary duty by acting with actual or constructive knowledge to cause Lehman to make misleading statements about liquidity and thereby potentially expose Lehman to causes of action by third parties.

[5724] Ernst & Young Presentation to the Examiner, Sept. 16, 2009 (held at Ernst & Young's request to provide the Examiner with an overview of Ernst & Young's role as Lehman's external auditor).
[5725] *Id.*
[5726] *Id.*
[5727] *Id.*

Given that: (1) there are no definitive standards or requirements for reporting a liquidity pool; (2) there are no definitive standards or requirements for what should or should not be included in a liquidity pool; (3) the SEC and FRBNY had some knowledge of Lehman's inclusion of questionable components in its reported pool but did not direct Lehman to make any disclosure or corrective statement; (4) the amount of questionable components in the reported pool did not become a significant portion of the reported total until late August 2008; and (5) the individual who publicly reported the amount of the liquidity pool after that time may validly assert reliance upon others for the accuracy of the information he recited, the Examiner finds insufficient evidence to support a determination that any officer or director breached a fiduciary duty in connection with the reporting of Lehman's liquidity pool.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	Chapter 11 Case No.
LEHMAN BROTHERS HOLDINGS INC., *et al.*,	:	08-13555 (JMP)
	:	(Jointly Administered)
Debtors.	:	

REPORT OF EXAMINER ANTON R. VALUKAS

Section III.A.6: Government

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6. The Interaction Between Lehman and the Government

a) Introduction

In the course of the Examiner's investigation, it became clear that an analysis of Lehman's survival strategies, its liquidity, its collateral pledges and the events leading to the bankruptcy filing must include a discussion of the interaction between Lehman and the Government agencies that regulated and oversaw Lehman. For example, when the Examiner questioned Lehman executives and other witnesses about Lehman's financial health and reporting, a recurrent theme in their responses was that Lehman gave full and complete financial information to Government agencies, and that the Government never raised significant objections or directed that Lehman take any corrective action. To test that assertion, and to understand the events leading to Lehman's bankruptcy filing, the Examiner had to analyze the role of the agencies.

At the highest levels, each of these agencies recognized – as early as 2007 but certainly by mid-March 2008, after the Bear Stearns near collapse – that Lehman could fail.[5728] Treasury Secretary Paulson, Fed Chairman Bernanke, FRBNY President Geithner and SEC Chairman Cox all had direct communication with Fuld. The day

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[5728] Examiner's Interview of Ben S. Bernanke, Dec. 22, 2009, at p. 5 (noting that after Bear Stearns nearly collapsed, the Government focused on the stability of investment banks, and that Lehman was seen as particularly vulnerable); Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 3 (noting concerns with Lehman throughout 2008, particularly around the time of Bear Stearns' near collapse, and that Lehman was viewed as the next-most vulnerable after Bear); Examiner's Interview with Henry M. Paulson, Jr., June 25, 2009, at p. 11 (noting that Paulson was particularly concerned with Lehman after Bear's near collapse and thus urged Lehman CEO Dick Fuld to raise capital or arrange for an investment by or sale to a third party).

after Bear Stearns Weekend, teams of Government monitors from the SEC and FRBNY were dispatched to and took up residence at Lehman to review and monitor its financial condition.[5729]

The SEC monitored Lehman as the company's primary regulator under the "Consolidated Supervised Entities" ("CSE") Program. Chief among the SEC's regulatory obligations was its responsibility to monitor and verify the contents of Lehman's liquidity pool.[5730] The FRBNY served as a lender to Lehman under the Fed's discount window, which became available to broker-dealers after Bear Stearns' near collapse. In this capacity, the FRBNY lent billions of dollars to Lehman secured by certain of Lehman's assets. Other Government entities, including the Department of the Treasury and the Federal Reserve, also had oversight authority over Lehman.

Although various Government agencies had information that raised serious questions about Lehman's reported liquidity and about the sufficiency of its capital and liquidity to withstand stress scenarios, the agencies generally limited their activities to collecting data and monitoring.

[5729] Examiner's Interview of Arthur G. Angulo, Aug. 12, 2009, at p. 2; Examiner's Interview of Jan H. Voigts, Aug. 25, 2009, at pp. 2-3.

[5730] Memorandum from Phillip Minnick, SEC, *et al.*, to Erik Sirri, SEC, *et al.*, re: Parent Company Liquidity Inspections Scope Memorandum for the Consolidated Supervised Entities (Feb. 20, 2008), at p. 1 [LBEX-WGM 017294] (defining the scope of the SEC's inspection of CSE liquidity, and directing the SEC to inspect CSE liquidity pools).

b) The SEC's Oversight of Lehman

(1) The CSE Program

The FRBNY, the Federal Reserve, and the Treasury Department all viewed that the SEC was Lehman's primary regulator.[5731] The SEC has statutory authority over broker-dealers such as LBI, but its authority over LBHI as the holding company is voluntary, not statutory.

In 2003, the European Union ("EU") issued the Financial Conglomerates Directive, which required that financial conglomerates operating within the EU be supervised either under EU financial regulations or by a set of substantially equivalent rules.[5732] The major investment banks preferred SEC regulation to EU regulation. The Gramm-Leach-Bliley Act of 1999 had created a void in the regulation of systemically-important large investment bank holding companies.[5733] Neither the SEC nor any other agency was given statutory authority to regulate such entities. To fill this regulatory

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[5731] Examiner's Interview of Ben S. Bernanke, Dec. 22, 2009, at p. 4 (Bernanke noted that the SEC – not the Fed – was Lehman's regulator); Examiner's Interview of Timothy F., Geithner, Nov. 24, 2009, at p. 4 (Geithner told the Examiner that the SEC - not the FRBNY - was Lehman's primary regulator); Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 8 (Paulson explained that the SEC – not Treasury – bore primary responsibility for regulating Lehman); SEC/FRBNY, Memorandum of Understanding Between the United States Securities and Exchange Commission and the Board of Governors of the Federal Reserve System Regarding Coordination and Information Sharing in Areas of Common Regulatory and Supervisory Interest (July 7, 2008), at p. 4 (Memorandum of Understanding between the SEC and FRBNY stating that the SEC is the "primary supervisor" of the CSEs).

[5732] Examiner's Interview with the SEC staff, Aug. 24, 2009, at p. 3.

[5733] SEC, Press Release, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008).

gap, the SEC created the Consolidated Supervised Entities ("CSE") Program in 2004.[5734] The CSE Program was technically voluntary: holding companies that agreed to the SEC's supervision on a consolidated basis received an exemption from the SEC's net capital rule in exchange for agreeing to submit to CSE regulation, but the firms remained free to comply with the net capital rule and withdraw from CSE supervision.[5735] The consequence of withdrawal would have been EU regulation, however, so as a practical matter the firms had little choice but to submit to CSE regulation.[5736] Goldman Sachs, Morgan Stanley, Bear Stearns, Merrill Lynch, and Lehman Brothers all opted into the CSE Program and became supervised consolidated entities.[5737]

The CSE Program was designed to protect broker-dealers affiliated with CSEs from collapse.[5738] Unlike commercial banks that could access income streams from customer deposits, the CSE investment banks were completely dependent on the credit

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[5734] *Id*.

[5735] *Id*. Since the net capital rule required only $5 billion of capital, compliance was not an issue for the CSE firms.

[5736] Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at p. 4 (noting that CSEs had strong incentives to join the CSE Program due to EU regulations).

[5737] Examiner's Interview of SEC staff, Aug. 24, 2009, at pp. 3-4.

[5738] *Id.* at p. 4. Former SEC Chairman Christopher Cox explained to Congress that the purpose of the CSE Program was "to monitor for, and act quickly in response to, financial or operational weakness in a CSE holding company or its unregulated affiliates that might place regulated entities . . . or the broader financial system, at risk." *The State of the United States Economy and Financial Markets: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 2 (2008) (Statement of Christopher Cox, Former SEC Chairman). Cox told the Examiner that the SEC's authority was limited to the broker-dealer, and that when he told Congress that the purpose of the CSE Program was to act quickly, he meant to act quickly with respect to the broker-dealer entity. Examiner's Interview of Christopher Cox, January 8, 2010, at p. 6.

markets for funding and did not enjoy backup protection from the Federal Deposit Insurance Corporation. As a result, liquidity risk was the SEC's foremost concern under the CSE Program.[5739]

The CSE Program gave the SEC the right to inspect.[5740] The SEC's oversight was particularly focused on the firms' liquidity and risk-management monitoring functions.[5741] Although the SEC did not develop a formula of rigid filing requirements, it did require the firms to satisfy a number of liquidity and risk-management related conditions. CSEs were required to implement liquidity models that ensured a level of liquidity sufficient to sustain themselves on a stand-alone basis for a minimum of one year without access to unsecured funding and without having to liquidate a substantial position.[5742] Assets in the firms' liquidity pools needed to be funded and accessible without regulatory interference or other impediments.[5743]

Each CSE was also required to maintain and document a system of internal controls for risk-management purposes. The CSEs' internal controls needed to be approved by the SEC prior to their implementation and the firms were required to submit to regular monitoring of their internal control mechanisms. The CSE Program

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[5739] Examiner's Interview of SEC staff, Aug. 24, 2009, at p. 10.
[5740] *Id.* at p. 4.
[5741] *Id.*
[5742] *Id.*
[5743] *Id.*

required the firms to conduct regular market-based and liquidity-related stress testing.[5744]

(2) Lehman's Participation in the CSE Program

Lehman became a CSE participant in 2005.[5745] The SEC found Lehman to be "highly cooperative," and the regulators received "everything they asked for."[5746] Even before mid-March 2008, when SEC staff periodically inspected Lehman on-site, the SEC staff met frequently with Lehman risk managers, internal auditors and financial personnel. A primary focus of the SEC was liquidity and the composition of Lehman's liquidity pool.[5747]

Although the SEC staff scrutinized both the size of and ability to monetize the pool, it did not look at Lehman's liquidity pool from a disclosure perspective.[5748] Instead, the SEC applied discounts to the assets that it viewed as less than completely liquid, or "easy to monetize," to assess Lehman's overall capital position.[5749] The SEC did not, however, suggest or demand that Lehman take similar haircuts when it publicly disclosed the amount of its pool.[5750]

[5744] *Id*.
[5745] *Id*. at p. 5.
[5746] *Id*.
[5747] *Id*. at p. 10.
[5748] *Id*.
[5749] Examiner's Interview of SEC staff, Aug. 24, 2009, at p. 11.
[5750] *Id.* (the SEC discounted the Citibank deposit from the value of Lehman's liquidity pool; the SEC was not aware, however, of the other clearing bank pledges and deposits Lehman included in the pool).

For example, in June 2008, the SEC became aware that Lehman included in its liquidity pool a multi-billion dollar deposit that Lehman had made with Citigroup as a precondition of continued banking relations.[5751] Because the deposit could not be withdrawn without adverse effects upon Lehman's day-to-day business, the SEC staff disagreed with Lehman's view that the deposit was properly included in the liquidity pool. Accordingly, the SEC staff discounted that amount for its own assessments of Lehman's liquidity.[5752] The SEC did not, however, take any action to require Lehman to remove the deposit from the amount it continued to report publicly.

Liquidity was an important factor in the stress testing that Lehman was required to run under the CSE Program. After March 2008 when the SEC and FRBNY began on-site daily monitoring of Lehman, the SEC deferred to the FRBNY to devise more rigorous stress-testing scenarios to test Lehman's ability to withstand a run or potential run on the bank.[5753] The FRBNY developed two new stress scenarios: "Bear Stearns" and "Bear Stearns Light."[5754] Lehman failed both tests.[5755] The FRBNY then developed a

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[5751] *Id*. Although the SEC believed that Lehman had deposited $5 billion with Citigroup, the actual amount of the deposit was $2 billion. *See* Section III.A.5.c of this Report, which discusses Lehman's dealing with Citigroup. The SEC later stated that this was an inaccurate recollection on the part of an SEC staffer and further stated that SEC was aware that the correct size of the deposit was $2 billion. SEC, References to SEC (Jan. 29, 2010), at p. 11.

[5752] Examiner's Interview of SEC staff, Aug. 24, 2009, at p. 11.

[5753] *Id*. The regulators used different stress tests for risk and liquidity. *See* Section III.A.1 of this Report, which discusses risk management and risk stress tests.

[5754] William Brodows, *et al.*, FRBNY, Primary Dealer Monitoring: Initial Assessment of CSEs (May 12, 2008), at p. 9 [FRBNY to Exam. 000017] (describing the framework for both the "Bear" and "Bear Light" scenarios).

new set of assumptions for an additional round of stress tests, which Lehman also failed.[5756] However, Lehman ran stress tests of its own, modeled on similar assumptions, and passed.[5757] It does not appear that any agency required any action of Lehman in response to the results of the stress testing.

The SEC recognized in 2007 that there were potential asset-valuation problems across the investment banking industry.[5758] SEC staff reviewed Lehman's asset valuations to ensure that the firm maintained an independent price valuation function that complied with various CSE reporting requirements. Lehman's valuation problems were more pronounced than those of other firms because its exposure to commercial real estate and Alt-A mortgages was larger than that of any of the other CSE firms.[5759]

In January 2008, the SEC began an inspection of valuation procedures in all of the CSE firms to ensure that the firms were complying with internal controls, to compare procedures across the five firms and to provide feedback to the firms.[5760] The SEC inspection revealed significant problems at Lehman. The SEC found that Lehman's

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[5755] *Id.* at p. 10 (showing that Lehman would need to raise $84 billion to survive a "Bear" run on the bank, and $15 billion to survive a "Bear Light" liquidity event).

[5756] FRBNY, Primary Dealer Monitoring: Liquidity Stress Analysis (June 25, 2008 (Revised June 26, 2008)), at pp. 3, 5 [FRBNY to Exam. 000033] (concluding that Lehman required $15 billion in additional liquidity to survive a liquidity stress event on this test's revised assumptions).

[5757] *See, e.g.*, Lehman, Presentation to the Federal Reserve & SEC: Updated Stressed Liquidity Scenario (July 2, 2008), at p. 9 [LBHI_SEC07940_348894] (showing that Lehman would survive the stress test with $13.1 billion in excess cash).

[5758] Examiner's Interview of SEC staff, Aug. 24, 2009, at p. 13.

[5759] *Id*.

[5760] *Id*.

Price Valuation Group was understaffed; and it found that Lehman's asset pricing function was overly "process driven."[5761] But the SEC did not release its findings or formally present them to Lehman prior to Lehman's demise.

(3) The SEC/OIG Findings

On April 2, 2008, Iowa Senator Charles E. Grassley requested the SEC Office of Inspector General ("SEC/OIG") to analyze the SEC's oversight of the CSE Program in the wake of Bear Stearns' near collapse. The SEC/OIG released its audit report on September 25, 2008, shortly after Lehman had filed for bankruptcy,[5762] but the report was circulated in draft form during the summer of 2008 and was reviewed by the CSE staff.[5763]

The SEC/OIG Report was critical of the SEC's regulation of Bear Stearns in particular and the CSE Program in general. The Report found that the SEC knew Bear Stearns had high leverage, had insufficient capital, and held an excessive volume of mortgage-backed securities; yet the SEC had taken no action to require a change in the firm's policies, despite the many potential red flags of excessive risk evident at Bear Stearns.[5764]

[5761] Notably, no one at the SEC ever saw any evidence suggesting that Lehman managed its valuations based on predetermined balance sheet targets. *Id.* at p. 14.

[5762] SEC/OIG, SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program, Rpt. No. 446-A (Sept. 25, 2008).

[5763] Examiner's Interview of Christopher Cox, Jan. 8, 2010, at p. 14.

[5764] SEC/OIG, SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program, Rpt. No. 446-A (Sept. 25, 2008) at p. ix.

The SEC/OIG questioned why the SEC imposed no leverage ratio limit on CSE firms such as Bear Stearns.[5765] The SEC/OIG noted that the SEC had also been aware of deficiencies in Bear Stearns' risk management but did not require changes.[5766] The SEC/OIG concluded that the SEC's capital requirements for CSEs were inadequate.[5767] The SEC/OIG Report found the SEC's liquidity requirements for CSEs to be unrealistically low.[5768]

At the time of Bear Stearns' near collapse in March 2008, it was widely thought at the highest levels of every relevant Government agency that Lehman could be the next investment bank to fail.[5769] Lehman's business model was markedly similar to Bear Stearns': high leverage, low capitalization, and a concentration of assets in illiquid

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[5765] The CSE Program did not impose leverage ratio limits. The SEC/OIG Report emphasized Bear Stearns' high gross leverage ratio – 33:1 – at the time of its near collapse. The Report observed that high leverage can both cause a loss of liquidity during a financial crisis and adversely influence market confidence in a highly leveraged firm. *Id*. at pp. x, 19-20.

[5766] The SEC/OIG found that, based upon the experience of Bear Stearns' U.K. mortgage originator subsidiary in the second quarter of 2006, the SEC had identified the risks that arose in the subprime crisis in the U.S. less than a year later. Yet the SEC did not apply pressure to Bear Stearns to reduce its subprime exposure. *Id*. at pp. x, 18, 21-22, 25.

[5767] The SEC/OIG found no evidence that the SEC required Bear Stearns to take increased charges to capital for its positions in stressed repos. *Id*. at pp. 11-13, 30-32.

[5768] *Id*. at pp. 14-15.

[5769] Examiner's Interview of Ben S. Bernanke, Dec. 22, 2009, at p. 5 (noting that after Bear Stearns nearly collapsed, the Government focused on the stability of investment banks, and that Lehman was seen as particularly vulnerable); Examiner's Interview of Christopher Cox, Jan. 8, 2010, at pp. 7-8 (following the near collapse of Bear Stearns, liquidity concerns made Lehman the SEC's "number one focus"); Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 3 (noting concerns with Lehman throughout 2008, particularly around the time of Bear Stearns' near collapse, and that Lehman was viewed as the next-most vulnerable after Bear); Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 11 (noting that Paulson was particularly concerned with Lehman after Bear nearly collapsed and urged Fuld to raise capital or arrange for an investment by or sale to a third party).

investments such as subprime or Alt-A mortgages.[5770] The Examiner asked the CSE staff whether it modified its approach to Lehman or directed any action by Lehman in light of the SEC/OIG proposed findings that it saw in summer 2008. The CSE officer in charge of Lehman responded that the SEC did not take any action: "We were tied to the mast here; the opportunities for re-engineering were quite limited, and to imply otherwise is wrong."[5771]

(4) The View From the Top

The Examiner interviewed former SEC Chairman Christopher Cox, who related that the investment banking industry was "increasingly viewed as precarious" in 2008 and, as a result, all investment banks were a concern for the SEC.[5772] The SEC focused on increasing capital and liquidity for all investment banks.[5773] The SEC had some success in that Bear Stearns increased its liquidity, but not enough to survive. Cox did not think there was any liquidity number large enough to withstand a run on the bank: "There's no amount of liquidity that can protect you from an indefinite run."[5774] After

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[5770] Jenny Anderson, *At Lehman, Allaying Fears About Being the Next to Fall*, N.Y. Times, Mar. 18, 2008 (noting similarities between Bear Stearns' and Lehman's business models, in particular their common reliance on short-term financing and the mortgage market).
[5771] Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at p. 14.
[5772] Examiner's Interview of Christopher Cox, Jan. 8, 2010, at p. 7.
[5773] *Id.*
[5774] *Id.*

Bear Stearns was sold to JPMorgan in March 2008, "Lehman became the number one focus."[5775]

Before Bear, Cox believed that he should not "hobnob" with the CEOs of regulated entities. He explained that the SEC might have to investigate those firms, or they might already be under investigation, and Cox did not want his communications to have any influence on those investigations.[5776] But Cox deliberately changed that approach after the near collapse of Bear Stearns.[5777] He told the Examiner: "Things were moving too fast" to observe careful protocols.[5778]

Beginning in March, 2008, Cox had direct calls with Fuld every couple of weeks, generally on two issues: (1) Fuld's desire that the SEC deal with short sellers, and (2) Lehman's plans with respect to SpinCo.[5779]

The Examiner asked Cox whether, in hindsight, he believed that the SEC could have done anything different that might have saved Lehman. Cox responded that many analysts have wondered why Fuld did not sell Lehman at a lower price, or take other actions to save Lehman earlier than he did.[5780] Cox said that "it came as a surprise [to Lehman] that the Government would not financially participate," and he believed

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[5775] *Id.* at p. 8.
[5776] *Id*.
[5777] *Id.* at p. 9.
[5778] *Id*.
[5779] *Id.* SpinCo, and other of Lehman's survival strategies, are discussed in Section III.A.3.
[5780] Examiner's Interview of Christopher Cox, Jan. 8, 2010, at p. 20.

that the Government's unwillingness to make a commitment to Lehman "entered into the FSA's judgment" in deciding not to approve a Barclays-Lehman deal.[5781] Although he said that he has no criticism of any agency, Cox stated that no statutory framework existed on September 14, 2008, that allowed the Government to help Lehman in a material way.[5782] Yet, Cox said, "I think people would have behaved differently if they were not expecting the Government to do something. In the end, the fact that there was no Government contribution made it impossible to get across the finish line."[5783] Further, Cox stated: "Maybe if the message could have been provided [that no Government funding existed] more than a week before [the bankruptcy], people might have ordered their affairs differently if they had known what was going to happen."[5784]

c) The FRBNY's Oversight of Lehman

Timothy Geithner, current Secretary of the Treasury and then-President of the FRBNY, developed serious concerns about Lehman as early as August 2007.[5785] The concerns grew in 2008, particularly in March after Bear Stearns nearly collapsed.[5786]

[5781] *Id.*

[5782] *Id.*

[5783] *Id.*

[5784] *Id.* Note however, that Secretary Paulson never promised Fuld Government assistance for Lehman. Examiner's Interview with Henry M. Paulson, Jr., June 25, 2009, at p. 17; Examiner's Interview with Richard S. Fuld, Jr., Sept. 30, 2009, at p. 21.

[5785] Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 3.

[5786] *Id.*

After Bear, Geithner viewed Lehman as the most exposed investment bank, with Merrill Lynch a distant second.[5787]

The problem was far broader than Lehman.[5788] Through the summer of 2008, it became clear to Geithner that the recession was building in magnitude and that it was going to imperil a range of institutions.[5789] Geithner became worried that the economic crisis was a gathering storm that "was getting away from us" and that it could "escalate in terms of force and we might not be able to contain it."[5790] Even so, "everyone got it wrong by underestimating the scale of the problem."[5791]

In March 2008, the FRBNY installed teams of monitors at Lehman, not as a regulator but as a potential lender.[5792] The FRBNY on-site analysts received real-time data on Lehman's liquidity and capital position through formal and informal channels at the firm, and synthesized this data in comprehensive daily reports distributed

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[5787] *Id.*; Examiner's Interview of Arthur G. Angulo, Aug. 12, 2009, at p. 5 (FRBNY analysts viewed Lehman as the next-most vulnerable firm after Bear Stearns nearly collapsed); Examiner's Interview of Jan H. Voigts, Aug. 25, 2009, at p. 3 n.3 (FRBNY viewed Lehman as "the weakest of the pack" following Bear Stearns' collapse).

[5788] Examiner's Interview of Jan H. Voigts, Aug. 25, 2009, at p. 3 (while Lehman was perceived to be weak, it was not "idiosyncratic" in this regard; rather Lehman was "symptomatic" of more structural problems in the financial sector around this time).

[5789] Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 3.

[5790] *Id.*

[5791] *Id.*; Examiner's Interview of Jan H. Voigts, Aug. 25, 2009, at pp. 5-6 (stating that the FRBNY did not fully appreciate the consequences of a bankruptcy by Lehman's holding company).

[5792] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 4 (FRBNY monitored Lehman as a potential lender under the TSLF and PDCF programs); Examiner's Interview of Arthur G. Angulo, Aug. 12, 2009, at p. 2 (FRBNY monitored Lehman as a prospective lender); Examiner's Interview of Jan H. Voigts, Aug. 25, 2009, at pp. 2-3 (same).

throughout the FRBNY.[5793] Geithner participated in several meetings with Lehman and other investment banks to "understand where [the investment banks] were [with capital and liquidity], and where they were going, and pull them to a more conservative place regarding capital and liquidity."[5794] Geithner was "consumed" with the "challenge to figure out how to make [Lehman] get more conservatively funded."[5795]

Although the SEC and FRBNY had equal access to the same data and Lehman personnel, the two agencies did not necessarily share their conclusions and analyses with one another.[5796] Indeed, because of what Bernanke described as "tricky" issues, he and Cox became directly involved in the negotiation of a formal Memorandum of Understanding ("MOU") that would allow the exchange of information between the two agencies.[5797] The MOU was not executed until July 2008.[5798] Yet even with the MOU

[5793] *See, e.g.*, FRBNY, Lehman IB Update (Aug. 27, 2008) [FRBNY to Exam. 007968] (a representative FRBNY daily report analyzing Lehman's liquidity pool, the status of Lehman's secured and unsecured funding, intraday funding, stock price, clearing bank actions, and significant stories about Lehman circulating in the press).

[5794] Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 4.

[5795] *Id*.

[5796] Examiner's Interview of Jan H. Voigts, Aug. 25, 2009, at p. 3 (the FRBNY and SEC did not often share their conclusions in the course of monitoring Lehman's liquidity).

[5797] Examiner's Interview of Ben S. Bernanke, Dec. 22, 2009, at p. 7. Bernanke described the "tricky" aspects of the MOU as whether, for example, the SEC could use information shared by the FRBNY to undertake an investigation. Bernanke did not state whether there had been any resolution to this issue.

[5798] SEC/FRBNY, Memorandum of Understanding Between the United States Securities and Exchange Commission and the Board of Governors of the Federal Reserve System Regarding Coordination and Information Sharing in Areas of Common Regulatory and Supervisory Interest (July 7, 2008).

in place, FRBNY witnesses noted that they did not receive all the documents they requested from the SEC in connection with Lehman's liquidity.[5799]

Certain FRBNY on-site personnel expressed the view to the Examiner that the SEC on-site personnel did not have the background or expertise to adequately evaluate the data they were given.[5800]

Geithner had a number of telephone conversations with Fuld around the time of Bear Stearns' near collapse, Lehman's announcement of its second quarter 2008 earnings and the days leading up to Lehman's bankruptcy. The calls centered around three topics: (1) Geithner repeatedly informed Fuld that the "Government cannot solve this problem for you;" and, therefore, (2) Lehman needed to raise more capital; or (3) form a strategic alliance with another entity with a stronger balance sheet.[5801] Geithner also spoke with Fuld about Fuld's proposal that Lehman become a bank holding

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[5799] Examiner's Interview of Jan H. Voigts, Oct. 1, 2009, at p. 7 (noting that the FRBNY did not receive certain SEC analyses regarding CSE commercial real estate positions and CSE liquidity pools despite asking for such information); Examiner's Interview of Arthur G. Angulo, Aug. 12, 2009, at p. 3 (noting that the MOU was "not significant").

[5800] Examiner's Interview of Arthur G. Angulo, Aug. 12, 2009, at p. 3 (noting that the SEC lacked sufficient staff and sufficient time to analyze Lehman "in-depth"); Examiner's Interview of Thomas C. Baxter, Jr., Aug. 31, 2009, at pp. 2, 5 (the "primary weakness" of the CSE Program was "SEC understaffing" and the lack of "higher-level skill sets" for SEC staffers). Those views percolated to the top. Bernanke observed that the Fed had "some skepticism and concern about the SEC's capacity, going back to Bear, where they were blindsided to a significant extent there as well." Bernanke was careful not to assign blame or fault, but observed that the SEC was "in over [its] head." Examiner's Interview with Ben S. Bernanke, Dec. 22, 2009, at p. 8. Chairman Cox countered the suggestion that SEC personnel were not competent by pointing out that other agencies, including Treasury and the Fed, hired them away. Examiner's Interview of Christopher Cox, Jan. 8, 2010, at pp. 19-20.

[5801] Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at pp. 5-6.

company. Geithner viewed that as "gimmicky:" "You can't solve a liquidity/capital problem by becoming a bank holding company."[5802]

Geithner believed that Fuld understood by July 2008 that Lehman required "a very substantial and expensive change" to survive.[5803] Geithner told the Examiner: "There is always some hope and denial in these things," but that it had appeared Fuld was attempting to find solutions with due urgency.[5804] The fundamental difficulty facing Lehman was timing. Lehman needed to persuade an investor (or investors) to buy into Lehman just at the time when the souring economy made potential investors highly skittish about absorbing more risk.[5805]

FRBNY witnesses uniformly emphasized to the Examiner that the SEC – not the FRBNY – was Lehman's primary regulator.[5806] The FRBNY's role was as a potential lender, not a regulator; after Bear Stearns nearly collapsed, the FRBNY opened the discount window to investment banks such as Lehman, and thereby became a "rather

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[5802] *Id.* at p. 6.

[5803] *Id.*

[5804] *Id.*

[5805] *Id.*

[5806] Examiner's Interview of Arthur G. Angulo, Aug. 12, 2009, at p. 3 (SEC, not the FRBNY, was Lehman's "main supervisor"); Examiner's Interview of Thomas C. Baxter, Jr., Aug. 31, 2009, at p. 4 (the SEC was "without question" Lehman's primary regulator); Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 4 (the SEC, not FRBNY, was Lehman's primary "supervisor"); Examiner's Interview of Jan H. Voigts, Aug. 25, 2009, at p. 2 (the SEC was Lehman's "primary regulator"); Examiner's Interview of William L. Rutledge, Aug. 27, 2009, at p. 4 (the SEC was "absolutely without question" the primary regulator of the CSEs).

late, reluctant creditor."[5807] As such, the FRBNY monitored Lehman's liquidity profile to be well-positioned to lend to Lehman under its new liquidity facilities.[5808] But the FRBNY, as an "interested creditor," worked with the SEC to "induce a series of behaviors regarding liquidity across the investment banks."[5809]

In advance of September 2008, the FRBNY was considering proactive measures to prevent, or mitigate, the collapse of major broker-dealers, and Lehman specifically. For example, in July 2008, FRBNY analysts presented Geithner with a proposal to provide intraday financing for broker-dealers via clearing banks in addition to providing overnight financing to broker-dealers via the PDCF.[5810] In such a scenario, the FRBNY could "enter into a 'conditional' non-recourse loan with the clearing bank at the beginning of the day, collateralized by a cash claim on the dealer in question, and the associated collateral."[5811] The clearing bank would then continue to extend credit to the dealer, and assuming the dealer survived the trading day, the clearing bank would then repay the FRBNY loan.[5812] The FRBNY tailored this plan to Lehman's repo book,

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[5807] Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 4.

[5808] Examiner's Interview of Jan H. Voigts, Aug. 25, 2009, at p. 2.

[5809] Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 4. Indeed, the FRBNY worked with the SEC to produce the liquidity stress scenarios that urged Lehman to increase its liquidity and reduce reliance on overnight commercial paper and less-liquid repos. *See* FRBNY, Primary Dealer Monitoring: Liquidity Stress Analysis (June 25, 2008 (Revised June 26, 2008)), at p. 5 [FRBNY to Exam. 000038].

[5810] Memorandum from Lucinda Brickler, FRBNY, *et al.*, to Timothy F. Geithner, FRBNY, re Managing a Loss of Confidence in a Major Tri-party Repo Borrower (July 7, 2008), at p. 1 [FRBNY to Exam. 027043].

[5811] *Id.* at p. 2.

[5812] *Id.* The plan was designed to address the possibility of an investment bank such as Lehman Brothers "los[ing] [the] confidence of its investors or clearing bank," which would then "pull away from providing

applying haircuts to Lehman's available collateral, and arriving at an additional amount of collateral that Lehman would need, in order to realize the full pledge value of that collateral.[5813]

In July 2008, senior FRBNY official (and current FRBNY president) William Dudley proposed a plan "[v]ery much in the spirit of what we did with Bear" to extend to Lehman a "Maiden Lane type vehicle."[5814] The "Maiden Lane" vehicle employed in Bear Stearns was a special purpose vehicle ("SPV") set up to induce JPMorgan to acquire Bear and to guarantee Bear's outstanding obligations; the FRBNY extended to JPMorgan a $30 billion non-recourse loan, collateralized by illiquid Bear assets.[5815] Under Dudley's proposal, this new "Maiden Lane type vehicle" would hold $60 billion in illiquid Lehman assets backstopped by $5 billion in Lehman equity.[5816] The Fed would then "guarantee[] financing or finance [] the remaining $55 billion."[5817] After removing the illiquid assets via the Maiden Lane SPV, a Clean Lehman ("Clean

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intraday credit" – a result that would be "disastrous for the firm and also cast widespread doubt on [triparty repos] as a nearly risk-free, liquid overnight investment." *Id.*

[5813] *Id.* at pp. 4-8. The proposal noted that such a plan would require further legal research.

[5814] E-mail from Timothy F. Geithner, FRBNY, to William Dudley, FRBNY (July 7, 2008) [FRBNY to Exam. 034332] (quoting and responding to Dudley's proposal).

[5815] FRBNY, Maiden Lane Transactions, *available at* http://www.newyorkfed.org/markets/maidenlane.html.

[5816] E-mail from Timothy F. Geithner, FRBNY, to William Dudley, FRBNY (July 7, 2008) [FRBNY to Exam. 034332] (quoting and responding to Dudley's proposal).

[5817] *Id*.

Lehman") would remain. The FRBNY, in turn, would have an equity stake in Clean Lehman.[5818]

Dudley's plan, while taking "illiquid assets off the market," and "preserv[ing] Lehman franchise value," provided for "[p]rotections to the Fed" as well.[5819] Geithner responded that further thought was required on "how we decide what assets to take," and that any plan would require "high procedural hurdles."[5820]

Ultimately, the FRBNY decided not to extend a Maiden Lane-style vehicle to Lehman. Rather, during the weekend of September 12-14, 2008, the FRBNY convened meetings to encourage a consortium of Wall Street to finance Lehman's illiquid assets, with the intention of facilitating a sale of Lehman to Barclays or another buyer.[5821]

The Examiner asked Geithner whether, in hindsight, he believed that the FRBNY could have done anything different that might have saved Lehman. Geithner's answer was no. He noted that "the Government of the United States left too much of the burden on the Fed to contain [the damage], and it was too late to use the full arsenal of Government powers . . . If these [emergency statutory powers] had come earlier, we

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[5818] *Id.*

[5819] *Id.* The plan's envisaged protections included interest from repayments to the FRBNY on the non-recourse loan, and equity in Clean Lehman. Dudley's plan also accounted for moral hazard, noting that the "[m]oral hazard considerations [would be low] given [the] equity dilution" involved for the salvaged investment bank. *Id.*

[5820] *Id.*

[5821] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at pp. 9-11.

could have made it somewhat less damaging."[5822] However, Geithner noted that he would have opposed any effort to give Lehman or other investment banks earlier access to the Fed's liquidity facilities. The challenge for the Government, and for troubled firms like Lehman, was to reduce risk exposure, and the act of reducing risk by selling assets could result in "collateral damage" by demonstrating weakness and exposing "air" in the marks.[5823] Geithner said that the FRBNY had "to make sure that the system would be held together and that the strongest institutions would not be imperiled by the weakest."[5824]

d) The Federal Reserve's Oversight of Lehman

Federal Reserve Chairman Bernanke agreed with Geithner that the SEC was Lehman's regulator and that the Fed had neither "direct [n]or indirect responsibility" for Lehman; nevertheless the Fed "followed [Lehman's] progress."[5825]

The Fed "became interested" in investment banks around the time that JPMorgan acquired Bear Stearns with the Fed's assistance in March 2008. Bernanke believed Lehman was the next-most vulnerable investment bank after Bear Stearns.[5826]

[5822] Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at pp. 9-10; *see*, *e.g.*, the Troubled Asset Relief Program ("TARP"), 12 U.S.C. § 5201-61.
[5823] Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 10.
[5824] *Id*.
[5825] Examiner's Interview of Ben S. Bernanke, Dec. 22, 2009, at p. 5.
[5826] *Id.*

Although he viewed Lehman's $6 billion capital raise in June 2008 positively, he believed that Lehman was "still perceived as a weak institution."[5827]

Bernanke had frequent communications with Geithner and then-Secretary Paulson about Lehman. Bernanke noted that Paulson was "frustrated" and "dissatisfied" by Fuld's "more inertial behavior" with respect to raising capital and finding strategic partners.[5828] The Fed, the FRBNY and the Treasury department were "trying to pressure Fuld to be more aggressive," but the Fed was "very conscious" of its "appropriate role" given that the SEC was the regulator.[5829]

The Examiner asked Bernanke whether, in hindsight, he believed that he or the Fed could have done anything different that might have saved Lehman. Bernanke responded that he should have been more engaged in dealings with the U.K. about Barclays' pre-bankruptcy efforts to acquire Lehman.[5830] Nevertheless, Bernanke did not believe that the Fed had the legal authority to bail out Lehman in September 2008. He noted that a Federal Reserve Bank such as the FRBNY could make a loan only if it was satisfactorily secured, that is, that the bank could reasonably expect a 100 percent return.[5831] Bernanke said a "fundamental impediment" existed for Lehman: By mid-

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[5827] *Id.*
[5828] *Id.* at p. 6.
[5829] *Id.*
[5830] *Id.* at p. 15.
[5831] *Id.* at 11.

September, Lehman lacked not just "standard" collateral, but "any" collateral.[5832] Lehman's tangible assets and securities fell "considerably short of the obligations that would come due."[5833] Bernanke believed that Lehman was insolvent by the week of September 8, 2008.[5834] Providing a loan to Lehman under those circumstances would be "lending into a run."[5835] If, as was the case, Lehman's collapse appeared imminent, a Federal Reserve loan would not stop the run; the collateral would run out before Lehman paid off all of the claims. Bernanke stated: "The assessment was that if there was a run, which there would be, the business value would be compromised, and all we would have accomplished would be to make counterparties whole and not succeed in preventing the collapse of the company."[5836]

Bernanke noted that, after passage of the TARP legislation, the Treasury had authority to inject capital directly into institutions: "If we had that [TARP] authority on September 14, we would have been able to save [Lehman], no question about it."[5837]

[5832] *Id.*

[5833] *Id.*

[5834] *Id.* at p. 13.

[5835] *Id.* at 11.

[5836] *Id.* at p. 12. In contrast, Bernanke explained, AIG had "considerable business value as reflected in its stock price." He stated that AIG had a large insurance company, which was a valuable asset and provided sufficient security for a loan. *Id.*

[5837] *Id.* at p. 13. The Examiner asked Bernanke if he could have made the case for TARP to Congress if Lehman had *not* failed. Bernanke responded: "Let me push back against any inference that we thought [Lehman] should fail in order to get the tools [to inject capital directly]." Bernanke was emphatic: "We never believed" that the Fed should let a major institution fail when it had the option to help. *Id.*

Bernanke told the Examiner: "I speak for myself, and I think I can speak for others, that at no time did we say, 'We could save Lehman, but we won't.' Our concern was about the financial system, and we knew the implications for the greater financial system would be catastrophic, and it was."[5838] According to Bernanke, a "range of views" existed about the likely effect of Lehman's failure on the economy. If the effect was measured on a scale of 0 to 100, some thought a Lehman failure would be a "minor disruption" – in the 1-15 range. Bernanke's own view was in the 90-95 range.[5839] However, the actual effect turned out to be "maybe 140."[5840] "It was worse than almost anybody expected."[5841]

e) The Treasury Department's Oversight of Lehman

Like Geithner and Bernanke, then-Treasury Secretary Paulson considered the SEC to be Lehman's regulator.[5842]

[5838] *Id.* at p. 14.

[5839] *Id.*

[5840] *Id.*

[5841] *Id.*

[5842] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 8. The Office of Thrift Supervision ("OTS"), a division of Treasury, did have regulatory jurisdiction over Lehman's bank subsidiary, and in the course of that authority, issued a report in July 2008 that was critical of Lehman's risk procedures. *See* Ronald S. Marcus, OTS, Report of Examination Lehman Brothers Holdings Inc. (July 7, 2008), at pp. 1-2 [LBEX-OTS 000392]. The report concluded that Lehman had made an "outsized bet" on commercial real estate – larger than its peer firms, despite Lehman's smaller size. The report further concluded that Lehman was "materially overexposed," *id.* at p. 1, to the commercial real estate sector, which was experiencing deteriorating market conditions. *Id.* at p. 2. The report faulted Lehman for "major failings in its risk management process," and noted that Lehman had made its "outsized bet" in violation of established internal risk limits. *Id.* As a result, the report stated that shedding "a substantial portion" of these positions "may be key to the survival of LBHI as an independent firm." *Id*. It is unclear that any corrective course of action was ever directed or implemented following the issuance of the OTS Report.

Paulson told the Examiner that, in his view, the economic crisis started in August 2007 when two Bear Stearns hedge funds failed. Despite those failures, Paulson initially believed the economic effects of the subprime crisis were contained and would not infect the rest of the economy.[5843] Paulson did not fully appreciate the global reach of the economic crisis until October 2008.[5844]

Paulson first became concerned about Lehman in November 2007, when he heard about Lehman's purchase of the Archstone-Smith Trust and immediately perceived the decision as unwise, given the condition of the market.[5845] After Bear Stearns failed in March 2008, Paulson viewed Lehman as the next most vulnerable bank. Paulson repeatedly urged Fuld to raise capital, find a strategic partner or sell Lehman.[5846]

Paulson never promised Fuld or Lehman that the Government would provide Lehman financial assistance.[5847] Fuld confirmed that no promise was made; nevertheless, Fuld continued to hold the belief that the Government would not let Lehman fail.[5848]

[5843] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 2.
[5844] *Id.*
[5845] *Id*. at p. 9.
[5846] *Id*. at p. 11.
[5847] *Id*. at p. 14.
[5848] Examiner's Interview of Richard S. Fuld, Jr., Sept. 30, 2009, at p. 21.

Paulson believed that the Government lacked authority to inject capital into Lehman Brothers. The Federal Reserve's willingness to provide financial help to Bear Stearns (toward the JPMorgan purchase) and AIG was not, in his view, inconsistent with the Federal Reserve's decision to deny aid to Lehman. With Bear Stearns, the Federal Reserve had a willing buyer (JPMorgan); Lehman did not. With AIG, AIG had valuable insurance subsidiaries to use as collateral; again, Lehman had nothing comparable.[5849]

f) The Relationship of the SEC and FRBNY in Monitoring Lehman's Liquidity

The SEC and FRBNY both monitored Lehman's liquidity. The SEC monitored to verify that Lehman's liquidity pool was unrestricted and could be monetized quickly,[5850] while the FRBNY monitored Lehman's liquidity as a potential lender. While both agencies theoretically had access to the same information, they did not necessarily share the information they collected with one another.[5851]

[5849] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 17.

[5850] Memorandum from Phillip Minnick, SEC, *et al.*, to Erik Sirri, SEC, *et al.*, re: Parent Company Liquidity Inspections Scope Memorandum for the Consolidated Supervised Entities (Feb. 20, 2008), at p. 1 [LBEX-WGM 017294].

[5851] Examiner's Interview of Jan H. Voigts, Oct. 1, 2009, at p. 7 (FRBNY did not readily share information without prompting because SEC was Lehman's primary regulator).

(1) The SEC Performed Only Limited Monitoring of Lehman's Liquidity Pool

A February 20, 2008 memorandum from the SEC titled "Parent Company Liquidity Inspections Scope for the Consolidated Supervised Entities" (the "Liquidity Inspections Scope Memorandum") states:

> [T]he [SEC] staff will identify all components of liquidity held by, or available to, the parent company without any restrictions. These assets generally will include a mixture of cash and highly liquid securities . . . . Once the pool of assets is identified the staff will sample the pool to confirm among other things, the existence of the assets, the legal entity with rights to the assets, that the assets are liquid, and that the assets are available to the parent without restriction . . . . The primary focus will be to verify that the cash proceeds are available to the parent company immediately, usually within twenty-four hours. Accordingly, the staff will review the firms' monetization policies.[5852]

The "primary focus" of the SEC's liquidity monitoring, as explained by the Liquidity Inspections Scope Memorandum, was to "verify" that CSE liquidity pools were "available to the parent without restriction" and could be monetized "immediately, usually within twenty-four hours."[5853] A former senior SEC CSE staff member, Matthew Eichner, told the Examiner that the Liquidity Inspections Scope Memorandum was never formally implemented as part of the CSE Program.[5854] Nevertheless, Eichner recalled that he communicated the "twenty-four hours" standard

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[5852] Memorandum from Phillip Minnick, SEC, *et al.*, to Erik Sirri, SEC, *et al.*, re: Parent Company Liquidity Inspections Scope Memorandum for the Consolidated Supervised Entities (Feb. 20, 2008), at pp. 1-2 [LBEX-WGM 017294].

[5853] *Id.* at p. 2.

[5854] Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at pp. 5-6.

to Lehman.[5855] Lehman had a copy of the Liquidity Inspections Scope Memorandum in its possession, implying that the SEC had shared it with Lehman. But Lehman applied a "five days" monetization standard for assets in its liquidity pool.[5856] There is no evidence that the SEC directed Lehman to comply with the 24-hour standard.

Eichner said that the SEC only "sampled" the CSE's liquidity pools to ensure that the firms' representations were accurate.[5857] Eichner stated that this sampling was not statistically significant, and that he never received any report indicating that Lehman did not pass these sampling tests.[5858] Eichner said that the SEC never had the opportunity to implement fully the steps set forth in the Liquidity Inspections Scope Memorandum because of the chaos surrounding Bear Stearns' near collapse.[5859]

On several occasions, the SEC did ask Lehman to remove questionable assets from its liquidity pool. For example, in a July 26, 2005 report on liquidity and risk management, the SEC identified a $1.5 billion committed, multi-currency unsecured bank facility as part of Lehman's liquidity pool. Contrary to Lehman's internal accounting, however, the SEC did not consider the facility a proper part of the liquidity

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[5855] *Id.* at p. 6.
[5856] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 16.
[5857] Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at p. 6.
[5858] *Id.*
[5859] *Id.* at p. 5.

pool.[5860] In late 2007 or early 2008, the SEC disagreed with Lehman's inclusion in its liquidity pool of certain classes of assets, and asked Lehman to remove them.[5861]

The SEC was aware in June 2008 that Lehman's liquidity pool included a $2 billion "comfort" deposit at Citigroup.[5862] The SEC staff viewed Lehman's inclusion of that deposit in its liquidity pool as problematic,[5863] and discounted the value of the pool accordingly.[5864] Nevertheless, there is no evidence that the SEC directed Lehman to remove the comfort deposit from its calculation of reported liquidity. Eichner told the Examiner that "we applied a much different standard [for including assets in the liquidity pool] than anyone else," and that the SEC "was very comfortable living with a world where the numbers in the public were the ones the firms worked out with their accountants."[5865]

[5860] SEC, Lehman Brothers Holdings Inc.: Report on Liquidity & Funding Risk Management (July 26, 2005), at p. 9 [LBEX-SEC 010895].

[5861] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 25 (Tonucci said the SEC asked Lehman to remove an "AEGIS" facility from its liquidity pool, and that Lehman complied).

[5862] Examiner's Interview of SEC staff, Aug. 24, 2009, at p. 11. There is some question whether the SEC thought the deposit was $2 billion or $5 billion. *Id*.

[5863] The SEC states that the SEC's CSE staff "noted that it was a problem to include the [Citi] deposit[] when determining the size of the pool . . . .The CSE [s]taff did, however, raise this as a concern with the Division Director." SEC, References to SEC (Jan. 29, 2010), at p. 20.

[5864] Examiner's Interview of SEC staff, Aug. 24, 2009, at p. 11.

[5865] Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at p. 6. Nor is there evidence that within the SEC, the Division of Trading and Markets advised the Division of Corporation Finance that there was an issue as to whether Lehman should have updated its public disclosures about its liquidity pool. *Id.* at p. 8.

In late August 2008, the SEC learned that JPMorgan wanted Lehman to pledge $5 billion in collateral to continue to fund Lehman trades.[5866] SEC personnel spoke to Lehman, and Lehman Treasurer Paolo Tonucci told them that $5 billion would "not affect" Lehman's liquidity pool.[5867] The SEC did not know that JPMorgan had demanded that Lehman post additional capital the week of September 8.[5868] The SEC was not aware of any significant issues with Lehman's liquidity pool[5869] until September 12, 2008, when officials learned that a large portion of Lehman's liquidity pool had been allocated to its clearing banks to induce them to continue providing essential clearing services.[5870] In a September 12, 2008 e-mail, one SEC analyst wrote:

> Key point: Lehman's liquidity pool is almost totally locked up with clearing banks to cover intraday credit ($15bn with jpm, $10bn with others like citi and bofa). This is a really big problem.[5871]

(2) The SEC and FRBNY Did Not Always Share Information about Lehman

The SEC and FRBNY each gathered and analyzed data concerning Lehman's liquidity pool. Although the two agencies executed a formal MOU sharing agreement, the agencies did not in fact share documents in several significant instances.

[5866] Examiner's Interview of SEC staff, Aug. 24, 2009, at 11-12.
[5867] *Id.*
[5868] *Id.*
[5869] *Id.*
[5870] E-mail from Michael Hsu, SEC, to Til Schuermann, FRBNY (Sept. 12, 2008) [FRBNY to Exam. 014851].
[5871] *Id.*

As a participant in the CSE Program, Lehman continuously transmitted liquidity information to the SEC for use in its scheduled on-site liquidity inspections. The FRBNY, by contrast, installed teams of officers on-site at each of the four CSEs, and the teams conducted their monitoring in-person and on a daily basis, in addition to receiving a continuous stream of liquidity-related reports. Given their overlapping monitoring functions, the SEC and Board of Governors of the Federal Reserve System executed an MOU on July 7, 2008, which allowed the regulators to share information regarding Lehman's liquidity position.[5872] Article III of the MOU established "procedures for sharing information in areas of common regulatory and supervisory interest." The MOU set forth:

> 13. As *primary supervisor* of CSEs, the [SEC] will provide the Federal Reserve, on an ongoing basis to the extent requested –
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> > a. Information and analysis regarding the financial condition, risk management systems, internal controls and capital, liquidity and funding resources of the CSEs . . . .[5873]

Likewise, the MOU stated:

> 12. The Federal Reserve will provide the [SEC] on an ongoing basis to the extent requested –

[5872] SEC/FRBNY, Memorandum of Understanding Between the United States Securities and Exchange Commission and the Board of Governors of the Federal Reserve System Regarding Coordination and Information Sharing in Areas of Common Regulatory and Supervisory Interest (July 7, 2008), at p. 4, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080707a1.pdf.

[5873] *Id.* (emphasis added.)

> a. Information and analysis regarding the financial condition, risk management systems, internal controls and capital, liquidity and funding resources of the CSEs . . . .[5874]

That is, by the terms of the MOU, the FRBNY and SEC were to share information insofar as the other agency affirmatively requested it. Bernanke said that the "premise" of the MOU was that the agencies would share information about the CSEs.[5875] The MOU further stated:

> 17. The [SEC] and Federal Reserve will collaborate and cooperate with each other in –
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> a. Obtaining (including through visitations, reports and other means), analyzing and evaluating information regarding the capital, liquidity, and funding position, and resources, and associated risk management systems and controls of CSEs . . .;
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> b. Setting supervisory and regulatory expectations, guidelines, or rules concerning the capital, liquidity, and funding position and resources, and associated risk management systems and controls, of CSEs . . . .[5876]

[5874] *Id*.

[5875] Examiner's Interview of Ben S. Bernanke, Dec. 22, 2009, at p. 7. While noting the broad premise of the MOU, Bernanke noted some "tricky" aspects of the MOU as well, *e.g.*, whether the SEC could use information shared by the FRBNY to undertake an investigation. Bernanke did not state whether there had been any resolution to this issue. Bernanke further stated that he worked on the MOU personally, with SEC Chairman Christopher Cox. *Id.*

[5876] SEC/FRBNY, Memorandum of Understanding Between the United States Securities and Exchange Commission and the Board of Governors of the Federal Reserve System Regarding Coordination and Information Sharing in Areas of Common Regulatory and Supervisory Interest (July 7, 2008), at p. 5, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080707a1.pdf.

Lehman prepared materials for distribution to both agencies, and gave presentations on liquidity issues to both agencies simultaneously.[5877] The SEC and FRBNY did share information and insight they obtained individually regarding Lehman's liquidity,[5878] but not always.

On or about August 20, 2008, the FRBNY became aware that a substantial portion of Lehman's liquidity pool was also allocated to clearing banks as collateral. In an e-mail exchange pertaining to Lehman's ongoing negotiations with clearing banks, FRBNY officer Voigts updated senior FRBNY personnel (including Geithner) on recent requests by Lehman's clearing banks for additional intraday collateral.[5879] Voigts noted (1) that Lehman had posted $5 billion to JPMorgan to match triparty investor haircuts, soon to be encumbered by a lien; and (2) that Lehman continued to post $2 billion in

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[5877] *See, e.g.*, e-mail from Danielle de la Vega, Lehman, to Michael A. Macchiaroli, SEC, *et al.* (July 29, 2008) [LBEX-DOCID 731328] (forwarding daily executive summary of Lehman's liquidity position for July 29, 2008); e-mail from Danielle de la Vega, Lehman, to Jan H. Voigts, FRBNY, *et al.* (July 30, 2008) [LBEX-DOCID 697484] (forwarding same); e-mail from Danielle de la Vega, Lehman, to Michael A. Macchiaroli, SEC, *et al.* (Aug. 21, 2008) (forwarding daily executive summary of Lehman's liquidity position for August 20, 2008); e-mail from Danielle de la Vega, Lehman, to Jan H. Voigts, FRBNY, *et al.* (Aug. 21, 2008) [LBEX-DOCID 731312] (forwarding same).

[5878] *See e.g.*, e-mail from Arthur G. Angulo, FRBNY, to Timothy F. Geithner, FRBNY (Sept. 12, 2008) [FRBNY to Exam. 014851] (forwarding e-mail exchange between Hsu and Schuermann) (discussed above); e-mail from Til Schuermann, FRBNY, to William Brodows, FRBNY, *et al.* (July 14, 2008) [FRBNY to Exam. 047757] (forwarding e-mail exchange between Hsu and Schuermann).

[5879] E-mail from Jan H. Voigts, FRBNY, to Arthur G. Angulo, FRBNY (Aug. 20, 2008) [FRBNY to Exam. 033297].

collateral to Citibank, intraday.[5880] The analysts concluded that Lehman had $7 billion less in liquidity than reported.[5881]

The FRBNY discounted the value of Lehman's pool to account for these collateral transfers. The FRBNY did not ask Lehman to exclude this collateral from its pool, or to take further action as a result of these revelations. Voigts explained: "how Lehman reports its liquidity is up to the SEC and the world."[5882] In the same vein, FRBNY witnesses repeatedly stated that they were mindful that the FRBNY was not Lehman's "primary regulator" under the CSE Program, and that the FRBNY was not monitoring Lehman with an eye toward regulatory compliance or enforcement.[5883] These functions, the witnesses have uniformly stated, were within the ambit of the SEC's CSE oversight.[5884] Nevertheless, the FRBNY apparently did not take steps to ensure that the SEC had the same information.[5885]

[5880] *Id*.

[5881] *Id.* Angulo wrote to Voigts: "Seems like LEH has $7B (and perhaps soon to be $8B+) less in available liquidity than reported," and later: "[c]onceptually I can see an argument for including the $7B in the liquidity pool if JPM and C[iti] release the collateral to LEH every night . . . . On the other hand, [it] doesn't seem quite right to view the $7B as 'unencumbered.'" E-mail from Arthur G. Angulo, FRBNY, to Jan H. Voigts, FRBNY (Aug. 20, 2008) [FRBNY to Exam. 033297]. Voigts agreed with Angulo's assessment. E-mail from Jan H. Voigts, FRBNY, to Arthur G. Angulo, FRBNY (Aug. 21, 2008) [FRBNY to Exam. 033297].

[5882] Examiner's Interview of Jan H. Voigts, Oct. 1, 2009, at p. 7.

[5883] Examiner's Interview of Arthur G. Angulo, Aug. 12, 2009, at p. 3; Examiner's Interview of Thomas C. Baxter, Jr., Aug. 31, 2009, at p. 4 (the SEC was "without question" Lehman's "main supervisor," and the FRBNY monitored Lehman as a potential lender).

[5884] Examiner's Interview of Jan H. Voigts, Oct. 1, 2009, at p. 7.

[5885] *Id*.

There is no evidence that the FRBNY declined to share information that was specifically requested by the SEC; however the FRBNY witnesses told the Examiner that they did not perceive any duty to volunteer liquidity information to the SEC because the SEC did not always share information with the FRBNY. The FRBNY was aware of and asked the SEC to share two "horizontals," or sector-wide reviews of CSE commercial real estate exposures and liquidity positions, the SEC had conducted. The SEC affirmatively declined to share these horizontals.[5886] In the words of one FRBNY witness: "there was not a warm audience" for sharing information between the two entities.[5887] The SEC confirmed that it did not share these analyses with the FRBNY, but represented that the analyses were still in draft at the time of Lehman's bankruptcy, and as such, not in a condition to be shared externally.[5888]

In sum, even though the SEC and FRBNY had an MOU in place to facilitate the exchange information about CSE liquidity, the FRBNY and the SEC did not share all material information that each collected about Lehman's liquidity pool.

g) The Government's Preparation for the "Lehman Weekend" Meetings at the FRBNY

The FRBNY, Treasury Department, the SEC and the Federal Reserve coordinated actions in what became known as the "Lehman Weekend" meetings of September 12-

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[5886] Examiner's Interview of Jan H. Voigts, Oct. 1, 2009, at p. 7.

[5887] *Id*.

[5888] Letter from SEC to Robert L. Byman, Counsel to the Examiner (Jan. 29, 2010).

14, 2008, at the FRBNY, in which the Government attempted to orchestrate a private-sector rescue of Lehman.

On Wednesday, September 10, 2008, FRBNY staff put together a draft gameplan for a "liquidity consortium" of major Wall Street banks to "provide a forum where these firms can explore possibilities of joint funding mechanisms to avert Lehman's insolvency."[5889] Although a draft, the staff's proposed gameplan is an instructive, contemporaneous record of the thinking of some in the FRBNY with respect to how to approach Lehman during the uncertain week of September 8, 2008.

The draft gameplan contemplated that the meeting would occur "at the very latest" on Friday the 12th.[5890] Consortium members would be given "[v]ery little advance" notice, "2 hours max," in order to "minimize the risk of outside leaks."[5891] The gameplan further specified: "FRBNY to host. [Treasury Secretary Henry] Paulson delivers introductory remarks."[5892] Substantively, the gameplan provided that the officials from the assembled banks would be

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[5889] FRBNY, Liquidity Consortium (Sept. 10, 2008), at p. 1 [FRBNY to Exam. 003517]; e-mail from Michael Nelson, FRBNY, to Christine Cummings, FRBNY, *et al.* (Sept. 10, 2008) [FRBNY to Exam. 003516] (distributing Liquidity Consortium outline with the subject line, "revised liquidity gameplan"). Possible consortium members would include those depository and investment banks with exposures to Lehman through loans, triparty repos and derivatives; such firms would include: Citibank, Credit Suisse, Deutsche Bank, Goldman Sachs, Morgan Stanley, Merrill Lynch, JPMorgan, and the Royal Bank of Scotland. FRBNY, Liquidity Consortium (Sept. 10, 2008), at p. 1 [FRBNY to Exam. 003517].

[5890] *Id.*

[5891] *Id.*

[5892] *Id.* at p. 2.

> told by Paulson that they have until the opening of business in Asia (Sunday night N[ew] Y[ork] time) to explore whether they can jointly come up with a credible plan to recapitalize Lehman to an extent necessary to enable an orderly winding down. Paulson conveys willingness of the official sector to let Lehman fail.[5893]

The draft states that the FRBNY should fix a maximum amount that it would be willing to finance to the consortium, "but not divulge our willingness to do so to the consortium."[5894] Similarly, the draft states that the FRBNY must "hone in on the monetary figure we think the consortium will have to provide in new capital," as well as "the type/maximum amount of any FR [Federal Reserve] financing to support the consortium."[5895] Geithner later told the Examiner that any extension of Government funding to Lehman contemplated in the gameplan draft was contingent on Lehman having a willing buyer.[5896]

As of September 10, 2008, the FRBNY had settled on the public line that no government funds would be invested to rescue Lehman.[5897] This public line was a bargaining strategy to encourage a private consortium of banks to provide the funds themselves.[5898] The draft liquidation consortium gameplan, however, did not foreclose

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[5893] *Id*.

[5894] *Id*. at p. 2.

[5895] *Id.* at p. 5.

[5896] Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 9 (when shown the Liquidity Consortium gameplan document, Geithner confirmed that the FRBNY would have considered extending financing to Lehman, but only if a willing buyer for the firm had surfaced).

[5897] Examiner's Interview of Thomas C. Baxter, Jr., Aug. 31, 2009, at p. 7.

[5898] *Id*. (shown the Liquidity Consortium gameplan document, Baxter confirmed the Examiner's understanding that the references in the document to a "willingness" in the official sector to let Lehman

the possibility that the FRBNY would finance some amount of liquidity; despite noting legal and fiscal obstacles in other areas, the draft did not raise any concern about the possibility of FRBNY financing.[5899] The gameplan slated the FRBNY to communicate with "foreign supervisors" on the evening of Friday September 12 while the consortium convened for its initial meeting.[5900]

A more detailed draft timeline for the implementation of the FRBNY's liquidation consortium plan was circulated the next morning, Thursday, September 11, 2008.[5901] The timeline provided that later in the morning Geithner would (1) inform Bernanke and Paulson that the FRBNY would convene the liquidity consortium on Friday; and (2) ask Paulson to make an introductory address to the group.[5902] Geithner would then contact BofA CEO Kenneth Lewis to probe BofA's interest in acquiring

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"fail," and the FRBNY's unwillingness to "divulge" the amount of financing it was willing to extend to the consortium was a "strategy" to encourage the gathered banks not to expect a "Bear Stearns solution," and thus to contribute their own funds to an industry solution to the Lehman problem).

[5899] The "Open Issues" section of the document identifies issues to be resolved in advance of the consortium meeting. FRBNY, Liquidity Consortium (Sept. 10, 2008), at pp. 2-3 [FRBNY to Exam. 003517]. These issues include: shareholder approval for any deal emerging from the meeting; the risk that creditors could put Lehman into involuntary bankruptcy prior to a resolution; and the need to obtain "[r]egulatory approvals," including from regulators outside of the United States. *Id.* Concern over legal authority or financial means to intervene to rescue Lehman is not present under the "Legal" sub-section of the draft agenda's "Open Issues" discussion. *Id.*

[5900] *Id.* at p. 2.

[5901] E-mail from Michael Nelson, FRBNY, to Christine Cumming, FRBNY (Sept. 11, 2008) [FRBNY to Exam. 003513] (cover e-mail); FRBNY, Timeline — Liquidation Consortium (Sept. 11, 2008) [FRBNY to Exam. 003514].

[5902] FRBNY, Timeline – Liquidation Consortium (Sept. 11, 2008), at p. 1 [FRBNY to Exam. 003514].

Lehman.[5903] If Lewis declined to make a bid on behalf of BofA, or if Lehman rejected the bid, the FRBNY would proceed with its consortium plan.[5904]

The September 11 draft timeline contemplated that the FRBNY would prepare the final list of consortium members on the evening of September 12, and settle on "minimum capital contributions expected from the consortium" as well as the "level" or "type of liquidity to be offered, if necessary, by the Federal Reserve."[5905] The timeline would have the FRBNY contact foreign regulators on the evening of September 12.[5906]

The timeline proposed that on Saturday and Sunday, after the consortium was convened, it would engage in due diligence on Lehman's assets in order to gauge the feasibility of any recapitalization plan, and report its progress to Bernanke, Paulson, and Geithner.[5907] If no plan was forthcoming, the FRBNY would "reach out to regulators in DC and abroad to inform them of potential market disruptions at the opening of business on Monday and/or possible bankruptcy filing by Lehman."[5908]

In his interview with the Examiner, FRBNY General Counsel Thomas Baxter described the Government's approach to the Lehman crisis succinctly. There were two possible models for Government intervention, Baxter explained: (1) the FRBNY could

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[5903] *Id.*
[5904] *Id.*
[5905] *Id.*
[5906] *Id.*
[5907] *Id.* at p. 2.
[5908] *Id.*

extend a "Maiden Lane"-style non-recourse loan to a potential purchaser of Lehman, as it did to JPMorgan with Bear Stearns;[5909] or (2) the FRBNY could convene a consortium of private market participants to finance Lehman's bad assets, as it had in the case of the near-failure of the hedge fund Long Term Capital Management ("LTCM") in 1998.[5910] The goal, Baxter said, was to make Wall Street view the LTCM intervention, rather than the Bear Stearns intervention, as the model for Lehman.[5911]

The FRBNY's actions in the Bear Stearns rescue placed public funds at risk and stood in contrast to the FRBNY's approach to LTCM. LTCM was a hedge fund that had become over-leveraged and was brought to the brink of collapse by market conditions caused by Russia's default on its debt obligations in 1998.[5912] The FRBNY feared that LTCM's creditors and counterparties would close out their positions, and liquidate collateral supporting those positions simultaneously. Such an *en masse* liquidation, the

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[5909] In order to contain the economic fallout of the Bear Stearns near collapse and to facilitate an acquisition of the failed investment bank by JPMorgan, on March 16, 2008, the Federal Reserve Board of Governors granted the FRBNY authority to extend a $29 billion senior loan to a newly-created Delaware LLC called "Maiden Lane." JPMorgan also extended a $1 billion subordinated note to Maiden Lane. Maiden Lane, in turn, purchased $30 billion of illiquid assets from Bear Stearns, as marked-to-market by Bear on March 14, 2008. The transfer involved $30 billion in illiquid real estate-related assets from Bear Stearns to Maiden Lane. Because the FRBNY loan was styled as a non-recourse loan, the FRBNY's commitment was secured only by the portfolio of assets held by Maiden Lane. Thus the U.S. Government was responsible for any losses in the event the liquidation of the transferred assets could not fully repay the principal advanced by the FRBNY. *See* FRBNY, Press Release: Summary of Terms and Conditions Regarding the JPMorgan Facility (Mar. 24, 2008), *available at* http://newyorkfed.org/newsevents/news/markets/2008/rp080324b.html.

[5910] Examiner's Interview of Thomas C. Baxter, Jr., Aug. 31, 2009, at p. 8.

[5911] *Id*.

[5912] General Accounting Office, *Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk*, Report to Congressional Requesters (Oct. 29, 1999), at 42.

FRBNY believed, would result in "a likelihood that a number of credit and interest rate markets would experience extreme price moves and possibly cease to function for a period of one or more days and maybe longer."[5913] After remedies short of Government intervention had failed, the FRBNY convened a consortium of LTCM's major creditors to devise an industry-created plan to recapitalize the hedge fund. Thus, on September 22 and 23, 1998, 14 banks and securities firms met at the FRBNY's offices, created a term sheet for a recapitalization of the hedge fund and, ultimately, committed to inject $3.6 billion in LTCM to avoid a disorderly liquidation.[5914] As former FRBNY President William McDonough emphasized in his testimony before the U.S. House of Representatives: "[T]his was a private sector solution to a private sector problem, involving an investment of new equity by Long-Term Capital's creditors and counterparties."[5915]

Rather than a Bear Stearns-style "bailout" for Lehman,[5916] the FRBNY went forward with plans for a LTCM-style "liquidation consortium" on September 12, 2008.

[5913] Statement by William J. McDonough, President of the Federal Reserve Bank of New York Before the Comm. on Banking and Financial Servs., U.S. House of Representatives, Oct. 1, 1998, at 4.
[5914] *Id*. at pp. 6-7; GAO Report to Congressional Requesters, Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk (Oct. 29, 1999), at 44.
[5915] Statement by William J. McDonough, President of the Federal Reserve Bank of New York Before the Comm. on Banking and Fin. Servs., U.S. House of Representatives, Oct. 1, 1998, at p. 7.
[5916] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 9.

h) On the Evening of Friday, September 12, 2008, the Government Convened a Meeting of the Major Wall Street Firms in an Attempt to Facilitate the Rescue of Lehman

By all accounts, the liquidation consortium meetings at the FRBNY began largely as conceived in the draft agenda and timelines. The FRBNY convened a meeting of the major Wall Street financial institutions, all of which agreed to finance Lehman's bad assets and thereby facilitate the sale of Lehman to one of its suitors.[5917] However, the deal foundered on the issue of whether Barclays would be able to guarantee Lehman's outstanding trades, as requested by the FRBNY.

True to the FRBNY's draft gameplan, Geithner spoke with Callum McCarthy, then-Chairman of the British Financial Services Authority ("FSA") on September 11, and informed McCarthy of FRBNY plans to convene "a consortium of financial institutions . . . to rescue Lehman."[5918]

During the morning of September 12, 2008, John S. Varley, Group Chief Executive of Barclays, spoke with Paulson.[5919] Varley informed Paulson that Barclays was interested in making a bid for Lehman.[5920] Paulson responded that any purchaser would need to make a bid before the end of the weekend, after which time the

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[5917] *Id*. at pp. 9-10.
[5918] Financial Services Authority (U.K.), Statement of the Financial Services Authority (Jan. 20, 2010), at p. 2.
[5919] *Id.* at p. 3.
[5920] *Id*.

Government planned to place Lehman into an orderly wind-down.[5921] According to the FSA, in a conversation later that day, Alistair M. Darling, Chancellor of the Exchequer, advised Paulson "that no transaction with Barclays would be possible if the level of risk to Barclays was inappropriate."[5922] Paulson "accepted this and advised that the FRBNY might be prepared to provide Barclays with regulatory assistance to support such a transaction if it was required."[5923]

On the evening of Friday, September 12, 12 investment bank CEOs were summoned to the FRBNY's headquarters at 33 Liberty Street in New York City.[5924] Bernanke remained in Washington, given the possibility that the Federal Reserve might need to exercise its emergency lending powers, which would require him to convene a Federal Reserve Board meeting.[5925] The CEO participants present at 33 Liberty included: JPMorgan's Jamie Dimon, Morgan Stanley's John Mack, Citigroup's Vikram Pandit and Robert Wolf of UBS. Executives from Lehman Brothers did not attend.[5926]

Paulson opened the meeting by noting the absence of Lehman representatives.[5927] Paulson said their absence was intentional, because the meeting was convened to

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[5921] *Id*.
[5922] *Id.* at p. 5.
[5923] *Id*.
[5924] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 9.
[5925] Examiner's Interview of Ben S. Bernanke, Dec. 22, 2009, at p. 9.
[5926] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 9.
[5927] *Id*.

discuss Lehman specifically.[5928] Paulson noted the absence of BofA and Barclays Capital executives as well, due to the fact that these banks were involved in potential deals to acquire Lehman.[5929]

Paulson stated that the purpose of the meeting was twofold. First, the Government tasked the CEOs with creating a plan to facilitate the acquisition of Lehman, and second, if such a plan was not forthcoming, Paulson stated the onus was on the CEOs to provide the Government with the means to resolve the consequences of Lehman's failure.[5930] Moreover, with regard to the financing of any potential rescue of Lehman, Paulson stated: "Not one penny will come from the Government."[5931] Paulson did not elaborate, but Lehman's only options were to be rescued by a firm (or a consortium of firms) or to file for bankruptcy on Monday, September 15.[5932]

Secretary Paulson told the Examiner that no Government aid would be forthcoming because he concluded that the Government lacked authority to inject capital into struggling institutions.[5933] While Paulson allowed that under Section 13(3)

[5928] *Id*.

[5929] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at pp. 15-16.

[5930] *Id*. at p. 16.

[5931] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 9 (reporting Paulson's statement).

[5932] *Id.* Cox said that most attendees "probably assumed that [Secretary Paulson's statement of no government help] was a negotiation" strategy and were "generally surprised when in fact there was no money there." Examiner's Interview of Christopher Cox, Jan. 8, 2010, at p. 15.

[5933] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 16.

of the Federal Reserve Act the Fed might be able to lend against any collateral,[5934] he feared that providing emergency funds to the ailing bank would cause its clients to flee, ensuring its demise.[5935]

That weekend, Lehman's "financial team" came on-site to the FRBNY and "opened their books" to representatives from the investment banks in order to work out the details of any potential rescue.[5936] Barclays was permitted to examine Lehman's books, in order to conduct the due diligence necessary to determine whether it would acquire Lehman.[5937] Baxter noted concern among the firms that by negotiating a rescue for Lehman, they would be "financing a sweetheart deal for one of their competitors."[5938] Nevertheless, due diligence and planning continued.

But Barclays and the British regulators had their own reservations. During the evening of September 13, 2008, Barclays advised the FSA that the FRBNY was asking Barclays to guarantee Lehman's financial obligations in a manner similar to that

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[5934] Section 13(3) provides that a Federal Reserve Bank may, "[i]n unusual and exigent circumstances" lend to any individual or corporation so long as the lending is "secured to the satisfaction" of the Federal Reserve Bank. 12 U.S.C. § 343. But the Fed and FRBNY emphasized that they could not lend against insufficient collateral. Examiner's Interview of Ben S. Bernanke, December 22, 2009, at 2 (then-FRBNY President Timothy F. Geithner informed Chairman Bernanke that the Fed would be "lending into a run," and that, while a loan might help pay off some counterparties, it would not save Lehman. Chairman Bernanke concluded that Lehman was insolvent and lacked any collateral, given that its assets fell short of obligations that would come due).

[5935] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 16.

[5936] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at pp. 9-10.

[5937] Financial Services Authority (U.K.), Statement of the Financial Services Authority (Jan. 20, 2010), at p. 5.

[5938] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 10.

provided by JPMorgan when it acquired Bear Stearns.[5939] Barclays recognized, and the FSA confirmed, that British regulations would require shareholder approval before such a guaranty could be granted.[5940] Later that evening, Barclays advised the FSA that "because of the guarantee" issue, it was "unlikely that a suitable structure to purchase Lehman could be put in place which would satisfy [its] Board."[5941] McCarthy spoke to Geithner that evening about the state of the negotiations, and McCarthy reported that although no proposal had yet been shown to the FSA by Barclays, "if one was it would raise significant issues."[5942] Yet, because no proposal had "been put forward . . . it was impossible to say whether any particular proposal would prove acceptable."[5943]

On the afternoon of Sunday, September 14, 2008 (London time), the FSA informed the FRBNY that the guaranty issue would need to be resolved before any take-over could be approved.[5944] According to the FSA, Geithner replied that the FRBNY had arranged for a consortium of Wall Street firms to take Lehman's illiquid assets, but that a guaranty from Barclays "would still be required."[5945] Barclays, the FSA

[5939] Financial Services Authority (U.K.), Statement of the Financial Services Authority (Jan. 20, 2010), at p. 7.

[5940] *Id*.

[5941] *Id*.

[5942] *Id*.

[5943] *Id*.

[5944] *Id.* at p. 8. Baxter advised the Examiner that the FRBNY did not learn that providing a guaranty had become an issue until "late" on Sunday, September 14. Examiner's Interview of Thomas C. Baxter, Jr., Aug. 31, 2009, at p. 8.

[5945] Financial Services Authority (U.K.), Statement of the Financial Services Authority (Jan. 20, 2010), at p. 8.

and the FRBNY continued to discuss the regulatory and prudential obstacles presented by the guaranty issue throughout the day on September 14. By late afternoon or early evening, however the FSA and Barclays "agreed that neither the Barclays Board nor the FSA could approve any transaction structure that required Barclays to provide the guarantee asked for by the FRBNY."[5946]

Over the weekend, the assembled banks had agreed to provide at least $20 billion in financing to facilitate Lehman's acquisition by Barclays.[5947] According to Government witnesses, it was not for want of cooperation, coordination or Government pressure that Lehman was not acquired.[5948] Rather, those Government representatives present for the meetings laid the failure of the deal on Barclays' inability to guarantee trading losses associated with the acquisition.[5949]

Baxter was clear in his conviction that the inability of Barclays to obtain a guaranty was due to the unwillingness of the British government, specifically the FSA, to waive the British legal requirement that Barclays obtain a shareholder vote on the issue.[5950] This critical viewpoint was uniformly held among the FRBNY witnesses interviewed by the Examiner. Voigts agreed that a sale of Lehman was not possible because Barclays was unable to obtain a waiver from the FSA to guarantee Lehman's

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[5946] *Id*. at p. 10.
[5947] Examiner's Interview of Henry M. Paulson, June 25, 2009, at p. 18.
[5948] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 9.
[5949] *Id.*; Examiner's Interview of Jan H. Voigts, Aug. 25, 2009, at p. 7.
[5950] Examiner's Interview of Thomas C. Baxter, Jr., Aug. 31, 2009, at p. 8.

obligations.[5951] Geithner echoed these comments, stating that a deal during Lehman Weekend was impracticable because Lehman lacked a buyer.[5952] In Geithner's view, had Lehman had a buyer in Barclays or any other third party, the Government would have extended financing to that buyer to help facilitate the sale.[5953] Bernanke also attributed the Government's ultimate inability to rescue Lehman to the absence of a buyer for the firm.[5954]

Baxter stated his belief that the British government simply did not want Barclays to acquire Lehman, and therefore refused to allow Barclays to guarantee the deal, or otherwise backstop the transaction.[5955] The FSA explained to the Examiner that, because Barclays was one of the U.K.'s clearing banks, "it was important to ensure that Barclays did not expose itself to a level of risk that would weaken it to an extent that could have a wider systemic impact on the U.K. financial system."[5956] Further, Chairman McCarthy told Chairman Cox that there was no precedent for waiving the U.K. law requirement that Barclays obtain shareholder approval prior to agreeing to any guaranty in these

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[5951] Examiner's Interview of Jan H. Voigts, Aug. 25, 2009, at p. 7.
[5952] Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 9.
[5953] *Id*.
[5954] Examiner's Interview of Ben S. Bernanke, Dec. 22, 2009, at p. 2.
[5955] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 10.
[5956] The Examiner sought, but was not granted, an interview with the FSA decision makers; but the FSA did provide written answers to questions. Financial Services Authority (U.K.), Statement of the Financial Services Authority (Jan. 20, 2010), at p. 6.

exigent circumstances.[5957] Cox indirectly confirmed to the Examiner that the FSA acted reasonably.[5958] For his part, Baxter stated that there was a "policy issue" with the FRBNY providing a backstop for an acquisition by a British bank.[5959] Baxter said that the FRBNY lacked this authority because the FRBNY could not issue a guaranty to support the transaction.[5960] Rather, the FRBNY could only provide secured financing in support of such a transaction.[5961] Baxter stated that he found it "shocking" that the deal would founder for lack of a guaranty, and that it was the financing of the deal, rather than the guaranty which should have been the most challenging barrier to overcome in any rescue of Lehman.[5962]

Paulson distinguished the Government's action to intervene to backstop AIG, from the absence of Government action to backstop Lehman. According to Paulson, Lehman had liquidity problems and no hard assets against which to lend.[5963] AIG, by contrast, Paulson said, had a capital problem at the holding company level, but

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[5957] *Id*. at p. 10.

[5958] Examiner's Interview of Christopher Cox, Jan. 8, 2010, at p. 18. (Cox recalled a specific conversation on the subject, but after SEC counsel would not permit him to recount that conversation, invoking the "deliberative process" privilege, Cox answered the general question: "In all your conversations with the FSA, did they ever take an unreasonable position?" Chairman Cox responded: "At no time in my dealings with the FSA did I think they were unreasonable; they had reasons for what they did.").

[5959] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 10.

[5960] *Id*.

[5961] *Id*.

[5962] *Id.*

[5963] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 16.

otherwise had regulated insurance companies that were perceived by the market as stable, well-capitalized, and having real value.[5964]

A bankruptcy filing by the holding company was another of the contingency plans discussed at the FRBNY that weekend.[5965] The Government concluded that an *en masse* liquidation of the holding company would be "awful," and should be avoided.[5966] Nevertheless, assuming no alternative was available, the plan envisioned by the Government would be for LBHI to file for Chapter 11, while JPMorgan continued to lend to LBI as a going concern. LBI would then be eased into a SIPA proceeding, and wound down in an orderly way.[5967] This plan did not play out once Barclays came back to the bargaining table with a proposal to acquire the broker-dealer after LBHI entered bankruptcy.

On Sunday September 14, Baxter and Cox participated in a conference call with Lehman's Board of Directors.[5968] Also present on the Government side of the call were SEC General Counsel Brian Cartwright and Alan Beller of Cleary Gottlieb Steen & Hamilton, who was engaged by the Treasury Department.[5969] Baxter said the call was

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[5964] *Id*.
[5965] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 10.
[5966] *Id*.
[5967] *Id.* at pp. 10-11.
[5968] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 14, 2008) [LBEX-AM 003932] (noting that Baxter and Cox addressed the Board by telephone).
[5969] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 10.

arranged at the request of Paulson and Geithner.[5970] According to Lehman Board minutes, Baxter and Cox emphasized that the Board needed to make a decision regarding whether to file for bankruptcy quickly, and that this was a decision for the Board alone.[5971] Baxter recalled making statements to this effect.[5972] Cox recalled that he did not mention bankruptcy, but rather stated that whatever decision Lehman might make needed to be made immediately.[5973] Cox also recalled that "others from the Fed" who were on the call added that the Government had made it clear in earlier meetings that Lehman should file for bankruptcy.[5974] Baxter said he made the point "that opening on Monday was not an option because of the chaos in the markets."[5975]

Also that evening, the Federal Reserve broadened the collateral eligible for financing through the PDCF "to closely match the types of collateral that can be pledged in the triparty repo systems of the two major clearing banks."[5976] However, the FRBNY limited the collateral LBI could use for overnight financing to the collateral that

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[5970] *Id*.

[5971] Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 14, 2008), at pp. 5-6 [LBEX-AM 003932].

[5972] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 11.

[5973] Examiner's Interview of Christopher Cox, Jan. 8, 2010, at p. 17.

[5974] *Id*.

[5975] Lehman Brothers Holdings Inc., Minutes of the Meeting of the Board of Directors (Sept. 14, 2008), at pp. 5-6 [LBEX-AM 003932]; Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 10.

[5976] FRBNY, Press Release (Sept. 14, 2008), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20080914a.htm.

was in LBI's box at JPMorgan as of Friday, September 12, 2008.[5977] This restriction was referred to as the "Friday criteri[on]."[5978] In addition, the FRBNY imposed larger haircuts on LBI's PDCF borrowing than it did on other investment banks,[5979] and the haircuts imposed on LBI's PDCF borrowing were larger than under Lehman's pre-bankruptcy triparty borrowing.[5980]

In connection with Lehman's preparations to file the LBHI Chapter 11 petition, the FRBNY, acting as a lender of last resort, advised Lehman that it would provide up

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[5977] Examiner's Interview of Robert Azerad, Sept. 23, 2009, at p. 5; Examiner's Interview of Christopher Burke, July 7, 2009, at p. 3. An experimental allocation by Lehman to the PDCF on Monday morning showed at least $72 billion of eligible Lehman securities being swept into the PDCF system. *See* e-mail from John N. Palchynsky, Lehman, to Craig L. Jones, Lehman, *et al.* (Sept. 15, 2008) [LBEX-DOCID 076981];. *see also* Lehman, PDCF Schedule of Eligible Securities (Sept. 14, 2008) [LBEX-DOCID 405695].

[5978] Examiner's Interview of Robert Azerad, Sept. 23, 2009, at p. 5; Examiner's Interview of Christopher Burke, July 7, 2009, at p. 3. According to Azerad, this restriction prevented Lehman from posting the range of collateral to the PDCF that other firms were allowed to post after September 15, 2008. Examiner's Interview of Robert Azerad, Sept. 23, 2009, at p. 5; *see also* e-mail from Timothy Lyons, Lehman, to Ian T. Lowitt, Lehman (Sept. 14, 2008) [LBEX-DOCID 070210] (stating "the fed is letting the other eighteen broker dealers fund a much broader range of collateral than us").

[5979] Examiner's Interview of Christopher Burke, July 7, 2009, at p. 3; *see also* e-mail from Ricardo S. Chiavenato, JPMorgan, to Christopher Carlin, JPMorgan, *et al.* (Sept. 15, 2008) [JPM-2004 0055329]; Examiner's Interview of Robert Azerad, Sept. 23, 2009, at p. 5. According to Azerad, the Fed imposed the wider haircuts on Lehman because the Fed was not willing to take any losses in its overnight financing of Lehman. *Id.*

[5980] *See* e-mail from Sindy Aprigliano, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Sept. 15, 2008) [LBEX-DOCID 4572426, 4579671] (attaching list of an estimated haircut impact of approximately $4 billion); e-mail from Sindy Aprigliano, Lehman, to George Van Schaick, Lehman, *et al.* (Sept. 15, 2008) [LBEX-DOCID 077028] (discussing the larger haircuts imposed by the Fed on Lehman's PDCF borrowing); e-mail from Robert Azerad, Lehman, to Susan McLaughlin, Lehman, *et al*. (Sept. 15, 2008) [LBEX-DOCID 457643] (explaining the PDCF haircuts would "result in a $4 billion drain in liquidity . . . ."); *see also* Lehman, PDCF Schedule of Eligible Securities (Sept. 14, 2008) [LBEX-DOCID 405695] (detailing the PDCF haircuts applied to Lehman for the various categories of accepted securities); e-mail from Ricardo S. Chiavenato, JPMorgan, to Christopher Carlin, JPMorgan, *et al*. (Sept. 15, 2008) [JPM-2004 0055329]. *But see* e-mail from Sindy Aprigliano, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Sept. 15, 2008) [LBEX-DOCID 068353] (stating the haircut impact from using the PDCF would be $2 billion).

to two weeks of overnight secured financing through the PDCF to allow LBI to accomplish an orderly liquidation.[5981]

Baxter rejected the idea that "moral hazard" arguments played a role in "allowing" Lehman to fail. Baxter said the whole purpose of the FRBNY's extraordinary actions that weekend was to rescue Lehman in some form:[5982] "In no way was the idea to make Lehman a 'poster child' for moral hazard."[5983] "Clearly," Baxter said, "my sense was that [the Government] was not just going through the motions" and that Lehman was not "sacrificed to moral hazard."[5984] Baxter attributed the failure of the rescue effort to the British government's refusal to offer a guaranty to backstop the acquisition.[5985] In his interview, Paulson said that although economic health depends on Wall Street firms believing that the Government cannot and will not rescue them in a crisis, economic stability was nevertheless more important to the economy than moral hazard.[5986]

[5981] Examiner's Interview of Shari D. Leventhal, Apr. 30, 2009, at pp. 4-5. Some FRBNY employees thought the FRBNY was risking too much exposure with the two-week funding timeframe. *Id.* at p. 5.
[5982] *Id.*
[5983] *Id.*
[5984] *Id.*
[5985] *Id.* There were two distinct issues: (1) The U.K. regulators' refusal to waive the shareholder vote requirement necessary to approve a Barclays guaranty of outstanding Lehman trades; and (2) Lehman's failure to obtain a guaranty from Barclays, or any other entity, for potential trading losses.
[5986] Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 22.

i) Lehman's Bankruptcy Filing

LBHI filed for bankruptcy protection on Monday, September 15. The FRBNY was surprised by the consequences that Lehman's filing had in terms of funding LBIE, which was taken into administration by British regulators due to inadequate capitalization.[5987] The FRBNY was unaware that LBIE was financed entirely by the parent – that is, that LBHI pulled liquidity into New York, and would then re-route that funding to LBIE in the U.K.[5988] Baxter said he was unaware until that Monday that LBIE was dependent on its LBHI parent, but he learned otherwise when LBHI was forced to file for bankruptcy due to cross defaults from LBIE going into administration in the U.K.[5989] Even then, Baxter assumed that the Bank of England had the capacity to fund LBIE in a manner similar to that by which the FRBNY funded LBI through the Primary Dealer Credit Facility discount window for broker-dealers.[5990] The FSA told the Examiner that once it became known that LBHI would file for bankruptcy, the FSA asked the FRBNY if financing (via the FRBNY's discount window for broker-dealers) would be made available to LBIE and was told that it would not.[5991]

[5987] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 11; Examiner's Interview of Jan H. Voigts, Aug. 25, 2009, at pp. 7-8 (noting surprise at the extent to which LBIE was dependent on LBHI, the consequences of LBHI's bankruptcy, and the importance and complexity of intercompany funding within Lehman generally).

[5988] Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 11.

[5989] *Id*.

[5990] *Id*.

[5991] Financial Services Authority (U.K.), Statement of the Financial Services Authority (Jan. 20, 2010), at pp. 10-11.

Following Lehman's bankruptcy, Lehman, through its broker-dealer, LBI, relied on the PDCF to obtain $40 to $50 billion in overnight financing needed to repay its clearing banks.[5992] In addition, Lehman funded itself after the bankruptcy filing through two other FRBNY programs, the Open Market Operations ("OMO") and the Term Securities Lending Facility ("TSLF"),[5993] as well as triparty term repos that had not yet expired.[5994] The FRBNY's overnight financing of LBI began Monday evening, September 15, with Lehman borrowing approximately $28 billion via the PDCF.[5995] The FRBNY's overnight financing continued through Thursday morning, September 18, 2008.[5996] LBI was placed into SIPA proceedings on September 19, 2008.

[5992] *See* e-mail from David A. Weisbrod, JPMorgan, to Jamie L. Dimon, JPMorgan, *et. al*. (Sept. 15, 2008) [JPM-2004 0080146] (listing Lehman's triparty repo borrowing at $51 billion ($28 billion from the PDCF, $2 billion from Barclays, and $21 billion from other investors) for Monday); Alvarez & Marsal, Summary of Meeting with James Hraska on 10/08/08 [Draft] (Oct. 8, 2008), at pp. 1-4 [LBEX-AM 003302] (listing the Fed's funding of Lehman (via the PDCF, OMO, and TSLF) for the week following the LBHI petition).

[5993] Examiner's Interview of Christopher Burke, July 7, 2009, at p. 4; Alvarez & Marsal, Summary of Meeting with James Hraska on 10/08/08 [Draft] (Oct. 8, 2008), at pp. 1-4 [LBEX-AM 003302].

[5994] *See* e-mail from David A. Weisbrod, JPMorgan, to Jamie L. Dimon, JPMorgan, *et. al*. (Sept. 15, 2008) [JPM-2004 0080146-47] (listing $21 billion in "mainly term repos" as part of LBI's triparty borrowing for September 15).

[5995] *See* e-mail from Edward J. Corral, JPMorgan, to William Walsh, JPMorgan, *et al.* (Sept. 15, 2008) [JPM-2004 0031195] (notifying the Fed that the Lehman assets used in LBI's $28 billion PDCF repo on Monday night satisfied the Friday criterion). Earlier on Monday, Lehman estimated that it would borrow up to $35 billion through the PDCF on Monday night. *See* e-mail from Sindy Aprigliano, Lehman, to Robert Azerad, Lehman (Sept. 15, 2008) [LBEX-DOCID 1071653] (providing John Feraca's PDCF estimate of $27 billion plus a buffer of $8 billion); e-mail from Robert Azerad, Lehman, to Susan McLaughlin, Lehman, *et al.* (Sept. 15, 2008) [LBEX-DOCID 071550] (estimating $34 billion of PDCF borrowing); e-mail from Paolo R. Tonucci, Lehman, to Susan McLaughlin, Lehman, *et al.* (Sept. 15, 2008) [LBEX-DOCID 071550] (estimating $28.3 billion for the collateral value of the PDCF borrowing).

[5996] Examiner's Interview of Robert Azerad, Apr. 20, 2009, at p. 5.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	Chapter 11 Case No.
LEHMAN BROTHERS HOLDINGS INC., *et al.*,	:	08-13555 (JMP)
	:	(Jointly Administered)
Debtors.	:	

REPORT OF ANTON R. VALUKAS, EXAMINER

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VOLUME 5 OF 9

Section III.B: Avoidance Actions

Section III.C: Barclays Transaction

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REPORT OF EXAMINER ANTON R. VALUKAS

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B. Are There Administrative Claims or Colorable Claims for Preferences or Voidable Transfers

1. Executive Summary

This Section of the Report addresses the first, second, third, fourth, seventh and eighth bullet points of the Examiner Order. The Examiner's findings are as follows:

Administrative Claims (First Bullet). The Examiner concludes that LBHI Affiliates may have administrative claims against LBHI related to "cash sweeps" totaling approximately $60 million.

Transfers in Respect of Foreign Exchange Transactions (Second Bullet). The Examiner identified foreign exchange ("FX") transaction settlements involving LBHI Affiliates that took place between September 15, 2008 and the date upon which each applicable LBHI Affiliate commenced its Chapter 11 case. The Examiner concludes that, (1) as a result of LBHI's bankruptcy, LBCC did not have sufficient funds to meet all of its obligations to its FX counterparties, and (2) operational disruption impacted whether, and in what order, counterparties were paid.

Preference Claims Against LBHI (Third Bullet). The Examiner concludes that LBSF and LBCS have colorable preference claims against LBHI under Section 547(b) of the Bankruptcy Code, but there is also evidence to support LBHI's assertion of new value and ordinary course defenses.

Potentially Voidable Transfers or Incurrences of Debt Claims (Fourth Bullet). The Examiner has not identified any fraudulent transfers under Section 548 of the

Bankruptcy Code or under state law based on the methodologies employed by the Examiner's financial advisors. The Examiner's financial advisors reviewed the Debtors' expansive trading databases, SOFAs, and general ledger. Ultimately, the Examiner identified several transfers in the Debtors' trading databases that may warrant further investigation, but any such potential claims belong to LBI. The SIPA Trustee has been contacted about these transfers. As for the other analytical approaches, the Examiner has not been able to complete his analyses because the Debtors have not been able to provide back-up material for certain transfers of interest.

Intercompany Accounts and Transfers Thirty Days Prior to the Petition Date (Seventh Bullet). The Examiner has investigated and catalogued intercompany funding transfers not involving collateral between LBHI and certain LBHI Affiliates that took place between August 1, 2008 and September 12, 2008, as well as for the corresponding time period in 2007.

Avoidance Transactions (Eighth Bullet). The Examiner reviewed various guaranties entered into by LBHI shortly before its bankruptcy filing and transfers of collateral in connection with those guaranties. The Examiner concludes that there are colorable claims against JPMorgan and Citi to avoid the guaranties that they received from LBHI and to avoid certain of the transfers made in connection with those guaranties under Sections 547(b), 548 and 544 of the Bankruptcy Code and state law. Such claims, however, are subject to substantial defenses including that the transfers of

collateral to JPMorgan or Citi are protected from avoidance based upon the safe-harbor provisions of the Bankruptcy Code. The Examiner concludes that the evidence does not support the existence of colorable claims against FRBNY, BNYM, HSBC and the CME Group ("CME"). The Examiner elected not to examine the BofA transactions for purposes of determining whether colorable claims exist with respect to such transactions because they are the subject of on-going litigation. The Examiner was unable to reach a conclusion with respect to a $200 million collateral transfer to Standard Bank because of the lack of information showing whether a Lehman Chapter 11 debtor was the source of this collateral transfer.[5997]

2. Examiner's Investigation of Possible Administrative Claims Against LBHI (First Bullet)

a) Summary

The Examiner investigated and identified cash transfers constituting post-petition extensions of credit that may give rise to administrative claims by LBHI Affiliates. Such transfers include those from LBHI Affiliates to LBHI, as well as receipts of cash by LBHI for the benefit of LBHI Affiliates. The Examiner concludes that cash transfers in a total amount of approximately $60 million may give rise to administrative claims.

[5997] The Examiner notes that the claims analyzed herein arising under Sections 547(b), 548 and 544 of the Bankruptcy Code and state law are dependent upon an analysis of Lehman's financial condition as of the time of these transfers. Because the Examiner was directed only to determine if these claims were colorable, the Examiner's financial advisors have limited their analysis to a determination as to whether evidence exists to support a finding of the requisite financial condition.

b) Introduction

This Section of the Report examines "whether LBCC or any other entity that currently is an LBHI Chapter 11 debtor subsidiary or affiliate ("LBHI Affiliate(s)") has any administrative claims against LBHI resulting from LBHI's cash sweeps of cash balances, if any, from September 15, 2008, the commencement date of LBHI's Chapter 11 case, through the date that such applicable LBHI Affiliate commenced its Chapter 11 case."[5998]

Neither the Examiner Order nor the Bankruptcy Code define the term "cash sweep." However, in seeking authority to continue its pre-petition cash management system after the LBHI petition date, the Debtors described their practice of collecting, concentrating and disbursing cash, including intercompany funding and the sweeping of excess cash.[5999] In a Cash Management Order, the Bankruptcy Court thereafter approved the Debtors' post-bankruptcy continuation of its cash management system, including intercompany funding, and provided that any post-petition intercompany cash sweep by the Debtors was a post-petition extension of credit entitled to superpriority status.[6000] Specifically, the Court ordered that "from and after the

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[5998] Examiner Order at p. 3, first bullet.

[5999] *See* Debtors' Motion Pursuant to Sections 105(a), 345(b), 363(b), 363(c) and 364(a) of the Bankruptcy Code and Bankruptcy Rules 6003 and 6004 (A) for Authorization to (i) Continue Using Existing Centralized Cash Management System, as Modified … ("Cash Management Motion"), at pp. 6-7, Docket No. 669, *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Oct. 3, 2008).

[6000] Final Order Pursuant to Sections 105(a), 345(b), 363(b), 363(c) and 364(a) of the Bankruptcy Code and Bankruptcy Rules 6003 and 6004 (A) Authorizing the Debtors to (i) Continue to Use Existing Cash

Commencement Date, (i) the transfer of cash to or for the benefit of any Debtor directly or indirectly from any Debtor or non-Debtor affiliate shall entitle the transferring affiliate to an allowed claim in the recipient Debtor's Chapter 11 case, under Sections 364(c)(1) and 507(b) of the Bankruptcy Code, having priority over any and all administrative expenses of the kind specified in Sections 503(b) and 507(b) of the Bankruptcy Code…."[6001] Section 364(c) of the Bankruptcy Code allows a debtor to obtain credit or incur debt with priority over administrative expenses.[6002]

Thus, in light of the terms of the Cash Management Order, in this Section of the Report, "cash sweep" refers to any cash transfer that occurred between September 15, 2008 and the date that the applicable LBHI Affiliate commenced its Chapter 11 case (in each case, the "Stub Period"), from (1) an LBHI Affiliate to LBHI or (2) a third party to LBHI for the benefit of an LBHI Affiliate. Excluded from the definition of "cash sweep" are post-petition cash transfers made in payment or settlement of existing obligations; such transfers would not be post-petition extensions of credit in accordance with Section 364(c)(1) of the Bankruptcy Code.

Management System, as Modified … (the "Cash Management Order"), at p. 6, Docket No. 1416, *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Nov. 6, 2008).

[6001] *Id.*

[6002] Section 364(c)(1) of the Bankruptcy Code states, in relevant part, "the court… may authorize the obtaining of credit or the incurring of debt… with priority over any or all administrative expenses of the kind specified in section 503(b) … of this title." 11 U.S.C. § 364(c)(1). Section 503(b) of the Bankruptcy Code states, in relevant part, that "there shall be allowed administrative expenses … including … the actual, necessary costs and expenses of preserving the estate." 11 U.S.C. § 503(b).

In order to provide the context for identifying cash sweeps giving rise to administrative claims, this Section of the Report begins with an overview of Lehman's pre-petition cash management system, which, as the Bankruptcy Court noted, "was extraordinarily complex and involved the regular movement of vast sums among affiliated entities."[6003]

c) Lehman's Cash Management System

Lehman's Global Treasury Group (the "Treasury Group") was responsible for managing the firm's liquidity pool, funding the entities' business needs and ensuring effective use of the firm's capital.[6004] The Treasury Group was subdivided into various departments,[6005] including the Cash and Collateral Management Group.[6006] The Cash and Collateral Management Group, among other things, monitored the cash position of Lehman entities and managed their intra-day funding requirements.

[6003] Memorandum Decision Denying Relief from the Automatic Stay to Effectuate Setoff under 11 U.S.C. § 553(a), at p. 16, Docket No. 3551, *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. May 12, 2009).

[6004] *See* Lehman, FSA Arrow Assessment - Treasury (Aug. 11, 2008), at p. 2 [LBHI_SEC07940_3272979].

[6005] The Treasury Group was comprised of the following departments: Cash and Collateral Management, Asset Liability Management, Financial Planning and Analysis, Creditor Relations, Treasury Controllers and Network Management. *See id.*

[6006] *Id.* At the time of the LBHI bankruptcy filing, Daniel J. Fleming was Senior Vice President and Global Head of the Cash and Collateral Management Group. Examiner's Interview of Daniel J. Fleming, Apr. 22, 2009, at p. 1.

(1) LBHI's Role as Central Banker

LBHI acted as the central banker for the Lehman entities, controlling the cash disbursements and receivables for itself, its subsidiaries and its affiliates.[6007] In addition, through its central banking system, LBHI managed cash globally, allowing Lehman entities to use cash efficiently. LBHI's cash management system was designed to track all cash activity, manage cash, maximize investment opportunities and minimize costs.[6008] The firm-wide cash management system also streamlined Lehman's management and regulatory reporting process.[6009]

LBHI's cash management system was not completely integrated, and certain elements of the system functioned independently.[6010] As such, in order to view Lehman's global cash picture, LBHI's cash management team gathered information from various financial software management tools,[6011] as opposed to retrieving the

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[6007] Cash Management Motion, at p. 4 (¶ 10), Docket No. 669, *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Oct. 3, 2008). Notwithstanding LBHI's role as central banker, LBI paid expenses for the benefit of many U.S. Lehman entities. However, LBHI was primarily responsible for funding the business operations of these entities. *Id.* at pp. 4 (¶ 10), 8 (¶ 21).

[6008] *See* Lehman, GCCM System Description / Project Overview [LBEX-LL 385979]; Lehman, Introduction to GCCM; Concepts and Detail of GCCM Disbursements and Receipts Accounting, at p. 2 [LBEX-LL 029285].

[6009] While the cash management system was the same for regulated and non-regulated entities, regulated entities were subject to certain regulatory requirements which, among other things, caused such entities to account for some intercompany transactions differently and to retain more cash in their bank accounts than they would absent such regulatory requirements. Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 2.

[6010] Examiner's Interview of David Forsyth, Oct. 29, 2009, at p. 2.

[6011] LBHI used various applications and platforms including the Summit Treasury Workstation ("TWS") to manage its treasury functions. With respect to cash management, LBHI also used a variety of software programs in conjunction with TWS, including the Global Cash and Collateral Management system, which

information from one integrated system. Because the system was not fully integrated, the cash management team could obtain only an approximation of Lehman's cash position at any point in time.[6012]

(2) Global Cash and Collateral Management

In 2006, LBHI began to implement the Global Cash and Collateral Management ("GCCM") system, an in-house banking platform. GCCM was created to, among other things: (1) generate real-time integrated views of cash positions across time zones; (2) provide transparency into the generation and use of cash; (3) manage risk by calculating real-time unsecured bank credit usage and minimize payment by systematically releasing payment messages based on credit availability; and (4) forecast and fund efficiently by providing start-of-day, intra-day and end-of-day projected and actual cash positions across all currencies, legal entities and bank accounts.[6013]

While GCCM was intended by Lehman to facilitate efficient monitoring of the cash activity of its entities, an entity may have used multiple source systems[6014] that may or may not have been integrated into GCCM at the time of the LBHI bankruptcy

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functioned as a gateway for cash flows to and from the firm, and Lehman's general ledger system (DBS). Lehman, Finance Systems Overview, pp. 8, 14 [LBEX-AM 004340].

[6012] Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 5.

[6013] Lehman, GCCM System Description / Project Overview [LBEX-LL 385979].

[6014] Source systems are the applications in which business transactions were recorded, and which subsequently transmitted transaction information to DBS. At the time of the LBHI bankruptcy petition, the source systems integrated with GCCM served various functions, including: (1) clearance, payment and settlement of trades; (2) loan product administration; (3) employee compensation, benefits and expenses; (4) cash netting and wire transfers; and (5) firm funding. Examples of source systems include (1) ASAP, a payment and settlement system for fixed income and equity; (2) Loan IQ, a source system for loan product transactions and; (3) ITS, a multi-currency trade processing, settlement and book-keeping system.

filing.[6015] Therefore, the Treasury Group was able to track only a portion of certain entities' cash activity using GCCM.

Lehman also used GCCM to consolidate cash for investment purposes, reduce the number of bank accounts at other financial institutions and manage its bank accounts more efficiently.[6016] Cash consolidation within the GCCM system was unlike a traditional "cash sweep" system in that funds from individual accounts were not automatically transferred into a consolidation account on a daily basis. Rather, the Treasury Group used GCCM to manually sweep cash from LBHI Affiliate accounts to an LBHI consolidation account on an intra-day or daily basis, as needed.[6017]

In other words, Treasury Group personnel monitored GCCM on a daily basis to determine whether affiliate bank accounts had excess cash that was not immediately needed for the affiliate's business operations. If an affiliate had excess cash, the Treasury Group manually wired such cash to a designated consolidation account of

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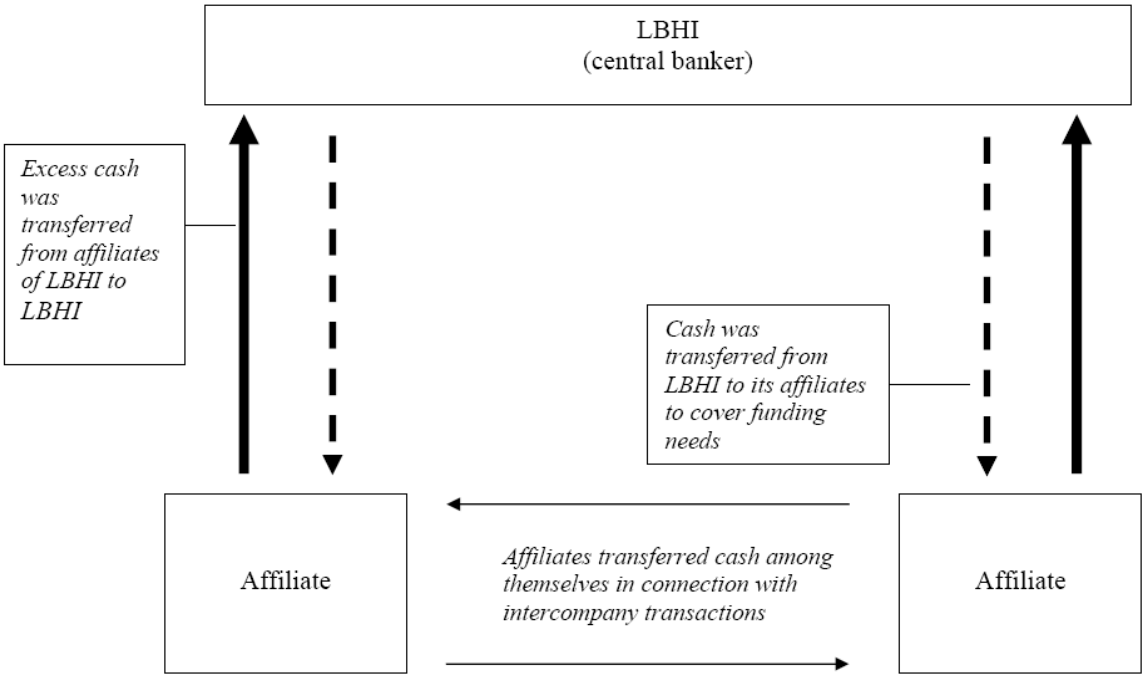
[6015] Integration into GCCM was done on a system-by-system basis, not on an entity-by-entity basis. Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 4. The Examiner observed that Loan IQ, a global multi-currency system for the processing and administration of bank loan products utilized by LCPI, had been integrated into GCCM at the time of the LBHI bankruptcy filing, and therefore data from Loan IQ was transmitted to GCCM. On the other hand, MTS (Mainframe Trading System), a securities trading system utilized by LBCC, had not been integrated into GCCM at the time of the LBHI bankruptcy filing, and therefore no data from MTS trades was included in GCCM.

[6016] *See* Lehman, Introduction to GCCM; Concepts and Detail of GCCM Disbursements and Receipts Accounting, at p. 4 [LBEX-LL 029285] (discussing Lehman's goal of creating an in-house bank model to, among other things, reduce the number of external bank accounts).

[6017] Cash Management Motion, at p. 5 (¶ 12), Docket No. 669, *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Oct. 3, 2008). The Treasury Group did not manually transfer cash between the External Bank Accounts of LBHI and its regulated subsidiaries on a daily basis. Rather, LBHI prefunded the obligations of its regulated subsidiaries, and such subsidiaries periodically transferred funds to LBHI or made payments to third parties on behalf of LBHI to decrease their intercompany payable. *See id.*

LBHI. On the other hand, if an affiliate had a negative cash position, LBHI funded the affiliate by wiring cash from its consolidation account to the affiliate's bank account. The following diagram illustrates the paths of these cash transfers among LBHI and its affiliates.

Movement of Cash Among LBHI and its Affiliates



As indicated in the diagram above, Lehman entities entered into transactions with other Lehman entities in the ordinary course of business. Such transactions may have resulted in transfers of cash among Lehman entities. However, in order to minimize the need to transfer cash among affiliates, Lehman established intercompany relationships in GCCM called "funding trees."[6018] Lehman entities connected to the same funding tree did not transfer cash to each other in connection with intercompany

[6018] Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at pp. 3-4.

transactions. Instead, such intercompany transactions were recorded on the books of these entities as intercompany payables and receivables.[6019]

Because GCCM was not fully integrated with Lehman's source systems, some transactions related to cash management took place outside of GCCM. For instance, certain cash transfers between LBHI and LCPI were recorded in the MTS system,[6020] which was responsible for the trading of fixed-income securities.[6021] Because MTS was a trading system that was not designed to record cash transfers, cash transfers were recorded in MTS as securities repurchase transactions.[6022]

(3) Lehman's External and Virtual Bank Accounts

LBHI maintained accounts at various banking institutions (collectively, the "External Bank Accounts"). Lehman tracked the movement and allocation of funds in External Bank Accounts using virtual accounts within GCCM. GCCM maintained two types of virtual accounts: (1) "Nostro Accounts," which mirrored External Bank Accounts,[6023] and (2) "In-House Accounts," which reflected the cash position, receivables and disbursements for each affiliate.[6024]

[6019] *Id*. at pp. 3-5.

[6020] In addition to cash transfers between LCPI and LBHI, the MTS system was also used to record cash transfers between LCPI and other Lehman entities. *Id.* at p. 7.

[6021] *Id.* at pp. 6-7.

[6022] *Id*. See Section III.B.3.e,8 of this Report, which discusses cash transfers recorded in MTS.

[6023] "Nostro" referred both to the actual accounts maintained at outside financial institutions and a representation of those actual accounts maintained within the GCCM system.

[6024] *See* Lehman, Introduction to GCCM; Concepts and Detail of GCCM Disbursements and Receipts Accounting, at pp. 3-4 [LBEX-LL 029285].

The In-House Accounts documented the amount of cash in LBHI's External Bank Account allocated to a particular entity. When an affiliate transferred monies to LBHI, those monies would be recorded with an accounting entry as an "intercompany payable" by LBHI owed to the affiliate, and a corresponding "intercompany receivable" would be recorded on the books of the affiliate.[6025] In this way, GCCM allowed LBHI to conduct its funding activity through a small number of External Bank Accounts, without segregating affiliate funds.

Furthermore, because Nostro Accounts and In-House Accounts within GCCM captured cash payment and receipt information, GCCM served as a conduit between the Lehman source systems and external banks.[6026] The transactions recorded in GCCM were ultimately recorded on the books of the participating Lehman entities via Lehman's general ledger system (DBS).[6027]

GCCM also facilitated the process by which LBHI and its affiliates made and received payments for the benefit of other affiliates.[6028] A receipt or payment of funds by one Lehman entity for the benefit of another was recorded in the Nostro Accounts and In-House Accounts within GCCM via an automated real-time process, and was

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[6025] *See id.* at pp. 6-17. This recording of intercompany payables and receivables applied to cash transfers, but not necessarily to transactions, such as securities trades, where cash is exchanged for items of value.

[6026] *See* Yury Marasanov, Ernst & Young, Accounts Payable / Fixed Assets / NPE / Cash Mgmt. Process Walkthrough (Nov 30, 2008), at p. 11 [EY-SEC-LBHI-CORP-GAMX-08-056981].

[6027] Jay Chan, Lehman, GCCM Training Manual, at p. 5 [LBEX-LL 652833].

[6028] In later Sections of this Report, the Examiner refers to activity captured in GCCM when LBHI acted as central banker for affiliates, thereby receiving or extending value on their behalf, as "quasi-funding" activity. See Section III.B.3.e of this Report, which discusses insider preferences against LBHI, and Section III.B.6 of this Report, which discusses activity occurring in the thirty days before bankruptcy.

subsequently posted to the DBS system via an automated daily batch process.[6029] Typically, the receipt of funds by one Lehman entity for the benefit of another was recorded as follows: (1) the source system generated a notice that a receipt of funds was expected, which was sent to GCCM; (2) upon receipt of this notice GCCM translated the In-House account information associated with the transaction to the Nostro Account; (3) GCCM then notified the bank that a receipt of cash was expected; (4) the bank received the funds in an External Bank Account; (5) the bank transmitted the wire's SWIFT data[6030] to GCCM, which provided the details of the transaction; (6) GCCM then compared the SWIFT data against the notice generated by the source system, and transmitted an acknowledgement of a receipt of funds to the source system; and (7) the transaction information recorded in GCCM and the source system was thereafter recorded in DBS.[6031]

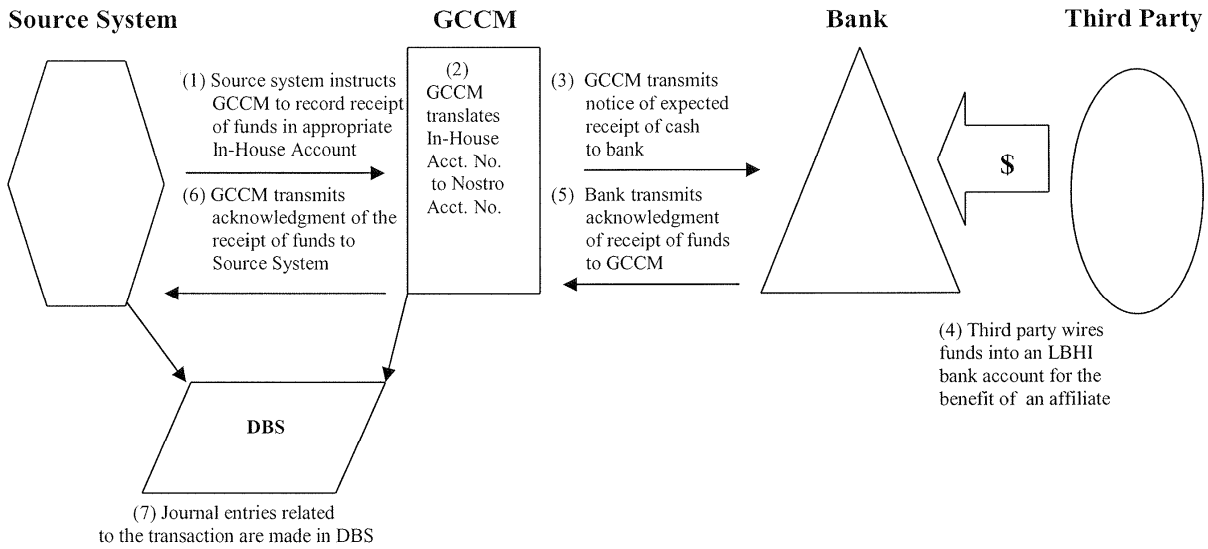
The following diagram illustrates the electronic transmissions that took place between the source systems, GCCM and banking institutions, as well as the subsequent recording of the transaction information in DBS in connection with the receipt of cash by LBHI for the benefit of an affiliate.

[6029] Jay Chan, Lehman, GCCM Training Manual, at pp. 2-6 [LBEX-LL 652833].

[6030] SWIFT (Society for Worldwide Interbank Financial Telecommunication) is the global standard by which banking customers automate and standardize financial transactions with banks.

[6031] *See* Jay Chan, Lehman, GCCM Training Manual, at pp. 3-5 [LBEX-LL 652833].

Receipt of Funds by LBHI for the Benefit of an Affiliate



The receipt of cash by one Lehman entity for the benefit of another was recorded with one journal entry in the source system and two journal entries in GCCM, which subsequently posted to DBS. The diagrams below illustrate the journal entries made in GCCM, the source system and the general ledger for the receipt of cash by LBHI for the benefit of LCPI, such as those received in connection with loan payments from third parties in the ordinary course of business.

Receipt of Funds by LBHI for the Benefit of LCPI *GCCM and Source System Journal Entries*				
	GCCM		**Source System**	
	Debit	Credit	Debit	Credit
Cash – LBHI	$100(a)			
Cash-LCPI		$100(b)	$100(e)	
Receivable-LCPI				$100(f)
Intercompany (Due from LBHI)	$100(c)			
Intercompany (Due to LCPI)		$100(d)		
Total	$200	$200	$100	$100

As shown in the diagram above, the journal entries in GCCM were as follows: (a) a debit to cash for LBHI corresponding to the receipt of cash in LBHI's External Bank Account; (b) a credit to cash for LCPI corresponding to the allocation of cash to LCPI's In-House Account; (c) a debit to an intercompany receivable to LCPI from LBHI for cash received by LBHI; and (d) a credit to an intercompany payable from LBHI to LCPI for the cash owed by LBHI to LCPI.

The diagram above also illustrates the following journal entries in the source system: (e) a debit to cash for LCPI for the receipt of cash from the third party; and (f) a credit to receivables for LCPI for a reduction of the third party's liability to LCPI.

These journal entries were subsequently recorded to the general ledger in a daily batch process. The diagram below illustrates the recording of these entries for LBHI and LCPI in the general ledger.

Receipt of Funds by LBHI for the Benefit of LCPI *LBHI and LCPI General Ledger Entries*				
	LBHI General Ledger Activity		**LCPI General Ledger Activity**	
	Debit	Credit	Debit	Credit
Cash - LBHI	$100(a)			
Cash-LCPI			~~$100~~ (1)	~~$100~~ (2)
Receivable-LCPI				$100(d)
Intercompany (Due from LBHI)			$100(c)	
Intercompany (Due to LCPI)		$100(b)		
Total	$100	$100	$200	$200

This transaction was recorded in the general ledger as follows: (a) a debit to cash for LBHI, corresponding to the receipt of cash in an LBHI External Bank Account; (b) a credit to LBHI's intercompany payables owed to LCPI, corresponding to the allocation of this cash to LCPI's In-House Account; (c) a corresponding debit to LCPI's intercompany receivables reflecting an increase in intercompany receivables from LBHI;

and (d) a credit to LCPI's receivables reflecting the receipt of cash from the third party.[6032]

(4) Bank Account Reconciliations

Bank account reconciliations were a critical component of LBHI's cash management system, and were necessary for maintaining complete and accurate cash records. A bank account reconciliation was performed by matching data from a financial institution with data recorded in both LBHI's internal cash management system and source systems to identify any inconsistencies or errors.[6033] LBHI used a third-party-vendor bank account reconciliation system, Global Smart Stream Reconciliations ("GSSR"), which supplemented GCCM and automated the majority of the bank reconciliation process.[6034]

GSSR performed the following two key cash reconciliations on a daily basis: (1) the reconciliation of Nostro Accounts against External Bank Accounts; and (2) the reconciliation of In-House Accounts against source system records.[6035] Reconciliations

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[6032] There is also an entry in the general ledger related to LCPI with corresponding debit and credit amounts that offset each other. These are: (1) a debit to cash reflecting the receipt of cash from a third party; and (2) a credit to cash reflecting the allocation of cash held by LBHI to LCPI's In-House Account.

[6033] *See* Yury Marasanov, Ernst & Young, Accounts Payable / Fixed Assets / NPE / Cash Mgmt. Process Walkthrough (Nov. 30, 2008), at pp. 12-13 [EY-SEC-LBHI-CORP-GAMX-08-056981].

[6034] Jim McMahon, Ernst & Young, Bank Reconciliation Process Walkthrough (Nov. 30, 2008), at pp. 9-12 [EY-SEC-LBHI-EED-GAMX-08-024858].

[6035] In addition, reconciliations of Nostro Account and In-House Account balances in GCCM against DBS were performed in GSSR. In some cases, reconciliations of source systems against External Bank Accounts or against other source systems were also performed in GSSR. *See* Yury Marasanov, Ernst & Young, Accounts Payable / Fixed Assets / NPE / Cash Mgmt. Process Walkthrough (Nov. 30, 2008), at pp. 12-13 [EY-SEC-LBHI-CORP-GAMX-08-056981].

of the Nostro Accounts against External Bank Accounts assessed the accuracy of the balances in an entity's External Bank Accounts at the end of the day.[6036] Reconciliations of the In-House Accounts against source system records substantiated the cash balances documented in each entity's books and records. In addition, reconciliations of Nostro Account and In-House Account balances in GCCM against DBS records ensured that all entries to GCCM were correct, serving as an additional safeguard against inaccuracies in the In-House Account and Nostro Account reconciliations.

As part of the reconciliation process, GSSR identified inconsistencies, or "breaks," between the data reported by financial institutions and the data reported in LBHI's cash management system.[6037] Breaks were not an unusual occurrence. A break report was created when listed items from either the bank system or GCCM did not have a corresponding match in the other system.[6038] Each break was investigated and resolved by Treasury Group personnel.[6039] For example, if an External Bank Account received a wire transfer from a third party, but the corresponding deposit had not been recorded in the corresponding Nostro Account within GCCM prior to the reconciliation, this transaction was listed on the break report. Likewise, if a payment to a third party was recorded in a Nostro Account within GCCM, but the bank did not complete the

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[6036] *See id.* at p. 13.
[6037] *See id*. at p. 12.
[6038] *See id*.
[6039] *See id*. at p. 13.

wire transfer until after the account reconciliation, the transaction would be listed on the break report.

d) Effect of the Bankruptcy on the Cash Management System

Just prior to the LBHI bankruptcy filing, financial institutions including Citibank and JPMorgan froze LBHI's bank accounts.[6040] As a result, immediately following LBHI's bankruptcy filing: (1) funds could not be withdrawn from these accounts; (2) payments could not be made using funds in these accounts;[6041] and (3) the Treasury Group was unable to retrieve real-time account information. Nonetheless, the banks continued to accept payments made to these accounts.

Because LBHI's bank accounts were frozen, the cash management processes of LBHI affiliates were also disrupted. Funds were no longer transferred from LBHI's External Bank Accounts to the External Bank Accounts of its subsidiaries and affiliates.[6042] In addition, LBHI stopped manually transferring cash from affiliate bank accounts to its accounts, as it had done prior to the bankruptcy petition.[6043] On September 19, 2008, Lehman regained access to its bank accounts.

[6040] Examiner's Interview of David Forsyth, Oct. 29, 2009, at p. 3; Citigroup, Written Responses to Examiner's Inquiry (Jan. 12, 2010), at p. 3.

[6041] An exception was a payment of $23.5 million by LBHI to Weil on September 15, 2008.

[6042] The notable exception was pass-through principal and interest payments made to LCPI, which is discussed below in this Section of the Report.

[6043] Prior to the bankruptcy filing, LBHI treasury personnel transferred cash into LBHI accounts either daily or intra-day as needed. *See* Cash Management Motion, at pp. 6-7 (¶ 16), Docket No. 669, *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Oct. 3, 2008).

Following the LBHI bankruptcy filing and the bankruptcy filings of LBHI Affiliates, Lehman continued to use its cash management system, honored certain pre-petition obligations related to the cash management system and maintained and used certain existing External Bank Accounts.[6044] In addition, the Debtors closed certain External Bank Accounts and established new External Bank Accounts ("New Accounts"), transferring cash into the New Accounts. Further, the Debtors maintained certain pre-petition External Bank Accounts ("Legacy Accounts") because closing those accounts and opening new accounts would have required re-establishing the interfaces between such accounts and the various systems that Lehman operated pre-petition, and would thus have involved significant costs. To the extent Legacy Accounts were not maintained, monies slated for deposit into such accounts were redirected to New Accounts. The Debtors continue to use New Accounts and Legacy Accounts for all purposes of the estate, including collecting monies and making payments.[6045]

As an example of the changes described above, prior to September 15, 2008, LBHI received certain loan payments for the benefit of LCPI from third-party borrowers in the ordinary course of business. LBHI then transferred these funds on behalf of LCPI directly to the third-parties, LCPI investment vehicles or Lehman non-Debtor affiliates

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[6044] *See generally* Cash Management Order, Docket No. 1416, *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Nov. 6, 2008).

[6045] Lehman Brothers Holdings Inc., LBHI Operational Issues and Challenges (Nov. 3, 2008), at pp. 11-12 [LBEX-OTS 000866].

that held the loans.[6046] After the LBHI bankruptcy filing, funds received by LBHI on behalf of LCPI could not be transferred because LBHI's External Bank Accounts were frozen.

Consequently, on September 17, 2008, LCPI established new External Bank Accounts to collect such funds and LBHI no longer received such funds for the benefit of LCPI. LCPI subsequently made payments directly to third-party investors in connection with such transactions. On September 18 and 19, 2008, LBHI transferred the majority of the funds it previously received for the benefit of LCPI to an LCPI External Bank Account.[6047]

e) Cash Transfers Giving Rise to Administrative Claims

The methodology the Examiner used to identify cash transfers constituting post-petition extensions of credit that may give rise to administrative claims included a review of the Debtors' GCCM Records, Statements of Financial Affairs, cash transaction reports for Legacy Accounts and New Accounts, bank statement data[6048] and general ledger reports (collectively, the "Cash Transaction Records"). In addition, the Examiner conducted interviews with current and former Lehman personnel.

[6046] GCCM Intercompany Report, Sept. 1-15, 2008 [LBEX-LL 2551231- LBEX-LL 2564078].

[6047] *See* Section III.B.2.e.2 of this Report, which discusses the funds that remain in the LBHI External Bank Account.

[6048] Three separate data files including (1) Legacy Account data (2) New Account data and (3) a separate data file for LCPI Legacy Account data comprised the population of bank statement data.

Specifically, to identify (1) cash transfers from LBHI Affiliates to LBHI and (2) cash received by LBHI for the benefit of any LBHI Affiliate, for the period from September 15, 2008 through the date that the applicable LBHI Affiliate commenced its Chapter 11 case, the Examiner created queries and analyzed reports generated from Debtor bank statement data and GCCM. Transactions with common characteristics were analyzed to determine whether such transactions met the definition of cash sweeps.[6049] Finally, the Examiner reconciled the cash transfer information identified in the bank statement data against the GCCM funding report and intercompany report data.

The Examiner analyzed bank statement data for approximately 65 accounts, constituting the Debtors' U.S. and foreign bank accounts.[6050] The Examiner's findings based on the methodology described above are as follows:

(1) Cash Transfers from LBHI Affiliates to LBHI

The Examiner has identified a transfer of $58,969,818 from LCPI to LBHI on October 1, 2008.[6051]

[6049] See Section III.B.2.b of this Report, which discusses cash sweeps that give rise to administrative claims.

[6050] The Debtors provided bank statement data for: (1) U.S. bank accounts of LBHI, East Dover, LB 745, LBCC, LBCS, LBDP, LBFP, LBSF, LCPI, LOTC and PAMI Statler; and (2) foreign bank accounts of LBHI (UK Branch), LBSF and LBCS. E-mail from Lauren Sheridan, Lehman, to Heather D. McArn, Jenner & Block (Jan. 21, 2010) (noting that Lehman has provided the Examiner with the complete universe of all transaction activity for Debtor entities); e-mail from Lauren Sheridan, Lehman, to Heather D. McArn, Jenner & Block, *et al*. (Jan. 29, 2010) (indicating that Scottish Finance, CES, CES V, CES IX, Luxembourg LLC and BNC had either minimal or no banking activity during the Stub Period).

[6051] *See* XO Jet LCPI Receipt Support Analysis [LBEX-AM-5641494 - LBEX-AM-5641497].

On September 30, 2008, LCPI received $58,969,818 from a third party in connection with an aircraft lease.[6052] These funds were subsequently transferred to LBHI on October 1, 2008, three business days prior to the LCPI bankruptcy filing. According to Lehman, this transfer likely occurred in order to "protect" the funds from being seized by Citibank.[6053] These funds have not been remitted by LBHI to LCPI as of the date of this Report.[6054] The Examiner has determined that LCPI may be entitled to an administrative claim against LBHI in connection with this transfer.

(2) Cash Received by LBHI on Behalf of LBHI Affiliates

The Examiner has identified cash received by LBHI for the benefit of LBHI Affiliates in the total amount of $264,944,535.[6055]

LBHI received $258,903,936 of this total amount for the benefit of LCPI, relating to principal and interest payments from third parties.[6056] On September 18 and 19, 2008, LBHI remitted a total of $258,745,279 to LCPI for these principal and interest payments.[6057] LBHI has not remitted the remaining balance of $158,657 to LCPI in connection with these transactions, as of the date of this Report. The Examiner has

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[6052] *See id.*

[6053] E-mail from Lauren Sheridan, Lehman, to Ken Halperin, Duff & Phelps (Jan. 5, 2010).

[6054] *See* XO Jet LCPI Receipt Support Analysis [LBEX-AM-5641494 - LBEX-AM-5641497].

[6055] *See* Debtor Bank Statement Data [LBEX-AM 5642100 - LBEX-AM 5642389]; *see also* GCCM Intercompany Report [LBEX-LL 2040576 - LBEX-LL 2041244].

[6056] *See* Debtor Bank Statement Data [LBEX-AM 5642100 - LBEX-AM 5642389]; *see also* GCCM Intercompany Report [LBEX-LL 2040576 - LBEX-LL 2041244].

[6057] *See* Debtor Bank Statement Data [LBEX-AM 5642100 - LBEX-AM 5642389]; *see also* GCCM Intercompany Report [LBEX-LL 2040576 - LBEX-LL 2041244].

determined that LCPI may be entitled to an administrative claim against LBHI in connection with these transactions.

LBHI also received a total amount of $6,038,929 for the benefit of LBSF during the period from October 1 through October 3, 2008, related to interest rate swap coupon payments from third parties.[6058] During 2009, LBHI remitted a total amount of $5,710,986 to LBSF in connection with these transactions.[6059] LBHI has not remitted the remaining balance of $327,943 to LBSF as of the date of this Report. The Examiner has determined that LBSF may be entitled to an administrative claim against LBHI in connection with these transactions.

In addition, the Examiner identified two receipts by LBHI for the benefit of LBCS and LBSF, which were *de minimis* in amount. On September 15, 2008, LBHI received $1,484 for the benefit of LBCS and $186 for the benefit of LBSF.[6060] As of the date of this Report, LBHI has not remitted these amounts to LBCS and LBSF. The Examiner has determined that LBCS and LBSF may be entitled to administrative claims against LBHI in connection with these transactions.

[6058] LBHI bank statement data [LBEX-AM 5642390].

[6059] *Id.*

[6060] *See* Debtor Bank Statement Data [LBEX-AM 5642100 - LBEX-AM 5642389]; *see also* GCCM Intercompany Report [LBEX-LL 2040576 - LBEX-LL 2041244].

(3) Other Relevant Transactions

The Examiner identified two transfers in the total amount of 7,065,352 NOK from LBI (on behalf of LBCC) to LBHI (for the benefit of LBIE) on September 15, 2008.[6061]

This transaction was the subject of a Bankruptcy Court decision dated May 12, 2009, concerning DnB NOR Bank ASA's ("DNB") entitlement to setoff funds deposited to a LBHI bank account post-petition.[6062] In its decision denying DNB's request for relief from the automatic stay to effectuate setoff, the Court noted that the transaction involved a transfer of funds from LBCC to LBHI. The Court noted that:

> [T]he current record fails to provide any explanation concerning the reason that LBCC initiated the transfer of funds to LBHI, the consequence of the transfer (other than as it relates to the setoff question) or whether the transfer either satisfies or gives rise to an intercompany claim. The Court also does not know whether the transfer is an example of ordinary course prepetition cash management procedures or represents an isolated transaction.[6063]

In investigating whether these NOK transfers constitute cash sweeps entitling LBCC to an administrative claim, the Examiner reviewed the record before the Court as well as Lehman's GCCM and RISC[6064] records. These records provided additional information regarding the entities involved in this transaction. Reflective of the

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[6061] *See* GCCM transaction detail [LBEX-LL 3356465 - LBEX-LL 3356471, LBEX-LL 3356472 - LBEX-LL 3356479] (funds transfer by LBI (for LBCC) was to the UK branch of LBHI (for LBIE).) The 7,065,352 Norwegian Kroner ("NOK") is equivalent to approximately $1.2 million.

[6062] *See* Memorandum Decision Denying Relief from the Automatic Stay to Effectuate Setoff Under 11 U.S.C. § 553(a), Docket No. 3551, *In re Lehman Brothers Holdings Inc.*, No. 08-13555, (Bankr. S.D.N.Y. May 12, 2009).

[6063] *Id*. at p. 15.

[6064] RISC stands for Real-time Information Systems for Commodities.

complicated nature of Lehman's cash management system, this data revealed that the transaction involved cash transfers made in settlement of foreign exchange transactions between LBCC and LBIE to exchange NOK for U.S. dollars.[6065] The transfers of NOK originated from an LBI bank account at DNB (on behalf of LBCC) to an LBHI (UK Branch) bank account at DNB (for the benefit of LBIE).[6066] Based on available information, the Examiner has determined that the corresponding U.S. dollar transfer from LBIE to LBCC was not consummated.[6067]

Because these cash transfers were made in settlement of existing obligations and were not post-petition extensions of credit, they do not constitute "cash sweeps" as defined in this Report.[6068] Thus, any potential claims that may arise from this multi-entity transaction are outside the scope of the Examiner's investigation.

[6065] *See* RISC statement detail [LBEX-AM 5641773, LBEX-AM 5641774, LBEX-AM 564177 and LBEX-AM 564180] (listing the execution and scheduled settlement dates for these foreign exchange transactions); *see also* Francois Chu-Fong, Lehman, Written Responses to Examiner Inquiry Regarding DnB NOR Transaction, attached to e-mail from Lauren Sheridan, Lehman, to Heather D. McArn, Jenner & Block (Jan. 15, 2010).

[6066] The Examiner determined that because LBCC did not have foreign currency bank accounts, LBI paid and received foreign currencies on its behalf. Likewise, in this transaction, LBHI UK served as LBIE's agent for the receipt of NOK.

[6067] *See* Debtor Bank Statement Data [LBEX-AM 5642100 - LBEX-AM 5642389] (reflecting that the U.S. dollar amounts were not transferred to LBCC).

[6068] The Examiner's review of these transfers focused on potential administrative claims by LBCC (an LBHI Affiliate) against LBHI arising from cash sweeps. The Examiner has not assessed whether any non-Debtor affiliates including LBI and LBIE may have claims against any Debtor in connection with these transfers.

3. Examiner's Investigation of Possible Avoidance Actions (Third, Fourth and Eighth Bullets)[6069]

a) Summary

This Section includes a discussion of (1) LBHI and LBHI Affiliate solvency determinations, (2) unreasonably small capital determinations, (3) insider preferences against LBHI, and (4) potential avoidance claims available to LBHI and LBHI Affiliates against financial participants and pre-Chapter 11 lenders.

b) LBHI Solvency Analysis

(1) Introduction

The analysis of LBHI's solvency is necessary as part of the Examiner's investigation into potential preferential and fraudulent transfers made by LBHI in the time leading up to its bankruptcy filing.[6070] The Bankruptcy Code defines "insolvent" as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation . . ."[6071] This "definition of insolvency is the traditional bankruptcy balance sheet test of insolvency: whether debts are greater than assets, at a fair evaluation, exclusive of exempted property."[6072] Although GAAP is

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[6069] This Section of the Report includes data extracted from Lehman's source systems, including, for example, GCCM, GSSR, and DBS.

[6070] Whether a debtor was insolvent at the time of a transfer affects the avoidability of that transfer as either a preference or a fraudulent transfer under the Bankruptcy Code. *See* 11 U.S.C. §§ 547(b)(3), 548(a)(1)(B)(ii)(I).

[6071] 11 U.S.C. § 101(32)(A).

[6072] *Akers v. Koubourlis* (*In re Koubourlis*), 869 F.2d 1319, 1321 (9th Cir. 1989).

relevant to a solvency analysis, it is not determinative.[6073] A court should ask: "What would a buyer be willing to pay for the debtor's entire package of assets and liabilities? If the price is positive, the firm is solvent; if negative, insolvent."[6074] Whether a company is insolvent is considered a mixed question of law and fact.[6075]

Valuation need not be exact:[6076] indeed, the "precise value of a company as a going concern is far from certain."[6077] The Second Circuit, in *Roblin,* explained:

> The matrix within which questions of solvency and valuation exist in bankruptcy demands that there be no rigid approach taken to the subject. Because the value of property varies with time and circumstances, the finder of fact must be free to arrive at the "fair valuation" defined in § 101[32] by the most appropriate means.[6078]

As explained in *Iridium,* "[n]o rigid approach should be taken regarding the fair valuation of a company within the context of [a] solvency analysis, but rather courts should consider the totality of the circumstances."[6079] Additionally, "though not

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[6073] *Shubert v. Lucent Tech., Inc.* (*In re Winstar Comm'c., Inc.*), 348 B.R. 234, 274 (Bankr. D. Del. 2005), *aff'd* 2007 WL 1232185 (D. Del. Apr. 26, 2007), *aff'd in part, modified in part on other grounds*, 554 F.3d 382 (3d Cir. 2009).

[6074] *Covey v. Commercial Nat'l Bank of Peoria*, 960 F.2d 657, 660 (7th Cir. 1992).

[6075] *Travelers Int'l AG v. Trans World Airlines, Inc.* (*In re Trans World Airlines, Inc.*), 134 F.3d 188, 193 (3rd Cir. 1998), *cert. denied* 523 U.S. 1138 (1998).

[6076] *Briden v. Foley*, 776 F.2d 379, 382 (1st Cir. 1985).

[6077] *Wolkowitz v. Am. Research Corp. (In re Dak Indus., Inc.),* 170 F.3d 1197, 1200 (9th Cir. 1999); *see also Brown v. Shell Canada, Ltd. (In re Tenn. Chem. Co.),* 143 B.R. 468, 479 (Bankr. E.D. Tenn. 1992) ("Exactness is not required in determining solvency or insolvency."), *aff'd* 112 F.3d 234 (6th Cir. 1997).

[6078] *Lawson v. Ford Motor Co. (In re Roblin Indus., Inc.)*, 78 F.3d 30, 38 (2d Cir. 1996) (quoting *Porter v. Yukon Nat'l Bank*, 866 F.2d 355, 357 (10th Cir. 1989)).

[6079] *Iridium Capital Corp. v. Motorola, Inc.* (*In re Iridium Operating LLC*), 373 B.R. 283, 344 (Bankr. S.D.N.Y. 2007) (Peck, B.J.) (the Second Circuit has adopted a "flexible approach to insolvency analysis"); *see also Neuger v. Casgar* (*In re Randall Constr., Inc.*), 20 B.R. 179, 184 (N.D. Ohio 1981) (determination of fair valuation "is, at best, an inexact science, and may often be impossible. As a result, insolvency frequently

dispositive, expert appraisals and valuations should be considered, when possible, in a solvency analysis."[6080]

In order to perform this analysis, the Examiner's financial advisors utilized an approach based on the market prices for LBHI equity and debt. This approach was complemented by (1) the utilization of the technique of retrojection; and (2) the application of "current awareness," as explained below.

The Examiner's financial advisors did not perform either a discounted cash flow valuation ("DCF") or a market comparable valuation of Lehman for several reasons. First, such analyses would have required significant time and expense to perform, and each has significant shortcomings with regard to its dependability and applicability to the Examiner's analyses. Second, Lehman's assets were comprised mostly of financial assets for which a projection of cash flows would have been challenging. Further, the investigation done by the Examiner's financial advisors included numerous dates over which Lehman's financial health was fluctuating with some severity. As a result, a DCF performed on a single date would not necessarily be applicable to any other date, causing the Examiner's financial advisors to have to perform separate DCFs for each date in which there was a potentially avoidable transaction. Finally, due to the subjectivity necessary when projecting cash flows or determining appropriate

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must be determined by proof of other facts or consideration of other factors from which insolvency may be inferred.")

[6080] *Iridium*, 373 B.R. at 344.

multiples, the Examiner's financial advisors found it more appropriate in this situation to rely on the contemporaneous analyses performed by all of the market participants. The presentation of price-book ratios, for example, indicates the collective, contemporaneous analysis of all market participants with regard to an appropriate discount that should be applied to Lehman relative to its peers. Any comparable company valuation performed by the Examiner's financial advisors would merely serve to replicate this analysis a year later.

Utilizing a market-based approach, the Examiner first concluded that there is sufficient evidence to support a finding of insolvency of LBHI beginning on September 8, 2008. Adjusting the market based approach pursuant to the technique of retrojection and the application of "current awareness," which would factor in information in existence but not known by the market, the Examiner concluded that there is sufficient evidence to support a finding of insolvency of LBHI beginning on September 2, 2008.

(2) Market-Based Valuation Analysis

(a) Basis for Utilization of a Market-Based Valuation Analysis

Lehman was in an industry where it was required to mark many of its assets to market every day. Although not all of Lehman's assets were marked with daily frequency,[6081] the book value of the firm's equity is typically a reasonable starting point

[6081] GAAP does not require firms to mark fixed assets to market. Rather, it allows those assets to be reported at book or depreciated values. Further, GAAP requires firms to perform goodwill impairment analyses, but it does not require firms to report appreciating values of goodwill or intangibles. Finally, GAAP does not require firms to mark most debt to market.

for the assessment of the firm's true equity. Despite the Examiner's financial advisor's determination that Lehman's valuation methodology for certain asset categories was reasonable,[6082] there is evidence indicating that Lehman's valuations were inaccurate or did not properly allow for firm-wide illiquidity and/or the appropriate levels of current distress.[6083] Although Lehman's internal mark-to-market marking models have an advantage over the market owing to their access to extensive private information, the markings that are reported to the public occur relatively infrequently (quarterly), and quickly become outdated. Quarterly mark-to-market values depend on quarterly accounting data and may not reflect the changing risk profile of the institution. Moreover, during the time period relevant to the Examiner's financial advisor's analyses, market values were declining rapidly and new information that impacted pricing was released frequently. Thus, while fluid equity markets interpret public information and incorporate new data into prices very quickly, the quarterly accounting marks of Lehman lacked such timeliness.

An additional explanation for the discrepancy between the market values and Lehman's book values is that the firm's internal mark-to-market models focus on the riskiness of the individual assets, and therefore do not necessarily correctly reflect the overall riskiness of Lehman. Often, large firms are less risky than the sum of their individual assets because of the benefit gained by diversification. In Lehman's case,

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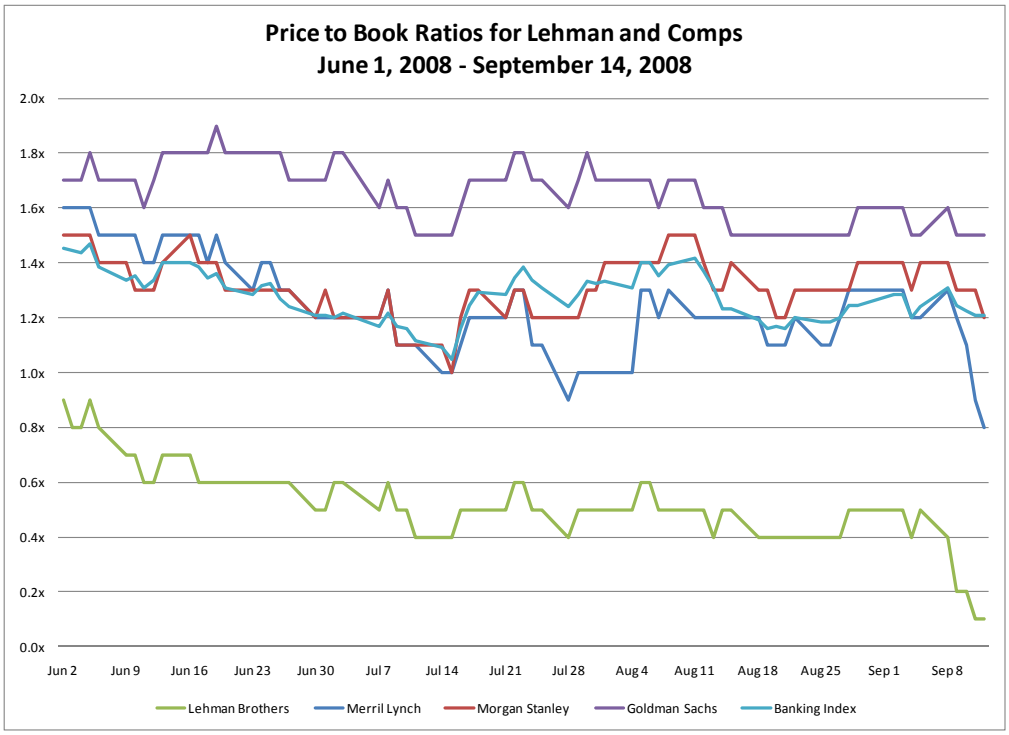
[6082] See Section III.B.3.(c) of this Report, which discusses this determination.

[6083] See Section III.A.5.i of this Report for a discussion of Lehman's liquidity pool.

where the liquidity of the firm was questionable, the firm as a whole may have been seen as riskier than the sum of its individual assets. Thus, the aggregate value of the firm's assets could be less than their sum, making it entirely reasonable and rational for the company's stock to trade below GAAP book value of equity.

Moreover, while Lehman's competitors and the investment banking community in general had equity market price-to-book ratios[6084] in excess of 1.0x throughout most of the summer of 2008, Lehman did not. As displayed in the chart below, Lehman's price to book ratio was well below 1.0x at all times beginning June 1, 2008, and for most of July, August and September, it was between 0.4x and 0.6x.



[6084] Price to Book ratio is measured as the market capitalization of a firm divided by the firm's book value of equity.

Thus, reliance upon Lehman's balance sheet alone would be imprudent in an insolvency analysis.

Rather than relying on a corporation's own balance sheet valuations, some courts have indicated that a market capitalization valuation methodology is the appropriate solvency analysis for a large, publicly traded financial institution such as LBHI.[6085] According to the court in *Iridium,* "[a] company's stock price "is an 'ideal datapoint' for determining value."[6086] The advantage of such contemporaneous market evidence is that it is "untainted by hindsight or post-hoc litigation interests."[6087] The Third Circuit in *VFB*, in affirming the district court's "primary" reliance on market-based valuations as a measure of value, reasoned that "[e]quity markets allow participants to voluntarily take on or transfer among themselves the risk that their projections will be inaccurate,"[6088] and that absent some reason to distrust it, the market price is "a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses."[6089]

It is for these reasons that the Examiner and his financial advisors believe that a market-based approach to the valuation of LBHI's solvency is the most relevant, with other approaches providing further analysis.

[6085] *See Iridium,* 373 B.R. at 346; *VFB LLC v. Campbell Soup Co.,* 482 F.3d 624, 631-33 (3rd Cir. 2007).
[6086] *Iridium,* 373 B.R. at 346.
[6087] *VFB LLC v. Campbell Soup Co.,*2005 WL 2234606, at *13 (D. Del. Sept. 13, 2005).
[6088] *VFB,* 482 F.3d at 631.
[6089] *Id.* at 663 (citing *In re Prince*, 85 F.3d 314, 320 (7th Cir. 1996)).

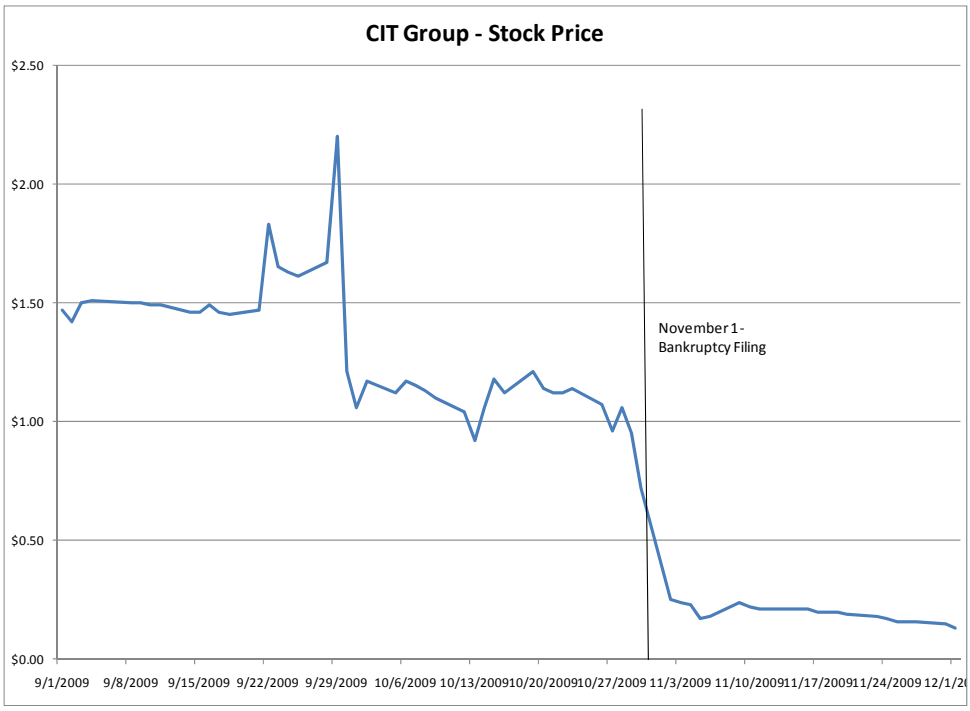
(b) Market Value of Assets Approach

While the courts in *Iridium* and *VFB* focused primarily, if not exclusively, on the market value of equity, the Examiner's financial advisors have included in their analysis the implication of solvency that results from an analysis of both the market value of equity and the market value of debt.

It is important to consider the market value of debt along with the market value of equity for several reasons. First, in the case of a bankruptcy, the value achieved from selling the assets of the company would have to fund the repayment of both debt and equity. To the extent that the creditors (and the debt market participants) feel that the value of the assets will not be sufficient to repay all of the debt, they will cause the debt to trade at a discount to par. This was the case in the months leading up to Lehman's bankruptcy filing.

In addition to discounts in the debt markets, one must consider option value embedded in the equity prices.[6090] As an illustrative example, the following chart tracks the stock price for CIT Group in the period up to and after its bankruptcy filing on November 1, 2009:

[6090] For a more detailed discussion of the option value embedded in equity prices, see Appendix No. 21, Duff & Phelps, LBHI Solvency Analysis (Feb. 1, 2010).



CIT Group was a company that was widely known to be insolvent; however even two days before the company filed for bankruptcy, its stock was trading above $1 per share. This phenomenon illustrates the fact that equity – being non-recourse, which definitively caps potential downside – encourages speculative trading even at times where upside potential is highly unlikely.

(i) Implied Asset Value

Discounts in the bond market work in conjunction with optionality in the equities market. A solvency analysis consists of a view of a company at a single point in time. At that point in time, asset and debt prices are essentially fixed and, as a result, the total expected payout to equity and debt holders is fixed as well. For a given value of a firm's assets, any increase in expected payout to bond holders comes at the expense

of equity holders and vice versa. As such, the Examiner's financial advisors considered both the equity and debt markets for Lehman in their analysis of implied asset value.

The valuation principal that establishes the framework for this analysis is, "The current value of assets minus the current value of liabilities equals the current value of the business owners' equity,"[6091] or:

Assets – Liabilities = Equity

Rearranging that formula, the current value of assets equals the current value of business owners' equity plus the current value of liabilities, or:

Assets = Equity + Liabilities

The exhibit below shows that the public market (for debt and equity) indicated that Lehman was insolvent on a balance sheet basis (1) between July 11 and July 15, 2008 (around the time of the IndyMac collapse); (2) on July 28, 2008; (3) on several dates between August 19 and August 28, 2008 (during certain KDB rumors and when certain customers were leaving); (4) on September 4, 2008; (5) and on all dates on and after September 8, 2008 (Fannie and Freddie failed on September 7;[6092] the termination of KDB talks[6093] became publicly known on September 9).[6094] There is evidence, however, that

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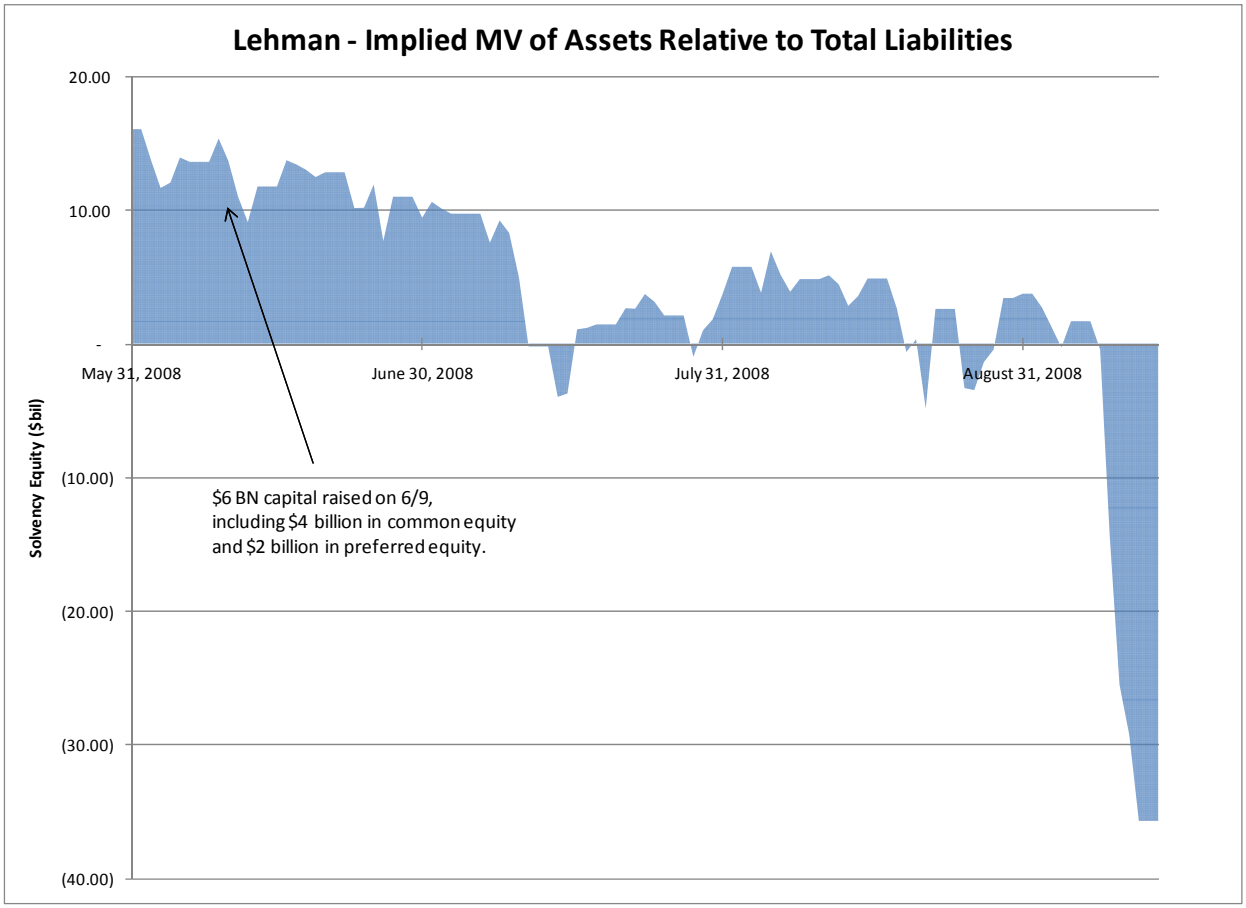
[6091] Shannon Pratt, *Valuing a Business*, Fifth Edition 350 (McGraw-Hill 5th ed. 2007) (1981). This accounting formula holds true regardless of whether one is referring to book value or fair market value – provided that one maintains consistency across his evaluation.

[6092] Office of Federal Housing Enterprise Oversight Press Release, (Sept. 7, 2008) (available at http://www.treas.gov/press/releases/hp1129.htm). Given that September 7, 2008 was a Sunday, September 8, 2008 was the first trading day thereafter.

[6093] See Section III.A.3.c for a discussion of the KDB negotiations.

the markets were not fully informed with regard to Lehman's true liquidity position, because of issues such as Repo 105 and Lehman's liquidity pool.[6095] Accounting for this potential for misinformation would result in findings of less solvency on all dates impacted by the misinformation.



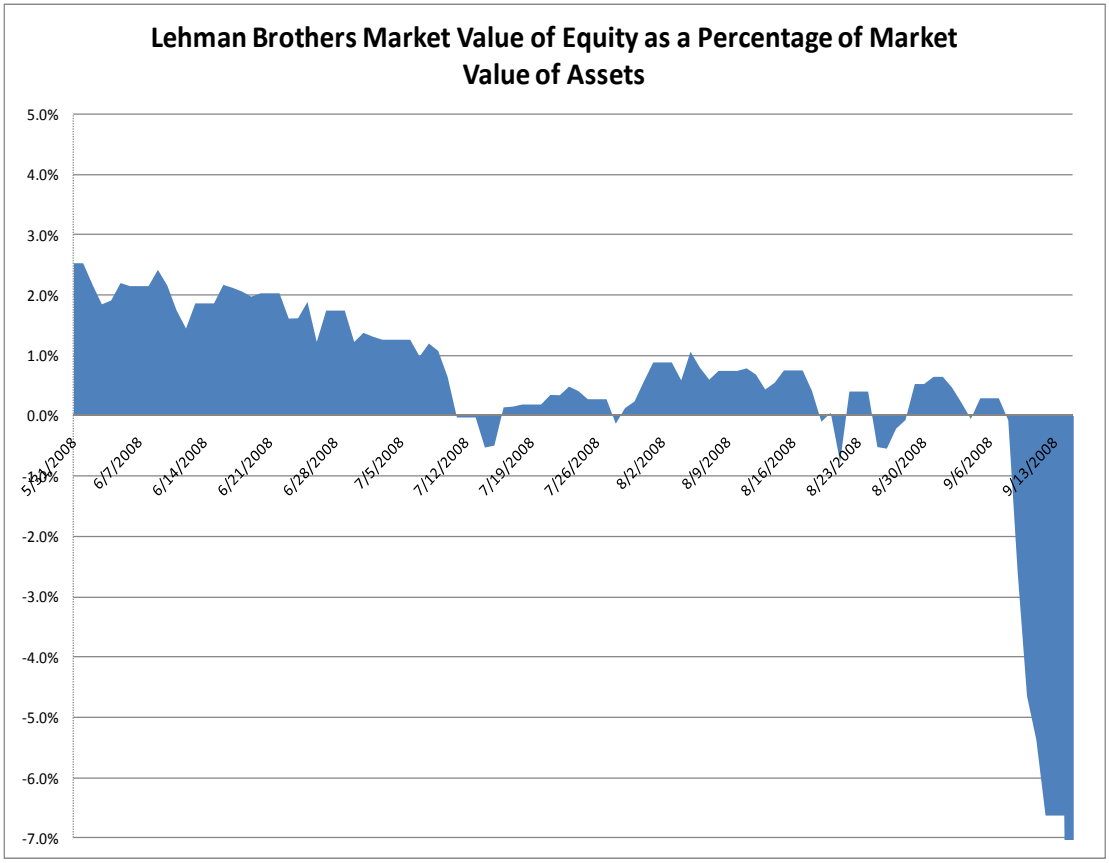
(ii) Small Equity Cushion

As is true with many highly leveraged firms, Lehman's small margin of equity relative to assets meant it did not need much loss of asset value to render it insolvent.

[6094] For calculations supporting the exhibit below, see Appendix 21, Duff & Phelps, LBHI Solvency Analysis (Feb. 1, 2010).

[6095] See Section III.A.4 of this Report which discusses Repo 105; see also Section III.A.5.i of this Report, which discusses Lehman's liquidity pool.

Beginning July 10, 2008, on all dates but one (August 5, 2008), the value of Lehman's solvency equity (computed as the market value of assets minus the par value of debt) was less than 1% of the market value of assets. This implies a very low margin for error. Thus, while it appears that Lehman was marginally solvent on several dates throughout August 2008, a fact finder may conclude that, given Lehman's small equity cushion and the low margin for error, LBHI was insolvent on those dates as well.



(iii) Limitations of the Market-Based Approach

A market value is not always a reliable measure of solvency, especially if the market is not aware of circumstances in existence which, if known, would adversely effect the market value. For example, the Third Circuit noted in *VFB* that "if the market

capitalization was inflated by [former parent]'s manipulations it was not good evidence of value."[6096]

In *Adler I*, the bankruptcy court for the Southern District of New York held that in determining the solvency or insolvency of a bankrupt securities clearing firm, the court was not bound by the price at which the stock was trading at the time of the challenged transfers, to the extent that the price was being maintained due to massive manipulation of the market.[6097] Instead, the court relied on stock prices one business day after the market manipulator closed, February 27, 1995, as a measure of the market price of the stock on the day of the challenged transfers, February 16, 1995. The result was a stock price more than seventy-five percent lower than what it had been trading at under manipulation.[6098] Because a solvency analysis must ascribe a price to the stock that "reflect[s] as nearly as possible a market untainted by [ ] manipulation," the court held that the stock prices after the market manipulator had closed were a more appropriate measure of value.[6099] The Southern District of New York in *Adler II* agreed, holding that the most accurate reflection of the stock's fair market worth as of February

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[6096] *VFB*, 482 F.3d at 632.

[6097] *Mishkin v. Ensminger (In re Adler, Coleman Clearing Corp.)*, 247 B.R. 51, 110 (Bankr. S.D.N.Y. 1999) *(Adler I)*, *aff'd* 263 B.R. 406 (S.D.N.Y. 2001*) (Adler II).*

[6098] *Id*.

[6099] *Id.* at 113.

16 was the stock price on February 27, after the market manipulator was out of business and thus unable to manipulate the market.[6100]

In order to adjust for the limits of market knowledge, the Examiner and his financial advisors analyzed how the valuation of LBHI might be affected if techniques of retrojection and "current awareness," described more fully below, were utilized to ascertain a more accurate value of LBHI, given its market capitalization prior to the filing.

a. Application of Retrojection

Because of the difficulty in valuing the assets and liabilities of a debtor on the exact date of a preferential or fraudulent transfer "courts often utilize the well-established bankruptcy principles of 'retrojection' and 'projection. . .'"[6101] There are two types of retrojection: (1) where evidence of insolvency at a reasonable time subsequent to the date of a transfer can be used as competent evidence of the debtor's insolvency on the date of the transfer, and (2) where evidence of insolvency at an early date and evidence of insolvency at a later date can be used as competent evidence of the debtor's insolvency for all of the dates in between. For both types of retrojection, courts

[6100] *Adler II*, 263 B.R. at 466-470.

[6101] *Coated Sales, Inc. v. First E. Bank (In re Coated Sales, Inc.)*, 144 B.R. 663, 666 (Bankr. S.D.N.Y. 1992) (citations omitted).

universally require proof that the debtor's financial situation did not change materially during the intervening period.[6102]

Accounting for the implied market value of LBHI's assets relative to its total liabilities, the exhibit in Section III.B.3.b.2.(i) demonstrates that LBHI was insolvent between July 11 and July 15, 2008, on July 28, 2008, on several dates between August 19 and August 28, 2008, on September 4, 2008, and on all dates beginning September 8, 2008. In order to utilize retrojection, Lehman's financial situation must not have materially changed in the intervening periods. Thus, the Examiner concludes that the earliest date to apply retrojection is September 2, 2008, the point at which KDB indicated that it relayed its decision not to continue talks with Lehman.[6103]

b. The Application of "Current Awareness"

The court in *Coated Sales* emphasized that although "a company's assets must be valued at the time of the alleged transfer and not what they turned out to be worth at some time after the bankruptcy court intervened," "it is not improper hindsight for a court to attribute 'current circumstances' which may be more correctly defined as

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[6102] *See, e.g., Killips v. Schropp (In re Prime Realty, Inc.),* 380 B.R. 529, 535 (B.A.P. 8th Cir. 2007) (recognizing validity of retrojection, but refusing to apply where trustee did not establish that debtor's financial condition had not substantially changed between the time of the transfer and when it may have become insolvent); *Briden,* 776 F.2d at 382, 382-83 (court found debtor insolvent at the time of a March and April transfer to sole stockholder where debtor's balance sheet for April overstated value of debtor's inventory; the court used retrojection to infer insolvency in March as well, given slow state of debtor's business).

[6103] For a more detailed account of circumstances surrounding the KDB deal, see Section III.A.3.c of this Report.

'current awareness' or 'current discovery' of the existence of a previous set of circumstances."[6104] As described by *Coated Sales*:

> 'Fair market' or 'going concern' value, although presumed to be determined free of impermissible hindsight, is not determined in a vacuum — free of external stimuli. In fact, fair market value presumes that all relevant information is known by seller and buyer. It follows, that a party purchasing assets at the time of the alleged preferential transfer would be aware of all relevant factors, which would include knowledge of a massive business-wide fraud and environmental contamination: otherwise, that party would be the victim of fraud. In sum, fair market valuation entails a hypothetical sale, not a hypothetical company. Thus, it is not improper hindsight for a court to attribute 'current circumstances' which may be more correctly defined as 'current awareness' or 'current discovery' of the existence of a previous set of circumstances.[6105]

In order to apply such an analysis, described as a "current awareness" methodology, the Examiner's financial advisors identified and evaluated circumstances that existed, but were unknown to the investing public, and which would have materially impacted a valuation of LBHI if they had been known. Such circumstances generally fall into one of two categories: (1) information that was made public by Lehman or other parties but was known or knowable as of an earlier date; and (2) information that was never made public, but has since been discovered during the course of the Examiner's investigation either through witness interviews or the review of either confidential or previously unreleased documents.

[6104] *Coated Sales*, 144 B.R. at 668 (citing *Cissel v. First Nat. Bank of Cincinnati*, 476 F. Supp. 474, 484 (S.D. Ohio 1979)); *Mutual Savings & Loan Ass'n v. McCants*, 183 F.2d 423, 425 (4th Cir. 1950)).
[6105] *Coated Sales*, 144 B.R. at 668.

For the first category, the Examiner has determined that there is sufficient evidence to support a finding to apply "current awareness" to circumstances surrounding the KDB deal. Following the Korean government official's statement regarding the end of negotiations with Lehman, the cost of insuring Lehman's debt surged by almost 200 basis points, Lehman's hedge funds pulled out, short-term creditors cut lending lines, JPMorgan required Lehman to execute Security and Guaranty Agreements, and Citi sought a guarantee agreement to continue to clear in Asia.[6106] Because Lehman was insolvent on the date that the public was informed of the end of negotiations between KDB and Lehman, and because this fact was in existence as of September 2, 2008 (the point at which KDB indicated that it relayed its decision not to continue talks with Lehman), the Examiner concludes that there is sufficient evidence to support a finding of insolvency beginning on September 2, 2008.

For the second category of information, information that has not yet become known to the public (at least prior to the publishing of this Report), the Examiner has determined that there is sufficient evidence to apply current awareness to the circumstances of Repo 105 and issues of liquidity.[6107] Applying a current awareness methodology to such circumstances, however, is inherently complicated because of the difficulty in predicting how the stock market might react to information that has never

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[6106] For a more detailed account of circumstances surrounding the KDB deal, see Section III.A.3.c of the Report.

[6107] See Section III.A.4 of this Report for a more detailed discussion of Repo 105; see Section III.A.5.i of this Report for a more detailed discussion of Lehman's liquidity pool.

become publicly known. Thus, this is an issue of fact that the Examiner has left unresolved due to the difficulty in reliably quantifying the result that such circumstances would have had on the fair market value of Lehman had they been known to the public.

(3) Conclusion

Utilizing a market-based approach, the Examiner first concludes that there is sufficient evidence to support a finding of insolvency of LBHI beginning on September 8, 2008. Adjusting the market-based approach pursuant to the technique of retrojection and the application of "current awareness," which would factor in information in existence but not known by the market, the Examiner concludes that there is sufficient evidence to support a finding of insolvency of LBHI beginning on September 2, 2008.

c) LBHI Affiliate Solvency Analysis

(1) Summary

This Section of the Report addresses whether there is sufficient evidence to support a finding that an LBHI Affiliate was "insolvent," as such term is defined by the Bankruptcy Code and applicable state law, prior to the date that each LBHI Affiliate commenced its Chapter 11 case.[6108] The Bankruptcy Court has charged the Examiner with determining, among other things: (1) whether any LBHI Affiliate has colorable

[6108] Consistent with the Court's order, the Examiner has only addressed those LBHI Affiliates that commenced their bankruptcy cases prior to the appointment of the Examiner. *See* Order Directing Appointment of an Examiner Pursuant to Section 1104(c)(2) of the Bankruptcy Code, at p. 3, Docket No. 2569, *In re Lehman Brothers Holdings Inc., et al.*, No. 08-13555 (Bankr. S.D.N.Y. Jan. 16, 2009).

claims against LBHI for potentially insider preferences arising under the Bankruptcy Code or state law; and (2) whether any LBHI Affiliate has colorable claims against LBHI or any other entities for potentially voidable transfers or incurrences of debt, under the Bankruptcy Code or otherwise applicable law.[6109] In order to prevail on a preference claim, the plaintiff must establish that the debtor entity was insolvent at the time of the challenged transfer.[6110] With respect to constructively fraudulent transfers, the plaintiff must establish that at the time of the transfer the debtor (1) was insolvent or became insolvent as a result of the transfer, (2) had unreasonably small capital for the purpose of continuing to engage in its business, or (3) incurred debts that were beyond the debtor's ability to pay as they matured.[6111] Accordingly, the determination of whether there are colorable claims of either preferences or constructively fraudulent conveyances requires an examination of each LBHI Affiliate's solvency condition as of the date a challenged transfer occurred.[6112]

The Bankruptcy Code defines "insolvent," for entities other than a partnership and a municipality, as the "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation."[6113] Fair value is "the

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[6109] *See id.*

[6110] *See* Appendix 1, Legal Issues, at Section IV.D.

[6111] *Id.*, at Section IV.A.2.

[6112] *Id.*, at Sections IV.A.2, IV.A.D.

[6113] 11 U.S.C. § 101(32)(A). The solvency analysis is undertaken exclusive of property transferred with intent to hinder, delay or defraud the entity's creditors, and property exempt from the debtor's estate pursuant to Section 522 of the Bankruptcy Code. *Id*.

price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[6114] This Section of the Report addresses the "going concern" value of each LBHI Affiliate.[6115]

A debtor is presumed to be insolvent for purposes of a preferential transfer analysis under the Bankruptcy Code during the period beginning 90 days prior to the commencement of the debtor's bankruptcy case.[6116] The following table sets forth the filing dates for each LBHI Affiliate, and the corresponding dates under Section 547(b)(4) of the Bankruptcy Code for the beginning of the 90-day preference period for non-insider transfers and for the one-year preference period for insider transfers.[6117]

[6114] Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, at 6. *See also* Appendix 1, Legal Issues, at Section IV.B.

[6115] An alternate means of valuation determines the "liquidation" value of the debtor. Courts in the Southern District of New York have applied this valuation standard when it is determined that the debtor is "nominally extant" or on its "deathbed," at the time in question. *Coated Sales, Inc. v. First E. Bank (In re Coated Sales)*, 144 B.R. 663, 667 (Bankr. S.D.N.Y. 1992). The individual circumstances of each LBHI Affiliate present questions of fact, to be determined by the Court, as to whether "going concern" or "liquidation" value is most appropriate for any given solvency determination. However, because each of the LBHI Affiliates was able to "continue day-to-day operations" in the months prior to commencing their bankruptcy cases, the Examiner deems it most appropriate to consider "going concern" value for the purpose of this analysis. *Iridium Capital Corp. v. Motorola, Inc. (In re Iridium Operating LLC)*, 373 B.R. 283, 344 (Bankr. S.D.N.Y. 2007).

[6116] 11 U.S.C. § 547(f).

[6117] These periods are calculated pursuant to Federal Rule of Civil Procedure 6(a) and the similar Federal Rule of Bankruptcy Procedure 9006(a).

Debtor Entity	Date Filed	90 Days Prior	One Year Prior
LB 745 LLC	9/16/08	6/18/08	9/14/07
PAMI Statler Arms LLC	9/22/08	6/24/08	9/21/07
Lehman Brothers Commodity Services Inc.	10/3/08	7/3/08	10/3/07
Lehman Brothers Special Financing Inc.	10/3/08	7/3/08	10/3/07
Lehman Brothers OTC Derivatives Inc.	10/3/08	7/3/08	10/3/07
Lehman Brothers Derivative Products Inc.	10/5/08	7/7/08	10/5/07
Lehman Commercial Paper Inc.	10/5/08	7/7/08	10/5/07
Lehman Brothers Commercial Corporation	10/5/08	7/7/08	10/5/07
Lehman Brothers Financial Products Inc.	10/5/08	7/7/08	10/5/07
Lehman Scottish Finance L.P.	10/5/08	7/7/08	10/5/07
CES Aviation LLC	10/5/08	7/7/08	10/5/07
CES Aviation V LLC	10/5/08	7/7/08	10/5/07
CES Aviation IX LLC	10/5/08	7/7/08	10/5/07
East Dover Limited	10/5/08	7/7/08	10/5/07
Luxembourg Residential Properties Loan Finance S.a.r.l.	1/7/09	10/9/08	1/7/08
BNC Mortgage LLC	1/9/09	10/10/08	1/9/08

While a debtor is presumed insolvent for the 90-day period identified above, this presumption is rebuttable. The Second Circuit has explained that "[a] creditor may rebut the presumption by introducing some evidence that the debtor was not in fact insolvent at the time of the transfer. If the creditor introduces such evidence, then the trustee must satisfy its burden of proof of insolvency by a preponderance of the evidence."[6118] A balance sheet showing that the debtor was solvent at the time of the

[6118] *Lawson v. Ford Motor Co. (In re Roblin Industries, Inc.)*, 78 F.3d 30, 34 (2d Cir. 1996).

transfer may be sufficient to rebut the presumption of insolvency.[6119] A balance sheet may be particularly effective if its accuracy can be confirmed by witness testimony from experts or officers and directors of the debtor.[6120] However, a court need not accept a balance sheet at face value, and a balance sheet deemed to be inaccurate will not suffice to overcome the presumption.[6121] Accordingly, this analysis considers the nature of the assets held by the debtor entities and notes when the possibility of misstatement affects the solvency determination.

This Section addresses the solvency of each LBHI Affiliate in turn. The following analysis assesses whether the fair value of each LBHI Affiliate's assets exceeded the face value of its liabilities during the period prior to its bankruptcy case. The Examiner also considered the risk that Lehman's valuation of each LBHI Affiliate's less liquid assets — those identified as FASB Level 2 and 3 — was unreasonable, and whether any reduction in the value of such assets would impact the determination as to the solvency of the LBHI Affiliate. Additionally, observations are provided on other factors impacting the

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[6119] *See Jones Truck Lines, Inc. v. Full Service Leasing Corp.*, 83 F.3d 253, 258 (8th Cir. 1996) ("A financial statement showing positive net worth is sufficient to rebut the presumption of insolvency [under §547(f)]."); *cf. In re Ramba, Inc.*, 416 F.3d 394, 403 (5th Cir. 2005) (noting that balance sheet did address issue of solvency, but holding that presumption was not rebutted because balance sheet in question did not reflect status at time of transfer).

[6120] *See Toy King Distributors Inc. v. Liberty Sav. Bank, FSB* (*In re Toy King Distributors, Inc.*), 256 B.R. 1, 91 (Bankr. M.D. Fla. 2000) (relying on balance sheets in conjunction with expert testimony in finding rebuttal of § 547(f) presumption); *T.M. Sweeney & Sons v. Crawford* (*In re T.M. Sweeney & Sons, LTL Services, Inc.*), 120 B.R. 101, 103, 106 (Bankr. N.D. Ill. 1990) (holding that presumption was rebutted by balance sheet showing solvency and testimony of debtor's former president).

[6121] *See* Appendix 1, Legal Issues, at Section IV.D.

solvency of the debtor entities, including the credit ratings for the applicable LBHI Affiliates.[6122]

The Examiner has reached the following conclusions:

1. There is sufficient evidence to support a finding that three LBHI Affiliates — LCPI, CES Aviation IX and CES Aviation V — were balance sheet insolvent as of May 31, 2008. Two of these entities, CES Aviation IX and CES Aviation V, remained insolvent through the commencement of their bankruptcy cases. LCPI was balance sheet insolvent through much of 2008, but received a $900 million capital infusion on August 29, 2008,[6123] which allowed it to become borderline solvent as of August 31, 2008. The Examiner concludes that there is insufficient evidence to rebut the presumption of insolvency for LCPI under Section 547(f) of the Bankruptcy Code after September 12, 2008, the last business day prior to the commencement of LBHI's bankruptcy case, for the reasons set forth in the following paragraph.

2. Three LBHI Affiliates – LBSF, LBCS and CES Aviation – were borderline solvent as of May 31, 2008, meaning that their balance sheets showed assets just slightly in excess of liabilities such that a minimal write down of asset values or a small unaccounted-for liability would render these entities insolvent. The small margin by

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[6122] As will be explained in more detail, for certain entities, such as LBDP and LBFP, which were rated independently of LBHI, ratings of AAA were reflective of the solvency of the entity. For other entities, such as LBSF and LBCS, investment-grade ratings were not dispositive of solvency. LBHI was rated 'A' at the time it filed for bankruptcy.

[6123] E-mail from A. Jacob, Lehman, to Kristie Wong, Lehman, *et al*. (August 28, 2008) [LBEX-SIPA 005564].

which these entities were solvent creates a factual issue to be resolved by the court on a case-by-case basis.[6124] During the week following LBHI's bankruptcy and thereafter, LBHI Affiliate counterparties terminated derivatives and other contracts at balance sheet losses estimated to be in the tens of billions of dollars;[6125] the securities in which certain LBHI Affiliates held an interest at LBI were transferred to Barclays;[6126] and exchange-traded derivatives positions cleared by LBI for the benefit of LBHI Affiliates (such as LBSF and LBCS) at clearing organizations such as the CME[6127] and OCC[6128] were liquidated. Moreover, after September 12, 2008, the collectability of intercompany obligations reflected as assets on the balance sheets of LBHI Affiliates became questionable. The LBHI Affiliates continued to update their balance sheets to reflect such activity, but based upon information made available to him to date, the Examiner concludes that there is insufficient evidence to rebut the presumption of insolvency

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[6124] The Examiner did not conduct an asset-by-asset valuation of each asset owned by LBHI Affiliates because of the time and cost required for such an exercise. Rather, positions across a number of different asset classes were reviewed for several Debtors. An entity's equity-to-total-assets ratio, as well as the relative likelihood of a misstatement of the value of an entity's assets, is considered in determining whether an entity that posted positive equity might nonetheless be borderline solvent. As the term is used here, a low equity-to-total-assets ratio would make an entity borderline solvent unless the composition of its assets was such that misstatement of their value was very unlikely. In light of the cost and time necessary to evaluate the valuation of all of the assets of each of the borderline solvent entities, the Examiner determined that it would not be a prudent use of Estate resources to perform such an exercise. For purposes of analyzing whether these LBHI Affiliates have colorable avoidance claims, the Examiner assumed that the borderline entities were insolvent.

[6125] *See* Section III.C.4 of this Report.

[6126] *See* Section III.C.3.a.2.c.i of this Report.

[6127] *See* Section III.B.3.g.5.h of this Report for a description of the liquidation of the CME house positions.

[6128] *See* Section III.C.6.f.3.c of this Report.

under Section 547(g) of the Bankruptcy Code after September 12, 2008, with respect to any of these LBHI Affiliates.

3. Nine LBHI Affiliates – LOTC, LB 745, LBDP, LBCC, BNC Mortgage LLC, LBFP, East Dover Limited, LSF and LRP – were solvent as of as May 31, 2008, and there is insufficient evidence to support a finding that any of these LBHI Affiliates became insolvent during the period ending August 31, 2008. However, for the reasons set forth above, the Examiner concludes that there is insufficient evidence to rebut the presumption of insolvency under Section 547(g) of the Bankruptcy Code after September 12, 2008 with respect to LOTC and LBCC.[6129]

4. There is insufficient evidence to reach a determination as to the solvency of debtor entity PAMI Statler Arms.[6130] PAMI Statler Arms is a subsidiary of Property Asset Management, Inc. ("PAMI"), and its sole asset is an apartment complex in

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[6129] LB 745's principal asset was Lehman's headquarters building at 745 Seventh Avenue in New York. *See* Section III.B.3.c.3.g of this Report. Following LBHI's bankruptcy, LBDP and LBFP continued to maintain their AAA-ratings, and the balance sheets of these entities continued to reflect positive equity. *See* Section III.C.4 of this Report. BNC Mortgage LLC's principal assets, as of August 31, 2008, were receivables owing by non-debtor Lehman subsidiaries. *See* Section III.B.3.c.3.k of this Report. East Dover Limited, according to its August 31, 2008 balance sheet, had liabilities of $4 million and equity of approximately $105.4 million. *See* Section III.B.3.c.3.l. LSF did not have any liabilities according to its May 31, 2008 and August 31, 2008 balance sheets. *See* Section III.B.3.c.3.m of this Report. LRP was established in May 2008 and did not post a balance sheet until June 2008. LRP was solvent as of August 31, 2008, and its assets consisted of one corporate loan whose value was protected by price flex. *See* Section III.B.3.c.3.e of this Report.

[6130] A motion to dismiss PAMI Statler Arms LLC's bankruptcy petition was filed on May 26, 2009. *See* Motion of Debtors Seeking Entry of an Order Pursuant to Section 1112(b) of the Bankruptcy Code Dismissing Chapter 11 Case of PAMI Statler Arms LLC, Docket No. 3650, *In re Lehman Bros. Holdings Co.*, No. 08-13555 (Bankr. S.D.N.Y. May 26, 2009). The hearing on the motion has been adjourned without a date. *See* Notice of Adjournment of Motion of Debtors Seeking Entry of an Order Pursuant to Section 1112(b) of the Bankruptcy Code Dismissing Chapter 11 Case of PAMI Statler Arms LLC, Docket No. 4060, *In re Lehman Bros. Holdings Co.*, No. 08-13555 (Bankr. S.D.N.Y. June 20, 2009).

Cleveland, Ohio. Lehman did not maintain separate financial statements for PAMI Statler Arms in its general ledger software program.

(2) Description of the Examiner's Analysis

The Examiner investigated the solvency of each of the LBHI Affiliates, taking as a starting point the balance sheets of each entity as of May 31 and August 31, 2008.[6131] The Examiner did not perform an audit, review, or examination (as defined by the American Institute of Certified Public Accountants) of any of the historical financial information, and therefore expresses no opinion with regard to same. The balance sheet information provided below for each of the debtor entities was obtained from Lehman's Hyperion system, which contains adjusted general ledger information. Lehman also used the DBS general ledger system, accessed through EssBase, for internal management purposes, but the Hyperion system was the source for all public financial statements.[6132] Balance sheet information for LBHI Affiliates that had their own subsidiaries is presented on a consolidated basis. Information regarding the composition of each debtor entity's financial inventory, and the SFAS 157 level of individual assets of the financial inventory, is available on Lehman's Global Finance System ("GFS"), a position-level database. However, the Examiner's investigation has revealed that the GFS database is

[6131] The Examiner's analysis focuses on May 31, 2008 and August 31, 2008, because these were the end dates of Lehman's second and third quarter reporting periods. Although Lehman did not file a 10-Q statement for the third quarter of 2008, its finance employees created financial statements for the third quarter ending August 31, 2008. Examiner's Interview of Kristie Wong, Dec. 2, 2009, at p. 4.

[6132] Examiner's Interview of Kristie Wong, Dec. 2, 2009, at p. 4.

incomplete and inaccurate with respect to many of the assets held by LBHI Affiliates.[6133] Accordingly, information from the GFS database is not relied upon in this Report unless it has been reconciled to publicly disclosed financial statements to ensure its accuracy.

Based on interviews with former and current Lehman financial personnel, as well as the Examiner's analysis of the systems and financial reports that were created by Lehman prior to the bankruptcy filing, the Examiner has determined that there is sufficient evidence to conclude that the LBHI Affiliates' balance sheets fairly represent the financial condition of each LBHI Affiliate as of May 31 and August 31, 2008.[6134]

However, the Examiner has determined that the balance sheets of the LBHI Affiliates created after August 31, 2008, which capture financial activity during the remaining pre-petition period for each LBHI Affiliate, are not sufficient for purposes of making a determination of the solvency of each LBHI Affiliate during this period.[6135] The Examiner bases this conclusion on a review of financial information obtained from various Lehman software systems. For example, in September 2008, the financial systems lacked information technology support and, contrary to normal operation, were not consistently receiving certain daily feeds between systems carrying pricing

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[6133] *Id*.

[6134] The Examiner did not conduct an investigation of each of the liabilities reported by the LBHI Affiliates and recognizes the possibility that there may be unreported or misstated liabilities which would be considered when determining the solvency of any given LBHI Affiliate.

[6135] This determination did not impact the use of balance sheet information for the limited purposes set forth in Section III.C.3.b.

and other information.[6136] As a result, the financial statements produced by such systems are not sufficiently reliable for use as the basis of any solvency determination.

Additionally, financial statements prepared by Lehman in the course of the bankruptcy proceedings confirm that they differ materially from the public financial statements that Lehman created in the ordinary course of its business prior to bankruptcy. The Monthly Operating Reports ("MOR"), which are filed with the U.S. Bankruptcy Court, specifically state that:

> The Debtors have prepared [the MORs], as required by the Office of the United States Trustee, based on the information available to The Debtors at this time, but note that such information may be incomplete and may be materially deficient in certain respects. This MOR is not meant to be relied upon as a complete description of the Debtors, their business, condition (financial or otherwise), results of operations, prospects, assets or liabilities. The Debtors reserve all rights to revise this report.[6137]

Among others, the MORs identify the following issues rendering the financials reported insufficient for the purposes of a solvency determination:

- They are not prepared in accordance with U.S. GAAP.
- They do not reflect normal quarterly adjustments that were generally recorded by the Debtor.
- Certain items are under research and may be accounted for differently in future monthly reports (no updates have been filed as of November 2009).
- Cash and restricted cash may not belong to the Debtor.

[6136] Examiner's Interview of Kristie Wong, Dec. 2, 2009, at p. 4.

[6137] Monthly Operating Report, Selected Debtor Balance Sheets, Docket 3916, *In re Lehman Bros. Holdings Inc., et al.*, No. 08-13555, at p. 11 (Bankr. S.D.N.Y. June 15, 2009).

- Securities and financial instruments are sometimes reported as of the last valuation recorded by Lehman and do not reflect realizable values of assets (i.e., they are not FAS 157 compliant).[6138]

Given the foregoing, and because of the extraordinary time and expense required to investigate the solvency of the LBHI Affiliates after August 31, 2008, the Examiner expresses no view of the solvency of the LBHI Affiliates after August 31, 2008. However, the Examiner notes that, of the evidence obtained, none suggests that the solvency status of the borderline solvent or insolvent LBHI Affiliates materially improved during the period beginning September 1, 2008, and ending on the commencement of the respective bankruptcy cases. Furthermore, as noted above, the Examiner finds that there is insufficient evidence to rebut the presumption of insolvency under Section 547(g) of the Bankruptcy Code after September 12, 2008 with respect to each of the borderline solvent LBHI Affiliates, LOTC, and LBCC.

Because the balance sheet solvency test asks whether the fair value of a debtor's assets exceeds its liabilities, the solvency analysis performed is not based on GAAP. Certain concepts that are not accounted for under GAAP, but which implicate the fair value of the Debtor's assets and its liabilities, are addressed here. For instance, the Examiner has investigated whether any LBHI Affiliate held intangible assets. Intangible assets are identifiable non-monetary assets that are not physical in nature, but contribute to the value of a firm. They do not appear on a balance sheet except in

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[6138] *Id*. at 4.

certain circumstances, such as when an intangible asset is purchased in a transaction and recorded under GAAP purchase accounting rules.[6139] Examples of intangible assets include customer lists, proprietary technology, internally developed software, and trade names. For purposes of this Section of the Report, intangible assets are relevant to the extent that they would render an otherwise insolvent debtor solvent, or impairment of the book value of intangible assets would render a solvent debtor insolvent. Therefore, the analysis has focused on identifying intangible assets for insolvent or borderline debtors as identified above.

Addressing the LBHI Affiliates on a consolidated basis, the Examiner has reviewed available documents and interviews with Legal Entity Controllers ("LEC") and identified intangible assets in the form of goodwill owned by LBSF and LBCS. However, the existence of these assets, discussed below, does not change the determination of those entities' solvency. Furthermore, based on the analysis provided in Section III.C.3 of this Report, it is possible that additional intangible assets may be held by certain LBHI Affiliates in the form of customer lists, proprietary technology or a workforce-related asset, but such intangible assets are not of material value and would not change the solvency determination for any of the LBHI Affiliates.

[6139] *See* Financial Accounting Standards Board, Statement of Fin. Accounting Standards No. 141(R), *Business Combinations* (2007).

The following is a summary table of the Examiner's conclusions regarding the solvency of LBHI Affiliates as of May 31, 2008:[6140]

Entity	Primary Business	Shareholder Equity ($million)	Shareholder Equity as % of Total Assets[6141]	Balance Sheet Solvency as of May 31, 2008
Lehman Commercial Paper Inc.	Originate and trade secured and unsecured loans; provide warehouse loans secured by mortgage loans and other assets	(62.0)	N/M	Insolvent (borderline as of August 2008)
CES Aviation IX LLC	Acquire and operate aircraft for Lehman	(0.9)	N/M	Insolvent
CES Aviation V LLC	Acquire and operate aircraft for Lehman	(3.5)	N/M	Insolvent
Lehman Brothers Special Financing Inc.	Lehman Brothers Inc.'s principal dealer in a broad range of derivative products including interest rate, currency, credit and mortgage derivatives	475.1	0.4%	Borderline
Lehman Brothers Commodity Services Inc.	Trade power, natural gas, oil, and structured products	26.0	0.4%	Borderline
CES Aviation LLC	Acquire and operate aircraft for Lehman	0.1	0.6%	Borderline
Luxembourg Residential Properties Loan Finance S.a.r.l.	Investment and financing vehicle, which held loans (typically commercial loans including Term B Archstone loans)	2.6	0.4%	Solvent
Lehman Brothers OTC Derivatives Inc.	Over-the-counter derivatives dealer	225.5	4.2%	Solvent
LB 745 LLC	Owner of Lehman's headquarters located at 745 Seventh Avenue in New York	55.3	7.2%	Solvent

[6140] Data is as of May 31, 2008, except in the case of Luxembourg Residential Properties Loan Finance S.a.r.l. whose data is as of August 31, 2008. Financial data is not available for PAMI Statler Arms LLC.

[6141] "N/M" indicates that the ratio is not meaningful due to the fact that the entity had negative equity.

Entity	Primary Business	Shareholder Equity ($million)	Shareholder Equity as % of Total Assets[6141]	Balance Sheet Solvency as of May 31, 2008
Lehman Brothers Derivative Products Inc.	AAA-rated termination derivative product company that intermediates interest rate and currency swaps between market counterparties and Lehman Brothers Special Financing	47.4	8.9%	Solvent
Lehman Brothers Commercial Corporation	Dealer in over-the-counter foreign currency forwards and options and exchange-traded futures and futures options	230.9	6.9%	Solvent
BNC Mortgage LLC	Subprime mortgage origination	11.1	45.8%	Solvent
Lehman Brothers Financial Products Inc.	AAA-rated continuation derivative product company that engages in over-the-counter interest rate and currency swaps and options, purchasing or selling exchange-traded futures and options, or government bonds and options	290.0	54.1%	Solvent
East Dover Limited	Historically purchased, leased and sold aircraft and related equipment; as of the bankruptcy filing, no longer performed these activities but held mostly intercompany receivables and payables	101.1	92.9%	Solvent
Lehman Scottish Finance L.P.	Hold equity-linked notes of other Lehman entities	57.4	100%	Solvent

Entity	Primary Business	Shareholder Equity ($million)	Shareholder Equity as % of Total Assets[6141]	Balance Sheet Solvency as of May 31, 2008
PAMI Statler Arms LLC	Owner of Statler Arms Apartments, a 297-suite apartment complex in Cleveland	Unknown	Unknown	Unknown

As indicated in the table above, while most of the 16 debtor entities maintained some degree of positive GAAP equity as of May 31, 2008, six entities posted negative or very low levels of capital in relation to their level of assets.[6142] These entities were LCPI, CES Aviation V LLC, CES Aviation IX, CES Aviation, LBCS, and LBSF.

The following issues and concepts are common to the analysis of one or more LBHI Affiliates and are discussed at the outset for clarity.

Fair Market Value of Balance Sheet Assets and SFAS 157 Assets. For the purpose of determining the balance sheet solvency of LBHI Affiliates, the asset values reported in financial statements must be representative of fair market value, or adjustments must be made to ensure that the fair value is captured.[6143] In the case of the assets held by LBHI Affiliates, most reported values are representative of fair market

[6142] For the period May 31, 2008, through August 31, 2008, all of the Debtors, except one, posted net payables to LBHI. The exception was LBDP, which posted a net $7.7 million receivable from LBHI in May 2008. However, this accounted for only 1.4% of LBDP's total assets and even with a complete loss of the receivable from LBHI, LBDP would remain solvent. Therefore, LBHI's potential failure to pay its receivables is not an issue in regard to the solvency of the LBHI Affiliates.

[6143] *See In re Roblin Indus., Inc.*, 78 F.3d at 36 ("It is also true that book values are not ordinarily an accurate reflection of the market value of an asset."); *In re Iridium Operating LLC*, 373 B.R. at 344 ("When a business is a going concern, fair value is determined by the fair market price of the debtor's assets that could be obtained if sold in a prudent manner within a reasonable period of time to pay the debtor's debts.") (internal quotation marks omitted).

value. Following is a list of asset types owned by LBHI Affiliates, and the relationship of the reported value to fair market value for each:

Asset	Relationship to Fair Market Value
Cash	Presumed to be at Fair Market Value
Accounts Receivable	Presumed to be at Fair Market Value assuming no material change in the financial health of counterparties.
Prepaid and Deferred Expenses	Presumed to be at Fair Market Value pending investigation. The instances of debtors owning these assets are addressed on a case by case basis below.
Securities and Other Financial Inventory	Presumed to be at Fair Market Value considering the requirement to mark these assets to market under SFAS 157. These assets are discussed further below.
Plant, Property and Equipment	Unlikely to be at Fair Market Value. Other than land, these assets are assumed to be wasting assets, meaning that their value decreases over time. Accordingly, Fair Market Value for these assets will generally be less than the purchase price. Due to cost and time constraints, the Examiner did not pursue an independent valuation of these assets for any LBHI Affiliate. As discussed below, certain LBHI Affiliates carried significant amounts of Plant, Property and Equipment, though in no case would a change from book value to Fair Market Value change the findings contained herein.
Goodwill and Intangibles	Unlikely to be at Fair Market Value. Goodwill and Intangibles are the result of purchase accounting requirements and do not necessarily reflect Fair Market Value.
Off Balance Sheet Assets	As the name suggests, these are assets that do not appear on the balance sheet. Based on interviews with LECs, no off-balance sheet assets have been identified for any debtor.

In assessing the equity component of the LBHI Affiliates' balance sheets, an analysis of the components of each entity's Securities and Financial Instruments Owned has been performed in order to understand where there may be risks of misstatement of the value of the entity's assets. Under SFAS 157, a firm is required to assess the fair value of a financial instrument based on Level 1 (a market quoted price), Level 2 (measurement with no observable price, but based on observable inputs) and Level 3 (measurement using unobservable inputs).[6144] Level 2 and 3 assets are at the greatest risk of misstatement because their valuation is not based on a market-quoted price. Data from Lehman's GFS system, modified by Lehman's finance team,[6145] has been assessed in order to identify the amount of Level 2 and 3 assets held by each debtor. The ratio of equity to Level 2 and 3 assets is used as a measure of risk of possible insolvency as it represents the relative size of an entity's equity cushion as compared to the value of its assets subject to misstatement.

Capital Infusions. The task of monitoring the equity levels of Lehman's various legal entities was performed by LECs. While each legal entity required a different level of attention based on its activity, each was assigned an LEC who was responsible for

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[6144] Statement of Fin. Accounting Standards No. 157, Fair Value Measurements, at SFAS 157-10 to -12.

[6145] Lehman's controllers indicated that GFS was inaccurate and, on a quarterly basis, GFS was reconciled to publicly filed financial statements for LBHI on a consolidated basis. When necessary, other source systems were considered to provide support. No such exercise was performed at the legal entity level. Examiner's Interview of Kristie Wong, Dec. 2, 2009, at p. 4.

monitoring and producing entity financials.[6146] Unlike product controllers, whose responsibilities were assigned along product and business lines, LECs' responsibilities were determined by which legal entities they were assigned. The LECs were a critical part of the process whereby the financial data of each entity was assembled in a reportable form. The Examiner has found no evidence of a formal written policy prior to 2008 or any consistent unwritten policy that LECs were to keep entities solvent.[6147] However, when an operating entity did become balance sheet insolvent, LECs would often respond by proposing that a capital infusion be made into that entity.[6148] In general, the LECs for non-regulated entities aimed to maintain enough capital so as to avoid negative capital.[6149]

In 2008, however, Lehman's regulatory group markedly changed the way it approached capitalization requirements for certain legal entities because those entities, or entities of which they were subsidiaries, were the subject of heightened scrutiny by regulators and third parties as a result of falling asset prices. At least one witness has suggested that LBI, a broker/dealer, would be precluded from trading if one of its subsidiaries failed to meet a particular capital requirement.[6150] This is because a broker/dealer was required to meet reporting requirements on a consolidated basis,

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[6146] *See* Examiner's Interview of Michael Montella, Oct. 26, 2009, at pp. 2-7.
[6147] *Id*. at pp. 4-5.
[6148] *Id.* In the case of LCPI, these infusions were, until August 2008, insufficient to actually establish solvency.
[6149] *Id.* at pp. 10-11.
[6150] Examiner's Interview of Ada Shek, Nov. 24, 2009, at p. 6.

which included the financial information of all its subsidiaries.[6151] Moreover, LCPI had a triparty repo clearing agreement with JPMorgan, pursuant to which LCPI was obligated to maintain a particular equity-to-asset or leverage ratio.[6152] Beginning in May 2008, therefore, the LECs would meet in the beginning or middle of each month to identify projected profits and losses, write-offs, and other metrics.[6153] The LECs would then compare these figures to the previous month's equity and attempt to predict future equity levels and any capital infusion needs.[6154] It was not uncommon for front-office traders to send e-mails noting capital levels for certain entities, such as LCPI.[6155]

LCPI and LBSF, both subsidiaries of LBI, were of considerable concern to Lehman, regulators, and third parties because they were forced to take significant write-downs during 2008. Although there was a minor capital infusion in February 2008 of $200,000,[6156] the first major capital infusion occurred in May 2008, which was in response to a significant write-down of securities backed by real estate in California.[6157] From April through July 2008, LCPI continued to post negative equity levels and required

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[6151] *Id.*
[6152] *Id.* at p. 7.
[6153] *Id.*
[6154] *Id.* at pp. 6-7.
[6155] *Id.*
[6156] *Id.* The LEC for LCPI was unaware of any capital infusion for LCPI before February 2008.
[6157] *Id.*

significant capital infusions. The following chart shows capital infusions (in millions) received by LCPI, LBSF, and LBDP during 2008 in response to these concerns:[6158]

Debtor	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug08
LCPI	-	0.2	200.0	-	150.0	-	275.0	900.0
LBSF	-	-	-	-	100.0	-	-	-
LBDP	-	-	-	-	-	150.0	-	-

In terms of mechanics, the Examiner has identified three internal Lehman e-mails that describe the capital infusions for LCPI and LBSF and provide the relevant journal entries and wire transfers.[6159] The Examiner has not located any e-mail with respect to the July 2008 capital infusion of LCPI. As for LCPI, LBI would first request a "paydown" from LBHI to LBI, which was consummated by a wire transfer. LBHI would record a reduction in cash and an increase in its investment asset in LBI. Second, LBI would send the money back to LBHI because LCPI, according to internal e-mails, did not have a bank account.[6160] In other words, LBHI accepted LCPI's money on its behalf. Third, when LBHI received the money from LBI, it increased its cash account and reduced its intercompany receivable from LCPI. Finally, LCPI reduced its debt obligation to LBHI and credited its paid-in capital account. LCPI did not record a

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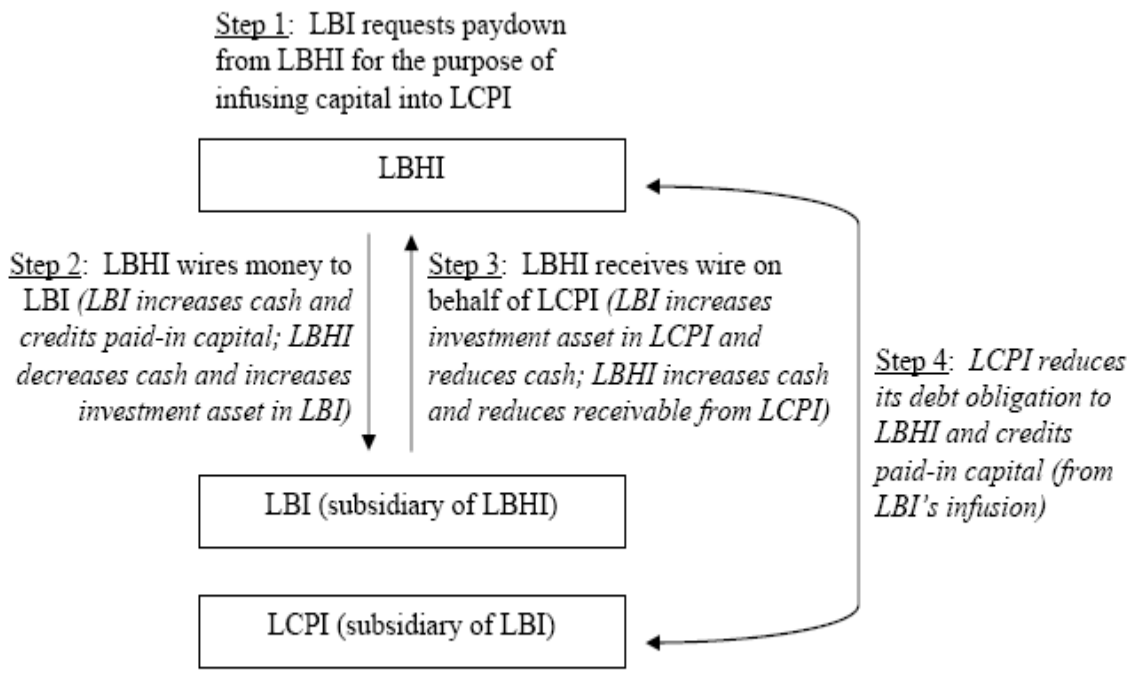
[6158] Capital Infusions are determined by noting the change in Additional-Paid-In-Capital, as reported in Lehman's Hyperion financial system.

[6159] E-mail from Jeffrey Su, Lehman, to Arthur Hiller, Lehman, *et al.* (Mar. 27, 2008) [LBEX-BARLEG 0000001 to -03]; e-mail from Jeffrey Su, Lehman, to Arthur Hiller, Lehman, *et al*. (May 30, 2008) [LBEX-BARLEG 0000004]; e-mail from Hui Wang, Lehman, to Helen Chu, Lehman, *et al.* (Aug. 28, 2008) [LBEX-SIPA 003320].

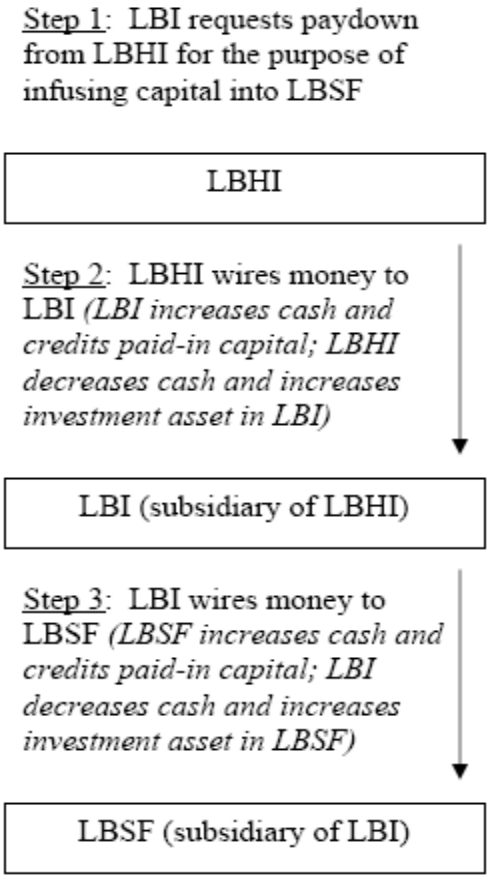
[6160] This is inconsistent with observations of LCPI's books and records. Dan J. Fleming, Lehman's former Global Head of Cash and Collateral Management, also stated in an interview that LCPI did have bank accounts. Examiner's Interview of Dan J. Fleming, Dec. 17, 2009, at p. 8.

receivable on its books and records when the money was given back to LBHI. In short, LCPI's liability in its intercompany account with LBHI decreased and LBHI kept the use of the money it originally transferred to LBI, causing no impact to its liquidity. As for infusions into LBSF, the process was identical, except that LBSF received the funds on its own behalf (they were not immediately remitted back to LBHI). The following illustrates the steps of the capital infusions received by LCPI and LBSF:

Infusions into LCPI March, May and August 2008



Infusion into LBSF May 2008



(3) Debtor-by-Debtor Analysis

(a) Lehman Commercial Paper Inc.

LCPI primarily engaged in the origination, trading, and servicing of secured and unsecured loans.[6161] LCPI's monthly balance sheets as of May 31, 2008 through August 31, 2008 were as follows:[6162]

Lehman Commercial Paper, Inc				
Balance Sheet Items at:	**May 31, 2008**	**June 30, 2008**	**July 31, 2008**	**August 31, 2008**
CASH & CASH EQUIVALENTS	675,756,009	725,929,267	2,708,432,808	961,859,857
SEC. & OTHER FINANCIAL INSTRUMENTS OWNED	29,433,762,189	28,305,430,247	25,718,241,256	23,593,952,592
CASH & SECURITIES SEGR. AND ON DEPOSIT	(31)	(31)	(74)	(31)
SECURITIES PURCHASED UNDER AGREEMENT TO SELL	19,578,651,244	22,275,502,285	21,168,272,398	21,366,118,677
RECEIVABLES- BROKER/DEALER	464,902,039	622,970,642	583,521,985	434,533,107
RECEIVABLES- CUSTOMERS	2,101,522,190	2,698,515,924	1,406,513,724	1,421,687,767
RECEIVABLES- OTHER	13,160,040,651	7,493,297,900	7,764,947,048	8,246,411,601
PROPERTY, EQUIPMENT & LEASE IMPROVEMENTS	1,462,823	1,828,038	1,773,679	1,707,311
TOTAL BRIDGE ACCOUNTS	6	6	6	6
DEFFERED EXPENSE & OTHER ASSETS	328,525,248	330,203,124	371,986,965	285,342,973
TOTAL ASSETS	**65,744,622,369**	**62,453,677,403**	**59,723,689,795**	**56,311,613,860**
COMMERCIAL PAPER & S.T. DEBT	454,183,781	28,140,653	18,158,345	3,020,383,281
SEC.& OTHER INSTRUMENTS SOLD NOT YET PURCHASED	1,105,104,778	2,122,362,958	2,369,393,978	3,369,552,952
SECURITIES SOLD UNDER AGREEMENT TO REPURCHASE	20,267,872,715	19,123,893,904	19,549,285,798	18,438,230,178
SECURITIES LOANED	(8,857,059)	(13,412,434)	(15,791,168)	(18,248,658)
OTHER SECURED FINANCING	6,684,055,232	6,745,696,751	6,430,902,517	6,729,268,740
PAYABLES- BROKER/DEALER	70,772,641	33,162,439	80,435,168	47,118,454
PAYABLES- CUSTOMERS	482,545,031	529,525,271	274,976,726	232,856,709
ACCD LIABILITIES & OTHER PAY.	36,750,913,611	34,026,234,430	31,177,301,584	24,285,597,683
SENIOR DEBT	0	0	0	0
TOTAL LIABILITIES	**65,806,590,731**	**62,595,603,973**	**59,884,662,948**	**56,104,759,340**
COMMON STOCK	10,000	10,000.00	10,000.00	10,000
F/X TRANSLATION ADJUSTMENT	22,422,006	18,600,078.01	22,624,113.30	45,165,409
RETAINED EARNINGS	(940,598,231)	-1,016,734,510.84	-1,314,805,129.27	(1,869,518,752)
TOTAL ADDITIONAL PAID IN CAPITAL	856,197,863	856,197,863.00	1,131,197,863.00	2,031,197,863
TOTAL STOCKHOLDER'S EQUITY	**(61,968,362)**	**(141,926,570)**	**(160,973,153)**	**206,854,520**
TOTAL LIABILITIES & STOCKHOLDER'S EQUITY	**65,744,622,369**	**62,453,677,403**	**59,723,689,795**	**56,311,613,860**
CAPITAL INFUSION	150,000,000		275,000,000	900,000,000

[6161] Lehman, LCPI Corporate Description [LBEX-BARLCT 0000723]. However, LCPI was not always used for this purpose as it formerly traded in commercial paper.

[6162] All balance figures are presented on a consolidated LCPI basis.

As this table shows, from May through July 2008, LCPI reported negative equity by amounts ranging from $62 million to $161 million. In August 2008, LCPI reported $207 million in positive equity.

As of May 31, 2008, LCPI held approximately $29.4 billion in financial inventory, with the remaining assets on its balance sheet comprised largely of reverse repos and intercompany receivables. Following is a table of the financial inventory directly held by LCPI as of May 31, 2008 and August 31, 2008.[6163]

Lehman Commercial Paper, Inc.
Total Financial Instruments Owned (Assets)

GAAP Asset Class	as of 5/31/08	% of Total	as of 8/31/08	% of Total
Commercial Paper & Money Market	1,500,606,326	5.10%	1,742,658,697	7.55%
Third Party Derivatives	274,401,594	0.93%	203,889,227	0.88%
Intercompany Derivatives	712,018,593	2.42%	2,831,028,078	12.26%
Total Derivatives	986,420,187	3.35%	3,034,917,305	13.15%
Corporate Debt	17,332,854,996	58.89%	12,442,838,192	53.90%
Corporate Equity	1,034,329,176	3.51%	88,723,365	0.38%
Governments & Agencies	19,658,550	0.07%	80,840,327	0.35%
Real Estate Held for Sale	5,090,122,271	17.29%	3,863,492,546	16.74%
Mortgages & Mortgage Backed	3,469,770,683	11.79%	1,831,526,818	7.93%
	29,433,762,189	100.00%	23,084,997,251	100.00%

Source: Hyperion.

[6163] Information regarding the financial inventory held by each Debtor entity is obtained from Lehman's Hyperion reporting system. Note that there is an irreconcilable variance between the sum of the individual line items for financial instruments owned in this table and the total stated in Hyperion for August.

As of May 2008, approximately $17.3 billion, or 59%, of LCPI's financial instrument positions were corporate loans, dropping to approximately $12.4 billion, or 53%, by August 2008. At the same time, the value of intercompany derivatives increased significantly from approximately $710 million, or 2.4% of total financial instruments in May 2008, to $2.8 billion, or 12.3%, in August 2008.

As of August 31, 2008, LCPI held approximately $23.6 billion in financial inventory, with the remaining assets on its balance sheet comprised largely of reverse repos and intercompany receivables. Because over 99% of Corporate Debt and Mortgage and Mortgage Backed securities are SFAS levels 2 and 3, the Examiner estimates that approximately 60% of LCPI's financial inventory was FASB 157 levels 2 and 3.[6164] The marks assigned these assets are not supported by a market quoted price and they have a high risk of misstatement.

Section III.C.3 of this Report analyzed potential intangible assets held by LCPI on a stand-alone (i.e., unconsolidated) basis. While it is possible that additional intangible assets may exist in LCPI in the form of customer lists, proprietary technology and human capital, the Examiner has determined that such intangible assets are not of material value and would not change the solvency determination of LCPI.[6165]

[6164] Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2008 (Form 10-Q) (filed on Jul. 10, 2008).

[6165] Due to the cost and time required by such an exercise, the Examiner did not perform an investigation into the possible intangible assets in each of LCPI's subsidiaries.

The majority of LCPI's Deferred Expenses and Other Assets relate to its investment of $225 million in its subsidiary Leveraged Loan Trading Holdings Partners ("LLTHP"). Based on a review of the consolidated balance sheets of LLTHP, the Examiner has concluded that the value of LCPI's investment in LLTHP should not have been impaired.[6166]

LCPI Capital Infusions. LCPI was significantly leveraged and posted negative equity from April 2008 through July 2008. In February, March, May, July and August 2008, LCPI obtained capital infusions from LBI in an attempt to post positive equity. According to internal documents, the negative equity in July was a result of $1 billion in losses in, among others, SunCal and TXU Energy positions.[6167] Losses in August 2008 were the result of write-downs in mortgage residual positions as well as write-downs of certain corporate loans.[6168] Interviews with Lehman finance personnel revealed that there was an effort to keep LCPI, as the subsidiary of LBI, balance sheet solvent.[6169]

[6166] LLTHP's consolidated balance sheets showed a level of assets that remained relatively steady throughout fiscal year 2008. Its largest asset was its investment in Luxembourg Trading Finance SARL, which, in turn, holds Archstone Term B loans. Because of the price flex feature of these loans, their value would not be impaired. Furthermore, LLTHP posted steady increases in retained earnings throughout fiscal year 2008, and, with few liabilities, posted significant positive equity.

[6167] E-mail from Kristie Wong, Lehman, to Anthony Stucchio, Lehman, *et al.* (July 29, 2008) [LBEX-SIPA 005520].

[6168] E-mail from Kristie Wong, Lehman, to Paolo Tonucci, Lehman (August 27, 2008) [LBEX-SIPA 005564].

[6169] Examiner's Interview of Kristie Wong, Dec. 2, 2009, at p. 2; Examiner's Interview of Joselito Rivera, Oct. 13, 2009, at pp. 5-6. However, LEC Mike Montella stated that LECs may in some circumstances allow a non-regulated entity to post negative equity at month end. Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 10-12. This contradiction may be explained by the fact that Wong, who was head LEC, also stated that the capital infusions LCPI received in May and July of 2008 were intended to allow it to post positive equity, but that the amount of capital necessary to do so was underestimated.

While there were no capital guidelines other than the principle of avoiding negative equity, LECs were aware of the fact that an entity such as LCPI would be reviewed and questioned by regulators.[6170]

LCPI became balance sheet insolvent for the first time in February 2008. It posted positive equity by a small margin in March 2008, but then posted negative equity until August, despite the capital infusions it received during this time.[6171] In August 2008, LCPI received a $900 million capital infusion from LBI which was sufficient to allow it to maintain borderline balance sheet solvency apparently until its bankruptcy filing. Below is a table of LCPI's monthly equity in the year prior to its bankruptcy filing, along with its ratio of equity-to-total-assets, and the Examiner's solvency determination as of each month.

Examiner's Interview of Kristie Wong, Dec. 2, 2009, at p. 3. Thus, LECs attempted to maintain positive equity in LCPI, but were occasionally unable to do so.

[6170] Examiner's Interview of Michael Montella, Oct. 26, 2009, at pp. 10-12; Examiner's Interview of Kristie Wong, Dec. 2, 2009, at p. 2.

[6171] Wong stated that she did not know why this would be so. She surmised that the capital infusions were simply inadequate. Examiner's Interview of Kristie Wong, Dec. 2, 2009, at p. 3.

	Equity	Solvency Determination	Ratio of Equity to Total Assets
September 30, 2007	$372,928,608	Borderline	0.61%
October 31, 2007	$484,906,910	Borderline	0.74%
November 30, 2007	$310,007,656	Borderline	0.53%
December 31, 2007	$302,649,926	Borderline	0.51%
January 31, 2008	$132,490,100	Borderline	0.20%
February 29, 2008	($6,669,838)	Insolvent	N/M
March 31, 2008	$255,994,138	Borderline	0.41%
April 30, 2008	($159,512,650)	Insolvent	N/M
May 31, 2008	($61,968,362)	Insolvent	N/M
June 30, 2008	($141,926,570)	Insolvent	N/M
July 31, 2008	($160,973,153)	Insolvent	N/M
August 31, 2008	$206,854,520	Borderline	0.37%

Note: N/M signifies "Not Meaningful" due to negative values of equity.
Source: Hyperion.

(b) CES Aviation, CES Aviation V LLC, CES Aviation IX

The CES Aviation entities – CES Aviation, CES Aviation V LLC, and CES Aviation IX – were established for the purpose of acquiring and operating aircraft for Lehman. Their balance sheets as of May 31, 2008 and August 31, 2008 are as follows:

CES Aviation		
Balance Sheet Items at:	**May 31, 2008**	**August 31, 2008**
CASH & CASH EQUIVALENTS	665,422	354,419
PROPERTY, EQUIPMENT & LEASE IMPROVEMENTS	21,873,360	21,467,298
DEFFERED EXPENSE & OTHER ASSETS	49,778	19,911
TOTAL ASSETS	**22,588,560**	**21,841,628**
ACCRUED LIABILITIES & OTHER PAYABLES	22,456,891	21,913,826
TOTAL LIABILITIES	**22,456,891**	**21,913,826**
RETAINED EARNINGS	(6,868,331)	(7,072,197)
TOTAL ADDITIONAL PAID IN CAPITAL	7,000,000	7,000,000
TOTAL STOCKHOLDER'S EQUITY	**131,669**	**(72,197)**
TOTAL LIABILITIES & STOCKHOLDER'S EQUITY	**22,588,560**	**21,841,628**

CES Aviation V LLC		
Balance Sheet Items at:	**May 31, 2008**	**August 31, 2008**
CASH & CASH EQUIVALENTS	67,210	149,463
RECEIVABLES- OTHER	38,622	38,622
PROPERTY, EQUIPMENT & LEASE IMPROVEMENTS	4,343,043	4,242,042
DEFFERED EXPENSE & OTHER ASSETS	51,572	20,629
TOTAL ASSETS	**4,500,447**	**4,450,756**
ACCD LIABILITIES & OTHER PAY.	7,954,035	8,003,875
TOTAL LIABILITIES	**7,954,035**	**8,003,875**
RETAINED EARNINGS	(3,453,588)	(3,553,119)
TOTAL STOCKHOLDER'S EQUITY	**(3,453,588)**	**(3,553,119)**
TOTAL LIABILITIES & STOCKHOLDER'S EQUITY	**4,500,447**	**4,450,756**

CES Aviation IX		
Balance Sheet Items at:	**May 31, 2008**	**August 31, 2008**
CASH & CASH EQUIVALENTS	237,092	247,444
RECEIVABLES- OTHER	7,934	7,934
PROPERTY, EQUIPMENT & LEASE IMPROVEMENTS	7,865,753	7,686,986
DEFFERED EXPENSE & OTHER ASSETS	33,672	13,469
TOTAL ASSETS	**8,144,451**	**7,955,833**
ACCRUED LIABILITIES & OTHER PAYABLES	9,001,137	8,952,961
TOTAL LIABILITIES	**9,001,137**	**8,952,961**
RETAINED EARNINGS	(856,686)	(997,128)
TOTAL STOCKHOLDER'S EQUITY	**(856,686)**	**(997,128)**
TOTAL LIABILITIES & STOCKHOLDER'S EQUITY	**8,144,451**	**7,955,833**

These entities' assets consisted largely of aircraft, cash and prepaid insurance on aircraft. Liabilities are related to the use of the aircraft, such as transportation costs, and intercompany payables to LBHI and LBI. Because of the nature of their business, all three CES entities held exclusively fixed assets, and the Examiner concludes that none held significant intangible assets.

With no intangible assets associated with these entities, CES Aviation V LLC and CES Aviation IX were balance sheet insolvent as of May 31, 2008, and August 31, 2008. The entities' book value for property, equipment and lease improvements ("PEL") takes into account depreciation and does not reflect the fair market value of these entities' aviation equipment. However, even assuming the PEL was worth its purchase price ($8.7 million), the entities' equity deficit is too significant to overcome any increase from the book value of the assets.

As of May 31, 2008, CES Aviation posted positive shareholders' equity by a very slim margin. Accordingly, the Examiner concludes that CES Aviation was borderline solvent as of May 31, 2008. In July 2008, CES Aviation posted negative equity and did so through August 31, 2008. However, because its margin of negative equity was very small – $15,813 and $72,197 in July and August 2008, respectively – it is possible that the fair market value of PEL in this entity would be sufficiently above the value reported on its balance sheet to push CES into positive equity. Accordingly, given the uncertainty of the market value of certain aviation assets in this entity, and their impact on the solvency of the entity, the Examiner concludes that CES Aviation remained borderline solvent as of August 2008. In light of the time and expense to the Debtors' estates required to conduct an independent valuation of these assets, the Examiner has determined that it would be an imprudent use of the Estate's resources to do so. The table below provides the monthly equity positions of each entity.

	CES Aviation		CES Aviation V		CES Aviation IX	
	Equity	Solvency Determination	Equity	Solvency Determination	Equity	Solvency Determination
September 30, 2007	$917,722	Borderline	($2,841,129)	Insolvent	($465,808)	Insolvent
October 31, 2007	$770,068	Borderline	($2,939,739)	Insolvent	($524,954)	Insolvent
November 30, 2007	$765,759	Borderline	($2,953,150)	Insolvent	($589,790)	Insolvent
December 31, 2007	$626,549	Borderline	($3,026,449)	Insolvent	($648,527)	Insolvent
January 31, 2008	$444,105	Borderline	($3,059,305)	Insolvent	($701,748)	Insolvent
February 29, 2008	$331,361	Borderline	($3,148,726)	Insolvent	($720,203)	Insolvent
March 31, 2008	$237,230	Borderline	($3,220,516)	Insolvent	($761,657)	Insolvent
April 30, 2008	$49,335	Borderline	($3,401,644)	Insolvent	($802,240)	Insolvent
May 31, 2008	$131,669	Borderline	($3,453,588)	Insolvent	($856,686)	Insolvent
June 30, 2008	$49,067	Borderline	($3,446,161)	Insolvent	($909,705)	Insolvent
July 31, 2008	($15,813)	Borderline	($3,494,369)	Insolvent	($1,013,850)	Insolvent
August 31, 2008	($72,197)	Borderline	($3,553,119)	Insolvent	($997,128)	Insolvent

Source: Hyperion.

(c) LB Special Financing

LBSF was Lehman Brothers Inc.'s principal dealer in a broad range of derivative products, including interest rate, currency, credit and mortgage derivatives. For the reasons described below, the Examiner deems LBSF to have been borderline solvent as of May 31, 2008, and August 31, 2008. LBSF's balance sheets as of April 30, 2008, through August 31, 2008 are as follows:[6172]

[6172] Note that all balance figures are presented on a consolidated LBSF basis.

LB Special Financing Inc.					
Balance Sheet Items at:	**April 30, 2008**	**May 31, 2008**	**June 30, 2008**	**July 31, 2008**	**August 31, 2008**
CASH & CASH EQUIVALENTS	32,268,168	39,695,084	40,170,990	38,978,054	54,277,418
CASH & SEC.SEGR. & ON DEPOSIT	0	121,898,763	130,804,614	142,211,812	158,859,102
SEC. & OTHER FININANCIAL INSTRUMENTS OWNED	78,574,785,243	71,822,087,467	81,038,596,170	77,021,236,554	66,005,066,729
SECURITIES PURCHASED UNDER AGREEMENT TO SELL	4,799,272,249	5,579,013,493	3,117,305,188	3,213,698,449	3,253,884,281
SECURITIES BORROWED	43,783,917,364	26,365,338,267	34,440,447,484	36,632,787,111	26,565,362,945
RECEIVABLES- BROKER/DEALER	4,553,931,571	6,946,351,256	3,907,417,323	6,618,862,372	4,083,561,521
RECEIVABLES- CUSTOMERS	1,462,805,597	1,584,409,453	1,503,468,998	2,306,493,702	2,230,283,390
RECEIVABLES- OTHER	2,581,362,126	2,159,122,186	2,162,547,954	2,394,986,043	3,549,323,316
GOODWILL & INTANGIBLES	284,765,999	284,763,199	287,253,790	287,250,990	291,248,190
PROPERTY, EQUIPMENT & LEASE IMPROVEMENTS	11,460,586	10,919,044	12,549,216	12,328,440	10,108,220
DEFFERED EXPENSE & OTHER ASSETS	219,240,440	199,515,090	391,189,073	448,445,623	430,075,277
TOTAL BRIDGE ACCOUNTS	31	3	1	4	2
TOTAL ASSETS	**136,303,809,375**	**115,113,113,305**	**127,031,750,801**	**129,117,279,154**	**106,632,050,391**
COMMERCIAL PAPER & S.T. DEBT	188,128,111	184,568,237	185,291,739.29	190,472,213.47	176,893,415
SEC.& OTHER INSTRUMENTS SOLD NOT YET PURCHASED	55,595,965,409	40,456,549,211	45,632,121,885.11	45,395,025,250.05	33,540,848,955
SECURITIES SOLD UNDER AGREEMENT TO REPURCHASE	4,347,510,621	2,936,970,849	2,887,343,577.67	3,698,729,925.45	4,249,528,937
SECURITIES LOANED	43,991,644,009	40,672,680,943	43,011,801,476.53	44,678,811,748.63	35,540,001,644
OTHER SECURED FINANCING	2,429,178,131	1,918,859,123	1,906,166,762.30	1,414,153,886.91	1,074,702,425
PAYABLES- BROKER/DEALER	3,696,490,806	3,304,690,852	3,956,473,979.96	4,240,558,371.16	5,253,116,854
PAYABLES- CUSTOMERS	3,689,374,176	4,268,820,487	3,154,191,489.04	2,980,868,156.83	2,657,840,130
ACCD LIABILITIES & OTHER PAY.	21,622,506,426	20,211,734,488	25,187,338,234.46	25,373,700,109.15	23,040,698,961
SENIOR DEBT	695,725,691	683,144,683	659,429,677.75	640,889,783.27	630,005,545
TOTAL LIABILITIES	**136,256,523,382**	**114,638,018,874**	**126,580,158,822**	**128,613,209,445**	**106,163,636,866**
COMMON STOCK	1,000	1,000	1,000	1,000	1,000
F/X TRANSLATION ADJUSTMENT	(26,146)	(55,861)	(23,322)	(15,863)	(16,532)
RETAINED EARNINGS	(202,688,861)	125,149,292	101,614,301	154,084,572	118,429,057
TOTAL ADDITIONAL PAID IN CAPITAL	250,000,000	350,000,000	350,000,000	350,000,000	350,000,000
TOTAL STOCKHOLDER'S EQUITY	**47,285,993**	**475,094,431**	**451,591,979**	**504,069,709**	**468,413,525**
TOTAL LIABILITIES & STOCKHOLDER'S EQUITY	**136,303,809,375**	**115,113,113,305**	**127,031,750,801**	**129,117,279,153**	**106,632,050,391**
CAPITAL INFUSION	0	100,000,000	0	0	0
EQUITY AS % OF TOTAL ASSETS	0.03%	0.41%	0.36%	0.39%	0.44%

As of May 31, 2008, LBSF held approximately $72 billion in financial inventory, with the remaining asset balance made up largely of receivables, reverse repos and securities borrowed. Of the financial inventory, nearly 80% is comprised of derivatives and government and agency securities, including 15% allocated to intercompany derivatives. Following is a table of the inventory directly held by LBSF as of May 31, 2008 and August 31, 2008.

Lehman Brothers Special Financing
Total Financial Instruments Owned (Assets)

GAAP Asset Class	as of 5/31/08	% of Total	as of 8/31/08	% of Total
Commercial Paper & Money Market	87,851,674	0.12%	38,050,077	0.06%
Third Party Derivatives	21,490,667,702	29.92%	22,267,378,700	33.74%
Intercompany Derivatives	11,124,364,636	15.49%	10,977,690,112	16.63%
Total Derivatives	32,615,032,338	45.41%	33,245,068,813	50.37%
Physical Commodities	526,763,622	0.73%	413,833,886	0.63%
Corporate Debt	3,279,571,273	4.57%	5,215,184,322	7.90%
Corporate Debt & Other	3,806,334,896	5.30%	5,629,018,208	8.53%
Corporate Equity	9,379,851,772	13.06%	9,113,820,996	13.81%
Governments & Agencies	24,877,048,749	34.64%	17,668,641,729	26.77%
Mortgages & Mortgage Backed	1,055,968,037	1.47%	310,466,906	0.47%
	71,822,087,467	100.00%	66,005,066,729	100.00%

As set forth in Section III.A.2 of this Report, the Examiner has determined that there is insufficient evidence to support a finding, for purposes of a solvency analysis, that Lehman's derivative instruments or corporate debt and equity positions were unreasonably marked.

LBSF was a warehouse for derivative positions and did not originate business activity or perform significant business operations. However, goodwill did appear on its consolidated balance sheet as of June 2007 in the amount of approximately $285 million due to the acquisition of Eagle Energy. Due to the cost and time required, the Examiner did not conduct an investigation of the reasonableness of the magnitude of the goodwill and intangibles; even if the goodwill was written off completely, LBSF would continue to post positive equity for all months in 2008 other than March and

April. Moreover, Section III.C.3 of this Report analyzes potential intangible assets in LBSF on a stand-alone (i.e., unconsolidated) basis. While it is possible that additional intangible assets may exist in the form of customer lists, proprietary technology and/or human capital, such intangible assets are not of material value and would not change the solvency determination of LBSF.[6173] Below is a table of LBSF's monthly equity in the year prior to its bankruptcy filing, along with its ratio of equity-to-total-assets, and the Examiner's solvency determination as of each month.

	Equity	Solvency Determination	Ratio of Equity to Total Assets
September 30, 2007	$418,047,690	Borderline	0.51%
October 31, 2007	$812,630,989	Borderline	0.85%
November 30, 2007	$574,878,581	Borderline	0.60%
December 31, 2007	$712,458,966	Borderline	0.64%
January 31, 2008	$723,769,461	Borderline	0.55%
February 29, 2008	$953,503,304	Borderline	0.73%
March 31, 2008	$270,750,552	Borderline	0.19%
April 30, 2008	$47,285,993	Borderline	0.03%
May 31, 2008	$475,094,431	Borderline	0.41%
June 30, 2008	$451,591,979	Borderline	0.36%
July 31, 2008	$504,069,709	Borderline	0.39%
August 31, 2008	$468,413,525	Borderline	0.44%

Source: Hyperion.

As with other LBHI Affiliates, LECs attempted to make sure that LBSF had positive equity. Accordingly, while in February and March of 2008, LBSF paid dividends of $300 million and $500 million to LBI, just two months later, in May 2008,

[6173] Due to the cost and time required, the Examiner did not perform an investigation into the possible intangible assets in each of LBSF's subsidiaries.

LBSF received a capital infusion of $100 million from LBI. Without this additional $100 million, LBSF would have been balance sheet insolvent as of May 2008.

As illustrated above, LBSF maintained an equity-to-total-assets ratio of no more than 0.44% from March through August 2008. Even though the Examiner concludes that there is insufficient evidence to support a finding, for purposes of a solvency analysis, that the assets held by LBSF were unreasonably marked, LBSF's assets would only need to lose 0.45% of their value in order to render LBSF balance sheet insolvent. Because of its small equity cushion, the Examiner deems LBSF to have been borderline solvent as of May 31, 2008, and August 31, 2008.

(d) LB Commodity Services

LBCS's principal business was the trading of power, natural gas, oil, and structured products. The following table details LBCS's balance sheets as of May 31, 2008, and August 31, 2008:[6174]

[6174] Note that all balance figures are presented on a consolidated LBCS basis.

LB Commodity Services Inc.		
Balance Sheet Items at:	**May 31, 2008**	**August 31, 2008**
CASH & CASH EQUIVALENTS	6,850,371	22,550,284
SEC. & OTHER FININANCIAL INSTRUMENTS OWNED	5,488,309,683	4,340,355,972
SECURITIES PURCH. UNDER AGREEMENT TO SELL	0	4,155,555
RECEIVABLES- BROKER/DEALER	1,263,880,051	1,085,836,004
RECEIVABLES- CUSTOMERS	265,921,188	86,194,370
RECEIVABLES- OTHER	106,985,698	280,851,379
PROPERTY, EQUIPMENT & LEASE IMPROVEMENTS	7,718,516	7,034,975
DEFFERED EXPENSE & OTHER ASSETS	145,476,400	0
GOODWILL & INTANGIBLES	284,763,199	291,248,190
TOTAL BRIDGE ACCOUNTS	0	378,237,034
TOTAL ASSETS	**7,569,905,106**	**6,496,463,763**
SEC.& OTHER INSTRUMENTS SOLD NOT YET PURCHASED	3,538,571,157	2,058,364,215
COMMERCIAL PAPER & ST DEBT	152	79,068
PAYABLES- BROKER/DEALER	145,550,384	8,834,794
PAYABLES- CUSTOMERS	207,624,790	115,438,486
ACCD LIABILITIES & OTHER PAY.	2,974,541,324	3,485,452,763
SENIOR DEBT	677,617,075	624,483,872
TOTAL LIABILITIES	**7,543,904,882**	**6,292,653,199**
COMMON STOCK	100	100
F/X TRANSLATION ADJUSTMENT	(116,705)	(47,837)
RETAINED EARNINGS	(4,883,170)	172,858,302
TOTAL ADDITIONAL PAID IN CAPITAL	31,000,000	31,000,000
TOTAL STOCKHOLDER'S EQUITY	**26,000,224**	**203,810,565**
TOTAL LIABILITIES & STOCKHOLDER'S EQUITY	**7,569,905,106**	**6,496,463,763**
EQUITY AS % OF TOTAL ASSETS	0.34%	3.14%

The increase in stockholders' equity from May to August was due to an increase of approximately $117 million in retained earnings between May and June 2008, and another $60 million increase between June and July 2008. LBCS also posted a receivable from LBI of $1.3 billion on May 31, 2008, and $1.1 billion on August 31, 2008. Given the pending failure of LBI and LBHI, it is possible that the August 31 value of the receivable from LBI should be valued at less than book value. However, in light of the cost and

expense of examining this issue, and because the Examiner deems LBCS to be borderline solvent even if the receivable from LBI is valued at full book value, the Examiner has determined that it would not be a prudent use of resources to investigate this issue further.

As shown above, as of May 31, 2008, LBCS's balance sheet showed $5.5 billion in financial inventory, decreasing to $4.3 billion by August 31, 2008. Following is a table of the inventory directly held by LBCS as of May 31, 2008, and August 31, 2008.

LB Commodity Services
Total Financial Instruments Owned (Assets)

GAAP Asset Class	as of 5/31/08	% of Total	as of 8/31/08	% of Total
Commercial Paper & Money Market	3,016,437	0.05%	2,343,645	0.05%
Third Party Derivatives	3,982,759,627	72.57%	2,763,758,194	63.68%
Intercompany Derivatives	914,611,931	16.66%	1,009,617,031	23.26%
Total Derivatives	4,897,371,558	89.23%	3,773,375,225	86.94%
Physical Commodities	526,763,622	9.60%	413,833,886	9.53%
Corporate Debt	61,158,066	1.11%	150,801,915	3.47%
Corporate Debt & Other	587,921,688	10.71%	564,635,801	13.01%
Governments & Agencies	(0)	0.00%	1,301	0.00%
	5,488,309,683	100.00%	4,340,355,972	100.00%

Of LBCS's financial inventory portfolio, almost 90% pertains to derivatives, with 17% and 23% allocated to intercompany derivatives in May and August, respectively. The Examiner's valuation analysis of derivative positions, described in Section III.A.2 of the Report, indicates that there is insufficient evidence to support a finding, for purposes of a solvency analysis, that they were unreasonably marked. Also, while LBCS did perform business operations and, as discussed in Section III.C.3, it is possible

that additional intangible assets may exist in the form of customer lists, proprietary technology and human capital, the Examiner has determined that such intangible assets are not of material value.[6175] However, as noted above for LBSF, LBCS's parent entity, approximately $285 million in goodwill and intangibles did exist beginning in June 2007 due to the acquisition of Eagle Energy. These same goodwill assets are reflected on LBCS's consolidated balance sheet. The Examiner has determined that if this goodwill were entirely written off, LBCS would become balance sheet insolvent as of May and August 2008. However, due to the expense and time required, the Examiner has not engaged in an investigation of the reasonableness of the magnitude of the goodwill and intangibles.[6176]

Below is a table of LBCS's monthly equity in the year prior to its bankruptcy filing, along with its ratio of equity-to-total assets, and the Examiner's solvency determination as of each month.

[6175] As noted above, the analysis in Section III.C.3 was performed on LBCS on a stand-alone (*i.e.*, unconsolidated) basis. Due to the cost and time required, the Examiner did not perform an investigation into the possible intangible assets in each of LBCS's subsidiaries.

[6176] LBHI guaranteed certain of the obligations of LBCS, LBCC, LOTC and LBSF, pursuant to a Lehman Executive Committee Order dated June 9, 2005. *See* Lehman, Unanimous Written Consent of the Executive Committee of the Board of Directors of Lehman Brothers Holdings Inc. (June 9, 2005) [LBEX-AM 003415-003417]. LCPI and LOTC also received guaranties from LBHI for their activity with JPMorgan Chase on August 26, 2008. JPMorgan, Guaranty [JPM-2004 0005879-0005884]. The Executive Committee Order stated that LBHI would guarantee "payment of all liabilities, obligations and commitments of the subsidiaries." JPMorgan, Guaranty [JPM-2004 0005879-0005884]. Assuming that the guaranty is a legally enforceable obligation, it is not an asset of the Debtor entity, nor does it contribute to the solvency of the LBHI Affiliates. See Section III.A.5 and III.B.3.g of this Report for additional information on LBHI guaranties.

	Equity	Solvency Determination	Ratio of Equity to Total Assets
September 30, 2007	$90,229,685	Borderline	3.74%
October 31, 2007	$124,441,423	Borderline	4.15%
November 30, 2007	$132,927,603	Borderline	4.17%
December 31, 2007	$111,784,670	Borderline	3.18%
January 31, 2008	$123,068,926	Borderline	3.28%
February 29, 2008	$83,838,341	Borderline	1.81%
March 31, 2008	$54,934,471	Borderline	1.02%
April 30, 2008	$25,662,935	Borderline	0.38%
May 31, 2008	$26,000,224	Borderline	0.34%
June 30, 2008	$143,082,271	Borderline	1.46%
July 31, 2008	$203,052,519	Borderline	2.58%
August 31, 2008	$203,810,565	Borderline	3.14%

Source: Hyperion.

LBCS's equity-to-total-assets ratio of 0.3% in May 2008 and 3.14% in August of 2008, rendered it vulnerable to small write-downs or unforeseen liabilities.[6177] Accordingly, although LBCS's balance sheet indicates that it was solvent as of May 31 and August 31, 2008, the Examiner has determined that LBCS was borderline solvent during the period noted in the table above.[6178]

[6177] There is evidence that one of LBCS's subsidiaries, Eagle Energy Partners 1 L.P. ("Eagle Energy") may have been overvalued as of May and August of 2008. In May 2008, Eagle Energy's shareholder equity was $354 million. Hyperion report [LBEX-BARHYP 0000038-0000049]. In August, Eagle Energy's shareholder equity was $363 million. *Id.* The magnitude of Eagle Energy's book value of shareholder equity is relevant because in October 2008, LBCS sold Eagle Energy to Electricite de France SA for $230.5 million, over $100 million less than book value of the equity. Edvard Pettersson, *Lehman to Sell Eagle Energy Unit to EDF for $230.5 Million*, Bloomberg, October 1, 2008; Federal Energy Regulatory Commission, *FERC Authorizes Lehman-EDF Transaction*, October 30, 2008. Because of the narrow margin by which LBCS was balance sheet solvent in May 2008, a significant decrease in the equity of Eagle Energy, a Level 2 asset, would have rendered LBCS insolvent.

[6178] There were four Debtor entities that were reviewed and rated by rating agencies: LBCS, LBFP, LBDP and LBCC. Each entity obtained credit ratings of at least A. In light of the applicable precedent, the Examiner does not consider the rating itself to be dispositive of solvency.

(e) Luxembourg Residential Properties Loan Finance S.A.R.L.

LRP was established in May 2008 as an investment and financing vehicle to hold primarily commercial loans.[6179] Balance sheet information was not available for this entity until June and its balance sheet as of August 31, 2008, is stated as follows:

Luxembourg Residential Properties	
Balance Sheet Items at August 31, 2008	
CASH & CASH EQUIVALENTS	20,000
SEC. & OTHER FININANCIAL INSTRUMENTS OWNED	596,624,913
TOTAL ASSETS	**596,644,913**
ACCD LIABILITIES & OTHER PAY.	593,998,140
TOTAL LIABILITIES	**593,998,140**
COMMON STOCK	20,000
RETAINED EARNINGS	2,626,773
TOTAL STOCKHOLDER'S EQUITY	**2,646,773**
Total Liabilities & Stockholder's Equity	**596,644,913**

LRP's assets consist entirely of one corporate loan; an Archstone Term B loan in the principal amount of $597 million. As noted in Section III.A.2, the Examiner has determined that it was reasonable for Lehman to value its Archstone Term B loan at 99% of stated principal due to price flex.

Based on the fact that the Archstone Term Loan B was the only asset of LRP, and because there is no basis to expect any deterioration in the value of that asset, there is insufficient evidence to support a finding that LRP was insolvent as of August 31, 2008.

[6179] Examiner's Interview of Gerald Haupt, Oct. 13, 2009, at pp. 2-3. LRP is a distinct and separate entity from Luxembourg Finance, S.a.r.l., which is not a Debtor LBHI Affiliate.

(f) LB OTC Derivatives

LOTC is an over-the-counter derivatives dealer and its balance sheets as of May 31, 2008 and August 31, 2008 are stated as follows:

LB OTC Derivatives		
Balance Sheet Items at:	**May 31, 2008**	**August 31, 2008**
CASH & CASH EQUIVALENTS	0	31,661
SEC. & OTHER FININANCIAL INSTRUMENTS OWNED	2,006,960,062	1,760,363,783
SECURITIES PURCHASED UNDER AGREEMENT TO SELL	99,617,347	759,230,174
SECURITIES BORROWED	99,412,565	53,742,524
RECEIVABLES- BROKER/DEALER	1,531,638,380	944,631,818
RECEIVABLES- CUSTOMERS	1,605,884,195	1,095,052,703
RECEIVABLES- OTHER	47,733,513	54,138,936
DEFERRED EXPENSE & OTHER ASSETS	0	2,559,784
TOTAL BRIDGE ACCOUNTS	(0)	0
TOTAL ASSETS	**5,391,246,062**	**4,669,751,382**
COMMERCIAL PAPER & S.T. DEBT	187,220,440	1,013,982,923
SEC.& OTHER INSTRUMENTS SOLD NOT YET PURCHASED	3,900,934,006	2,274,803,899
SECURITIES SOLD UNDER AGREEMENT TO REPURCHASE	3,024,306	129,388
PAYABLES- BROKER/DEALER	48,967,601	14,091,730
PAYABLES- CUSTOMERS	196,846,122	199,396,799
ACCD LIABILITIES & OTHER PAY.	578,708,851	702,239,780
SUBORDINATED INDEBTEDNESS	250,000,000	250,000,000
TOTAL LIABILITIES	**5,165,701,327**	**4,454,644,519**
COMMON STOCK	100	100
RETAINED EARNINGS	125,544,736	115,106,863
TOTAL ADDITIONAL PAID IN CAPITAL	99,999,900	99,999,900
TOTAL STOCKHOLDER'S EQUITY	**225,544,736**	**215,106,863**
TOTAL LIABILITIES & STOCKHOLDER'S EQUITY	**5,391,246,062**	**4,669,751,382**

Of its $5 billion in total assets as of May 31, 2008, approximately $2 billion was in the form of financial instruments owned by LOTC. Almost 40% of the financial inventory was derivatives, with the other 60% comprised of corporate equity and corporate debt positions. The Examiner's valuation review of these assets suggests that

there is insufficient evidence to support a finding that these assets were unreasonably marked.[6180] The following is a table of the financial inventory directly held by LOTC as of May 31, 2008 and August 31, 2008:

LB OTC DERIVATIVES
Total Financial Instruments Owned (Assets)

GAAP Asset Class	as of 5/31/08	% of Total	as of 8/31/08	% of Total
Commercial Paper & Money Market	(1,037,563)	-0.05%	(737,700)	-0.04%
Third Party Derivatives	792,685,335	39.50%	664,058,534	37.72%
Intercompany Derivatives	263,105	0.01%	51,169	0.00%
Total Derivatives	792,948,439	39.51%	664,109,703	37.73%
Corporate Debt	911,345,248	45.41%	775,426,806	44.05%
Corporate Equity	303,715,608	15.13%	321,564,974	18.27%
Governments & Agencies	(11,670)	0.00%	(0)	0.00%
	2,006,960,062	100.00%	1,760,363,783	100.00%

Based on the positive equity cushion reflected on its balance sheet and the reasonableness of the value of the financial assets it owned, there is insufficient evidence to support a finding that LOTC was insolvent as of May 31, 2008 and August 31, 2008.

(g) LB 745 LLC

LB 745 is an entity established for the primary purpose of acquiring Lehman's headquarters building at 745 Seventh Avenue in New York. As of May 2008, the entity's core assets included approximately $193 million in receivables and $576 million

[6180] See Section III.A.2 of this Report.

for the property and related equipment.[6181] These values had not varied significantly by August 31, 2008. Although the value of the property on LB 745's balance sheet is not fair market value, the value of commercial real estate property in New York would likely have experienced significant appreciation from its purchase in 2001 to May 2008 or August 2008.[6182] The entity's largest liability is comprised of intercompany debt of approximately $600 million. LB 745's balance sheets as of May 31, 2008 and August 31, 2008 are as follows:

LB 745 LLC		
Balance Sheet Items at:	**May 31, 2008**	**August 31, 2008**
RECEIVABLES- OTHER	193,404,492	197,484,533
PROPERTY, EQUIPMENT & LEASE IMPROVEMENTS	576,533,350	568,301,224
DEFFERED EXPENSE & OTHER ASSETS	1,206,427	6,028,918
TOTAL ASSETS	**771,144,269**	**771,814,675**
SECURITIES SOLD UNDER AGREEMENT TO REPURCHASE	4	4
ACCD LIABILITIES & OTHER PAY.	715,829,776	711,579,742
TOTAL LIABILITIES	**715,829,780**	**711,579,746**
RETAINED EARNINGS	55,314,488	60,234,928
TOTAL STOCKHOLDER'S EQUITY	**55,314,488**	**60,234,928**
TOTAL LIABILITIES & STOCKHOLDER'S EQUITY	**771,144,269**	**771,814,675**

Based on the assets held by LB 745, there is insufficient evidence to support a finding that LB 745 was insolvent as of May 31, 2008 and August 31, 2008.

[6181] Note that approximately $25 million of total receivables was an intercompany receivable from LCPI and $8 million from LBSF.

[6182] *See* Moody's/REAL Commercial Property Price Index, New York City Metro Area, Q4 2000-Q2 2009, *available at*, http://web.mit.edu/cre/research/credl/rca.html.

(h) LB Derivative Products

LBDP is a termination derivative product company that intermediates interest rate and currency swaps between market counterparties and LBSF. In order for investment banks like Lehman, which are rated below AA or AAA, to trade with certain highly rated counterparties, banks establish derivative product companies that can maintain a high rating from the rating agencies. In general, these AAA ratings are dependent on certain criteria, the most visible of which are: (1) hedging market risk through back-to-back transactions or "mirror transactions" with another corporate entity; (2) minimizing counterparty credit risk with the hedging counterparty by requiring collateral on negative mark-to-market exposures to the counterparty; and (3) maintaining strict capital requirements.[6183]

LBDP entered into a variety of derivative transactions and eliminated market risk by entering into "mirror transactions" with LBSF, which were guaranteed by LBHI. As a termination structure, LBDP would provide for the acceleration and cash settlement of all contracts before their maturity upon certain events.[6184] Furthermore, LBDP purchased a surety bond from Ambac Assurance Corp., which guaranteed that its obligations to counterparties would be fulfilled.[6185]

[6183] Standard & Poor's Ratings Direct, Lehman Brothers Derivative Products Inc. (Feb. 4, 2000).

[6184] Lehman, Lehman Brothers Derivatives Products Operating Guidelines, Article X (July 16, 1998) [LBEX-BARLEG 0001824-0001885]; Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 5.

[6185] Standard & Poor's Ratings Direct, Lehman Brothers Derivative Products Inc., at p.2 (Feb. 4, 2000).

LBDP's assets consisted almost entirely of interest rate swaps and money market instruments. Its balance sheets as of May 31, 2008, and August 31, 2008, are as follows:

LB Derivative Products Inc		
Balance Sheet Items at:	**May 31, 2008**	**August 31, 2008**
CASH & CASH EQUIVALENTS	86,538,624	5,745,136
SEC. & OTHER FININANCIAL INSTRUMENTS OWNED	432,292,498	756,349,084
RECEIVABLES- CUSTOMERS	7,600,000	0
RECEIVABLES- BROKER/DEALER	0	0
RECEIVABLES- OTHER	7,720,095	99
DEFFERED EXPENSE & OTHER ASSETS	514,973	674,972
TOTAL ASSETS	**534,666,190**	**762,769,292**
SEC.& OTHER INSTRUMENTS SOLD NOT YET PURCHASED	375,222,833	488,716,675
PAYABLES- CUSTOMERS	10,266,440	0
ACCD LIABILITIES & OTHER PAY.	91,767,234	66,595,639
SUBORDINATED INDEBTEDNESS	10,000,000	10,000,000
TOTAL LIABILITIES	**487,256,507**	**565,312,314**
COMMON STOCK	100	100
RETAINED EARNINGS	22,409,683	22,456,978
TOTAL ADDITIONAL PAID IN CAPITAL	24,999,900	174,999,900
TOTAL STOCKHOLDER'S EQUITY	**47,409,683**	**197,456,978**
TOTAL LIABILITIES & STOCKHOLDER'S EQUITY	**534,666,190**	**762,769,292**

The increase in LBDP's stockholder equity between May 31, 2008, and August 31, 2008, was largely due to a capital infusion of $150 million received from LBI, through LBHI, on June 12, 2008.[6186] This capital infusion was in response to the downgrade of Ambac, LBDP's insurer, and was required in order to maintain LBDP's AAA rating.[6187]

[6186] Lehman, Daily Treasury MIS as of 6/12/08 [LBEX-DOCID 552032].

[6187] E-mail from J. Palumbo, Ernst & Young, to W. Schlich and Jennifer Jackson, Ernst & Young, (Jun. 8, 2008) [EY-LE-LBHI-KEYPERS 257754]; e-mail from J. Goodman, Lehman, to C. O'Meara and V. DiMassimo, Lehman (June 6, 2008) [LBHI_SEC07940_781486].

LBDP was consistently rated AAA by S&P until it was placed on CreditWatch with negative implications on September 25, 2008. The entity's operating guidelines provide for the termination of all outstanding swaps should the following events occur:[6188]

- LBDP ceased to maintain an 'A' rating;
- LBSF fails to deliver the required collateral under the back-to-back transactions within a two-day cure period;
- LBDP fails to maintain the capital required; or
- LBHI or LBSF file for bankruptcy protection.

In this case, the termination trigger was the bankruptcy filing of LBHI on September 15, 2008.

Because the Examiner finds, for purposes of a solvency analysis, that there is insufficient evidence to conclude that LBDP's derivative assets were marked unreasonably, there is also insufficient evidence to support a finding that LBDP was insolvent during the period in question. The Examiner concludes that LBDP was balance sheet solvent on May 31, 2008, and August 31, 2008.

(i) LB Financial Products

LBFP was established for the purpose of engaging in over-the-counter interest rate and currency swaps and options, as well as trading exchange-traded futures and options, and government bonds and options. Similar to its sister company LBDP, LBFP

[6188] Lehman, Lehman Brothers Derivatives Products Operating Guidelines, Article X, at p. 25 (July 16, 1998) [LBEX-BARLEG 0001824-0001885].

was a derivative product company. As such, it eliminated market risk by entering into offsetting "mirror transactions" with LBSF, which was unconditionally backed by LBHI, and was bound by strict capital requirements. However, unlike LBDP, which had a termination structure, LBFP was a continuation derivative product company that would maintain its derivative positions through maturity, even upon a trigger event.[6189]

LBFP's assets consisted almost entirely of interest rate swaps and money market instruments. Its balance sheets as of May 31, 2008, and August 31, 2008, are as follows:

LB Financial Products Inc.		
Balance Sheet Items at:	**May 31, 2008**	**August 31, 2008**
CASH & CASH EQUIVALENTS	(56,027)	1,430,613
SEC. & OTHER FININANCIAL INSTRUMENTS OWNED	530,169,151	548,897,873
RECEIVABLES- OTHER	106	3,504
DEFFERED EXPENSE & OTHER ASSETS	5,889,140	5,779,137
TOTAL ASSETS	**536,002,370**	**556,111,126**
SEC.& OTHER INSTRUMENTS SOLD NOT YET PURCHASED	220,854,048	237,596,839
ACCD LIABILITIES & OTHER PAY.	25,142,974	29,705,786
TOTAL LIABILITIES	**245,997,022**	**267,302,625**
COMMON STOCK	10	10
RETAINED EARNINGS	39,871,006	38,674,159
TOTAL ADDITIONAL PAID IN CAPITAL	250,134,332	250,134,332
TOTAL STOCKHOLDER'S EQUITY	**290,005,348**	**288,808,502**
TOTAL LIABILITIES & STOCKHOLDER'S EQUITY	**536,002,370**	**556,111,126**

LBHI's bankruptcy filing automatically placed LBFP into "continuation mode," forcing LBFP into a wind-down phase as the entities were intertwined to a great extent,

[6189] Lehman, Lehman Brothers Financial Products Inc. Operating Guidelines [LBEX-BARLEG 0001886-0001933]; Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 5.

with LBHI playing both operational and financial roles for LBFP.[6190] LBFP's assets were primarily interest rate swaps and money market instruments. As a continuation structure, LBFP would not terminate these positions with counterparties upon a triggering event. Instead, a contingent manager would assist in managing the portfolio until final maturity and take responsibility for hedging the portfolio against interest rate movements. At the time of LBFP's voluntary bankruptcy filing, however, the status of the outstanding derivatives positions was unclear.[6191]

The Examiner finds insufficient evidence to support a finding, for purposes of a solvency analysis, that the assets held by LBFP were unreasonably marked. Therefore, the Examiner concludes that LBFP was balance sheet solvent on May 31, 2008, and August 31, 2008.

(j) LB Commercial Corporation

LBCC acted primarily as a dealer in over-the-counter ("OTC") foreign currency forwards and options and exchange-traded futures and futures options. LBCC's balance sheets as of May 31, 2008, and August 31, 2008, were as follows:

[6190] Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 5; *Standard & Poor's, Lehman Bros Financial Prod Ratings Put on Watch; Lehman Bros Derivative Prod Ratings Affirmed*, Sept. 25, 2008.

[6191] Lehman, Lehman Brothers Financial Products Inc. Operating Guidelines, [LBEX-BARLEG 0001886-0001933]; Standard & Poor's, *Lehman Bros Derivative Product Rts Cut, Put on Watch Neg; Lehman Bros Financial Product Rts Cut*, Oct. 6, 2008.

LB Commercial Corp.		
Balance Sheet Items at:	**May 31, 2008**	**August 31, 2008**
CASH & CASH EQUIVALENTS	678,036	23,755
SEC. & OTHER FININANCIAL INSTRUMENTS OWNED	1,356,600,864	912,862,084
RECEIVABLES- BROKER/DEALER	1,250,349,674	1,264,899,973
RECEIVABLES- CUSTOMERS	13,541,462	1,716,562
RECEIVABLES- OTHER	702,816,861	939,587,074
DEFFERED EXPENSE & OTHER ASSETS	(803)	(803)
TOTAL ASSETS	**3,323,986,094**	**3,119,088,646**
SEC.& OTHER INSTRUMENTS SOLD NOT YET PURCHASED	773,420,701	1,301,089,939
COMMERCIAL PAPER & S.T. DEBT	0	9,402,088
PAYABLES- BROKER/DEALER	608,606,177	468,207,184
PAYABLES- CUSTOMERS	79,895,667	77,720,011
ACCD LIABILITIES & OTHER PAY.	1,631,146,162	1,058,172,121
TOTAL LIABILITIES	**3,093,068,707**	**2,914,591,343**
COMMON STOCK	1,000	1,000
RSU MTM APPRECIATION	(211,560)	(211,560)
RETAINED EARNINGS	219,827,971	193,407,886
TOTAL ADDITIONAL PAID IN CAPITAL	11,299,976	11,299,976
TOTAL STOCKHOLDER'S EQUITY	**230,917,387**	**204,497,303**
TOTAL LIABILITIES & STOCKHOLDER'S EQUITY	**3,323,986,094**	**3,119,088,646**

A review of LBCC's balance sheet reveals that LBCC's financial inventory as of May 31, 2008, and August 31, 2008, was comprised entirely of derivatives. A sample of these derivatives was reviewed and are summarized below. The remainder of LBCC's assets as of these dates was largely receivables.

LB Commercial Corporation
Total Financial Instruments Owned (Assets)

GAAP Asset Class	as of 5/31/08	% of Total	as of 8/31/08	% of Total
Commercial Paper & Money Market	(27,625,745)	-2.04%	(48,950,953)	-5.36%
Third Party Derivatives	760,551,422	56.06%	393,277,657	43.08%
Intercompany Derivatives	623,334,582	45.95%	568,535,577	62.28%
Total Derivatives	1,383,886,004	102.01%	961,813,234	105.36%
Corporate Debt	887	0.00%	-	0.00%
Governments & Agencies	204,987	0.02%	-	0.00%
Mortgages & Mortgage Backed	134,731	0.01%	(197)	0.00%
	1,356,600,864	100.00%	912,862,084	100.00%

As described in Section III.A.2, the Examiner has found insufficient evidence to support a finding that Lehman's derivatives positions, as an asset class, were unreasonably marked. Additionally, the Examiner evaluated the reasonableness of the valuation of twelve option positions held by LBCC as of May 31, 2008.[6192] Lehman's GFS quotes for price and total dollar value for these positions were evaluated by comparison to price quotes from either Bloomberg or MarketWatch. The Examiner has determined that Lehman's prices for these positions were reasonable.

Given the makeup of its assets and the reasonableness of their marks, the Examiner concludes that there is insufficient evidence to support a finding that LBCC was balance sheet insolvent as of May 31, 2008 and August 31, 2008.

[6192] The Examiner evaluated call and put options on American International Group, Apple Inc., BP PLC, Citigroup, Google Inc., and the S&P 500. The GFS ticker symbols for the positions investigated were QWAPMG, QAPVAP, QQAAAR, QBPAN, QBPMM, QSXYUO, QBPMN, QSXYFS, QCIT, QBPSL, QGOOFN, and QVAFAO.

(k) BNC Mortgage LLC

BNC Mortgage LLC was a subprime mortgage originator. As of May 31, 2008, and August 31, 2008, its balance sheets were as follows:

BNC Mortgage LLC		
Balance Sheet Items at:	**May 31, 2008**	**August 31, 2008**
CASH & CASH EQUIVALENTS	1,572	1,572
RECEIVABLES- OTHER	23,843,678	20,335,920
DEFFERED EXPENSE & OTHER ASSETS	436,122	427,302
TOTAL ASSETS	**24,281,373**	**20,764,794**
ACCD LIABILITIES & OTHER PAY.	13,155,418	10,316,050
TOTAL LIABILITIES	**13,155,418**	**10,316,050**
COMMON STOCK	25,000,000	25,000,000
RETAINED EARNINGS	(56,305,764)	(56,982,974)
TOTAL ADDITIONAL PAID IN CAPITAL	42,431,718	42,431,718
TOTAL STOCKHOLDER'S EQUITY	**11,125,954**	**10,448,744**
TOTAL LIABILITIES & STOCKHOLDER'S EQUITY	**24,281,373**	**20,764,794**

As detailed above, 98% of BNC's assets consisted of intercompany receivables, split between receivables from Lehman Brothers Bank and Aurora Loan Services. Given BNC's substantial equity cushion, as well as the fact that its largest assets were receivables from non-debtor entities, its balance sheet was relatively strong. Accordingly, the Examiner concludes that there is insufficient evidence to support a finding that BNC was balance sheet insolvent as of May 31, 2008 and August 31, 2008.

(l) East Dover Limited

East Dover Limited was established for the sole purpose of purchasing, leasing and selling aircraft and related equipment. However, at the time of its bankruptcy filing, this entity was no longer used for this purpose and held mostly intercompany

receivables and payables. Its balance sheets as of May 31, 2008, and August 31, 2008, were as follows:

East Dover Ltd		
Balance Sheet Items at:	**May 31, 2008**	**August 31, 2008**
CASH & CASH EQUIVALENTS	59,605,203	100,373
SEC. & OTHER FININANCIAL INSTRUMENTS OWNED	(34)	(0)
RECEIVABLES- OTHER	49,135,409	109,486,530
DEFFERED EXPENSE & OTHER ASSETS	117,344	117,344
TOTAL ASSETS	**108,857,921**	**109,704,246**
ACCD LIABILITIES & OTHER PAY.	7,686,388	4,215,167
COMMERCIAL PAPER S.T. DEBT	32,513	30,817
TOTAL LIABILITIES	**7,718,901**	**4,245,983**
RETAINED EARNINGS	25,139,020	29,458,263
TOTAL ADDITIONAL PAID IN CAPITAL	76,000,000	76,000,000
TOTAL STOCKHOLDER'S EQUITY	**101,139,020**	**105,458,263**
TOTAL LIABILITIES & STOCKHOLDER'S EQUITY	**108,857,921**	**109,704,246**

As of May 31, 2008, over 50% of East Dover's assets were derived from cash. The remaining assets consisted largely of $46 million of intercompany receivables from LBI and LCPI. An intercompany receivable from LCPI of $39.1 million comprised 37% of East Dover's total assets. However, even if LCPI were unable to repay its obligation, East Dover had sufficient equity, $101 million, to cover its loss.

By August 31, 2008, East Dover's cash had decreased to less than 1% of total assets and was replaced by a $99 million intercompany receivable from LCPI. However, in this instance as well, even if LCPI were unable to repay its obligation, East Dover had sufficient equity – $105 million – to cover its loss.

There is insufficient evidence to support a finding that East Dover was insolvent and the Examiner concludes that East Dover was balance sheet solvent as of May 31, 2008, and August 31, 2008.

(m) Lehman Scottish Finance

LSF was established for the sole purpose of holding equity-linked notes of other Lehman entities. Its balance sheets as of May 31, 2008, and August 31, 2008, were as follows:

Lehman Scottish Finance LP		
Balance Sheet Items at:	**May 31, 2008**	**August 31, 2008**
CASH & CASH EQUIVALENTS	1,541,639	1,544,815
SEC. & OTHER FININANCIAL INSTRUMENTS OWNED	2,793,978	7,263,935
RECEIVABLES- OTHER	53,032,408	53,914,704
TOTAL ASSETS	**57,368,026**	**62,723,454**
TOTAL LIABILITIES	**-**	**-**
COMMON STOCK	50,000,000	50,000,000
RETAINED EARNINGS	7,368,026	12,723,454
TOTAL STOCKHOLDER'S EQUITY	**57,368,026**	**62,723,454**
TOTAL LIABILITIES & STOCKHOLDER'S EQUITY	**57,368,026**	**62,723,454**

LSF did not post any liabilities on its balance sheet as of May 31, 2008, or August 31, 2008. This is consistent with its role as a non-operating entity that was not involved in transactions and which was created for the sole purpose of holding equity-linked notes of other Lehman entities. At the same time, on May 31, 2008, LSF's assets consisted of $2.8 million in U.S. equities and $53 million in intercompany receivables. By August 31, 2008, its financial inventory, still consisting entirely of derivatives,

increased to $7.2 million. The receivables reported by LSF are primarily comprised of $9 million in Luxembourg Finance, S.a.r.l. redeemable common stock and $40 million in subordinate debt purchased from Luxembourg Finance, S.a.r.l. in 2007.

Given the lack of any liabilities and the composition of its assets, 93% being redeemable common stock and a subordinate loan, the Examiner concludes that there is insufficient evidence to support a finding that LSF was balance sheet insolvent as of May 31, 2008, and August 31, 2008.

(n) PAMI Statler Arms

PAMI was a Lehman entity created to own and manage a variety of real estate properties. One of its subsidiaries, PAMI Statler Arms, was established to hold title to the Statler Arms Apartments, a 297-suite apartment complex in Cleveland, Ohio. PAMI Statler Arms took ownership of the building in May 2008.

According to the Chapter 11 petition filed by PAMI Statler Arms, it had $20 million in assets and $38.5 million in liabilities at the time of its bankruptcy filing.[6193] No financial information is available for PAMI Statler Arms in Lehman's financial systems. Given the lack of data available on this entity, as well as the immaterial amount of assets involved, the Examiner is unable to draw any conclusion regarding the solvency of this entity.

[6193] Exhibit "A" to Voluntary Petition, Docket 1, *In re PAMI Statler Arms LLC*, No. 08-13664 (Bankr. S.D.N.Y. Sept. 22, 2008).

d) Unreasonably Small Capital

As set forth *supra,* the avoidance of a pre-petition transfer as constructively fraudulent requires, among other things, one of three measures of a debtor's financial condition to be satisfied: insolvency, "unreasonably small capital," or an inability to pay debts as they come due.[6194] This Section addresses whether, and as of what date, there is evidence sufficient to establish a finding that LBHI or an LBHI Affiliate had "unreasonably small capital." Because of the fact-intensive nature of the "unreasonably small capital" test, this Section draws extensively upon the facts and findings set forth more fully in other Sections of this Report, but repeats those facts to the extent necessary to provide clarity to the discussion of undercapitalization.

Given the relatively limited number of reported cases applying the unreasonably small capital test, as compared to the insolvency test, the unreasonably small capital test can fairly be characterized as an alternative test that a court may consider in the event that it determines that the debtor was not insolvent as of the date of the challenged transfer. As noted by Judge Richard Posner in a recent Seventh Circuit decision, the "unreasonably small capital" test allows a court to assess the avoidability of a given pre-petition transfer without necessarily "haggling over whether at the moment of the

[6194] *See* 11 U.S.C. § 548(a)(1)(B)(ii).

transfer the corporation became 'technically' insolvent, a question that only accountants could relish having to answer."[6195]

This test seems particularly apt in the Lehman matter, as the "unreasonably small capital" test can allow a fact-finder to take a broader view of certain risks, such as liquidity risk, that are not necessarily reflected on a balance sheet. Financial institutions such as Lehman have a relatively greater risk of failure due to a lack of liquidity, as compared to a risk of failure due to the value of their liabilities exceeding the fair value of their assets. As noted by Paul Shotton, Lehman's Global Head of Risk Control, in the aftermath of the near collapse of Bear Stearns, "[l]iquidity is more important than capital; most entities which go bankrupt do so because they run out of financing, not because the value of their assets falls below the value of their liabilities."[6196]

Accordingly, and in light of the purpose of the fraudulent conveyance laws – to ensure that property transferred by the debtor for less than reasonably equivalent value during the applicable period is available for distribution to the debtor's creditors – the Examiner has determined that it is prudent to address the "unreasonably small capital" test.

The Examiner emphasizes that a finding of "unreasonably small capital" is germane only to the narrow question of evaluating the viability of certain claims to

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[6195] *Boyer v. Crown Stock Distrib., Inc.*, 587 F.3d 787, 794 (7th Cir. 2009).

[6196] *See* E-mail from Paul Shotton, Lehman, to Christopher O'Meara, Lehman (Apr. 15, 2008) [LBHI_SEC07940_768467].

avoid transfers as constructively fraudulent under Section 548(a)(1)(B) of the Bankruptcy Code or under analogous sections of applicable state law. As "unreasonably small capital" denotes a financial condition short of insolvency, a finding of "unreasonably small capital" is not relevant to evaluating claims that require a finding of insolvency as one of their essential elements.[6197] Moreover, a finding that a transfer is constructively fraudulent does not require or imply a finding that a party to the transfer committed any bad acts.[6198] Rather, the purpose of fraudulent conveyance law is to protect creditors from "last-minute diminutions of the pool of assets in which they have interests" and not to identify or punish bad actors.[6199] For these reasons, the Examiner's application of the "unreasonably small capital" test is relevant only to his consideration of constructively fraudulent avoidance claims and is discussed only in that context.

As set forth in detail below, the Examiner has identified evidence that would support a determination by a finder of fact that LBHI, and each of the LBHI Affiliates that relied on LBHI to provide funding or credit support, had "unreasonably small capital" beginning early in the third quarter of 2008 and continuing through to the applicable petition date. The Examiner has also identified evidence that would support

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[6197] *See Pereira v. Farace*, 413 F.3d 330, 343 (2d Cir. 2005) (holding that a cash flow-based analysis that "projects into the future to determine whether capital will remain adequate over time" is not relevant to "determining whether a corporation is insolvent under the applicable Delaware law."); *but see ASARCO LLC v. Americas Mining Corp.*, 396 B.R. 278, 395 (Bankr. S.D. Tex. 2008).

[6198] *See In re FBN Food Servs., Inc.*, 82 F.3d 1387, 1394 (7th Cir. 1996).

[6199] *Bonded Fin. Servs., Inc. v. European American Bank*, 838 F.2d 890, 892 (7th Cir. 1988).

a contrary finding. As such, a future finder of fact would need to weigh carefully all evidence to determine whether the "unreasonably small capital" element is satisfied. Because conflicting evidence exists and because the "unreasonably small capital" test is "fuzzy"[6200] and infrequently considered by courts, the Examiner expresses no opinion as to how such a finder of fact would find.

(1) Summary

The "unreasonably small capital" test is a forward-looking analysis that considers whether, and at what point, a debtor could have reasonably projected that it faced an unreasonable risk of insolvency given its business model and financial condition.[6201] As a highly leveraged investment bank that required tens of billions of dollars in overnight funding, Lehman's primary insolvency risk was that it would not have sufficient funds to satisfy its debts as they came due.[6202] This risk, referred to as liquidity risk, differs from balance sheet insolvency, the condition where the fair value of the entity's assets is less than its liabilities.

[6200] *Boyer v. Crown Stock Distribution, Inc.*, 587 F.3d 787, 794 (7th Cir. 2009).

[6201] *See Boyer v. Crown Stock Distrib., Inc.*, No. 1:076-CV-409RM, 2009 WL 418275, at *11 (N.D. Ind. Feb. 17, 2009) (describing the "unreasonably small capital" test as "forward-looking, requiring consideration of liabilities the debtor would incur or contemplated transactions for which the remaining assets were unreasonably small"), *aff'd in part, rev'd in part*, *Boyer*, 587 F.3d at 787; *see also Brandt v. Hicks, Muse & Co., Inc. (In re Healthco Inter'l)*, 208 B.R. 288, 302 (Bankr. D. Mass. 1997) (describing "unreasonably small capital" as "an unreasonable risk of insolvency, not necessarily a likelihood of insolvency" that is "similar to the concept of negligence, which is conduct that creates an unreasonable risk of harm to another's person or property"); *cf. In re Vadnais Lumber Supply, Inc.*, 100 B.R. 127, 137 (Bankr. D. Mass. 1989) (noting that "unreasonably small capital . . . encompasses difficulties which are short of insolvency in any sense but are likely to lead to insolvency at some time in the future").

[6202] Although Lehman and other investment banks measured their "capital adequacy" according to metrics such as net leverage ratios and CSE Capital Ratios, as discussed below, these metrics do not adequately monitor or address an investment's bank's liquidity risk.

Lehman relied upon repo funding – a form of short-term secured financing – to support a substantial part of its less liquid assets.[6203] After the near collapse of Bear Stearns, Lehman recognized that its ability to obtain such financing was more dependent on the market's confidence in Lehman's viability than the actual value of the underlying asset being financed.[6204] After having engaged in a countercyclical strategy of increasing its real estate assets as well as increasing its positions in leveraged loans, private equity and other less liquid assets, by late 2007, Lehman recognized the need to reduce its firm-wide leverage. By January 2008, Fuld had ordered Lehman to cut its balance sheet in half, and by the second quarter of 2008, Lehman reversed course and executed a deleveraging plan in the second quarter of 2008 to "win back" the confidence of the market and Lehman's lenders.[6205] Notwithstanding Lehman's execution of this plan, the market did not respond as Lehman had anticipated.[6206] As discussed below, sufficient evidence exists to support a determination that Lehman knew or should have known that, beginning early in the third quarter of 2008, there was a reasonable

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[6203] Lehman defined "less liquid" inventory positions as including "derivatives, private equity investments, certain corporate loans, certain commercial mortgages and real estate positions." Lehman Brothers Holdings Inc., Quarterly Report as of Feb. 29, 2008 (Form 10-Q), at p. 68 (filed on Apr. 9, 2008) [LBEX-DOCID 1024435] ("LBHI 10-Q (Apr. 9, 2008)").

[6204] *See, e.g.*, E-mail from Paul Shotton, Lehman, to Chris O'Meara, Lehman (Apr. 15, 2008) [LBHI_SEC07940_768467].

[6205] Erin Callan, Lehman, Leverage Analysis [Draft] (Apr. 7, 2008), at p. 1 [LBEX-DOCID 1303158].

[6206] Starting in June 2008, Lehman's share price was approaching its 52-week low, would soon fall below $30 per share and would not again return to that level. *See also* Ben Levisohn, *Lehman: Independent for How Long? The diversified investment bank does not have the requisite strength or size for the current environment. But suitors are holding back - for now*, Business Week, June 11, 2008, *available at* http://www.businessweek.com/investor/content/jun2008/pi20080610_650233.htm) ("The market believes Lehman hasn't fully cleaned up its balance sheet and that the worst is still to come, management's assurances notwithstanding.").

possibility, or risk, that Lehman would suffer a material loss of market confidence in its near future, and that this loss of confidence would manifest itself as a loss of ability to finance its less liquid assets through the repo market.

The next step is to assess whether Lehman was reasonably prepared to absorb or address this reasonably foreseeable risk. Following the Bear Stearns event, the SEC and the FRBNY requested that each of the CSEs develop liquidity stress tests that addressed, among other things, a significant loss of repo financing of less liquid assets.[6207] Although Lehman projected that it could survive such a stress event, there is sufficient evidence to support a determination that certain of these projections were based on assumptions that failed to take into account factors that Lehman knew, or should have known, would directly impact its liquidity position in a stress event. In particular, Lehman assumed that its clearing banks would provide unsecured credit on an intra-day basis and that operational friction would not have a material impact on its liquidity, in each case during the projected stress event.

For the reasons discussed below, the Examiner finds that sufficient evidence exists to support a finding that, beginning in the third quarter of 2008 and at all times through each applicable petition date, LBHI and each of the LBHI Affiliates that relied on LBHI to provide funding or credit support had "unreasonably small capital" to engage in their businesses.

[6207] Joint Request of SEC and FRBNY: Liquidity Scenarios for CSEs (May 20, 2008), [LBHI_SEC07940_505195].

(2) Analysis of the "Unreasonably Small Capital" Test

(a) Summary of Legal Standard[6208]

Courts and commentators have recognized that the criteria for determining whether a company has "unreasonably small capital" are not clearly defined.[6209] There is agreement, however, that the "unreasonably small capital" test is a forward-looking analysis that examines not only how a company is performing at a given point in time, but also whether the company had sufficient resources to withstand reasonably foreseeable downturns in its performance or in the broader market in which it operates.[6210]

To determine whether a company has "unreasonably small capital," courts have assessed "both the nature of the enterprise itself and the extent of the enterprise's need for capital during the period in question."[6211] In conducting this analysis, courts look at

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[6208] The legal standard for "unreasonably small capital" is discussed more fully in Appendix 1, Legal Issues, at Section IV.A.2.b.

[6209] *In re Best Products Co., Inc.*, 168 B.R. 35, 54 (Bankr. S.D.N.Y. 1994) (noting that the test is "far from clear"). There is no statutory definition of the term "unreasonably small capital" (or its equivalent, "unreasonably small assets") under the Bankruptcy Code or applicable state law. The "unreasonably small capital" test requires "judicial consideration of the overall state of affairs surrounding the corporation and the challenged transfer itself," and thus is generally analyzed and applied on a "case-by-case" basis. *In re Suburban Motor Freight, Inc.*, 124 B.R. 984, 998-99 (Bankr. S.D. Ohio 1990); *see also Credit Managers Ass'n of So. Cal. v. Federal Co.*, 629 F. Supp. 175, 183 (C.D. Cal. 1985) (describing the "unreasonably small capital" test as "a question of fact that must be ascertained on a case by case basis"); *Barrett v. Continental Ill. Nat'l Bank & Trust Co.*, 882 F.2d 1, 4 (1st Cir. 1989) ("'Unreasonably' is clearly a relative term and demands, for the purposes of [Section 5 of the UFCA], the sort of relative, contextual judgment which looks to both the ends served by § 5 and the overall state of affairs surrounding the transferor corporation and the challenged transfer itself.").

[6210] *Moody v. Sec. Pacific Bus. Credit, Inc.*, 971 F.2d 1056, 1074 (3d Cir. 1992) ("The critical question is whether the parties' projections were reasonable."); *see also Boyer*, 2009 WL 418275, at *11; *In re Healthco Int'l*, 208 B.R.at 302.

[6211] *Barrett*, 882 F.2d at 4.

"all reasonably anticipated sources of operating funds, which may include new equity infusions, cash from operations, or cash from secured or unsecured loans over the relevant time period."[6212] In addition, a company "must account for difficulties that are likely to arise,"[6213] and otherwise "incorporate some margin for error."[6214] The object of an "unreasonably small capital" analysis is to determine the "moment . . . that bankruptcy is a consequence both likely and foreseeable."[6215]

Application of the unreasonably small capital test to Lehman involves a fact-intensive two-step analysis. The first inquiry is whether and at what point it was reasonably foreseeable that Lehman was at risk of losing access to the financing it required to operate its business and to satisfy its obligations as they came due. The second inquiry is whether Lehman's liquidity stress tests, which projected that Lehman could survive a period during which it would obtain reduced levels of financing, were reasonably constructed.

[6212] *Moody*, 971 F.2d at 1072 n.24.

[6213] *Id; In re TOUSA, Inc.*, -- B.R. --, Bankr. No. 08-10928, Adv. No. 08-1435-JKO, 2009 WL 3519403, at *74 (Bankr. S.D. Fla. Oct. 30, 2009) (describing the test as "whether a company has sufficient capital to support operations *in the event that* performance is below expectations") (emphasis added); *Carpenter v. Roe*, 10 N.Y. 227, 232 (1851) (invalidating a pre-bankruptcy transfer made at a time when the debtor was indebted, and had reason to believe that "insolvency would be the inevitable or probable result of *want of success* in the business in which he was engaged"); *In re Iridium Operating LLC*, 373 B.R. at 344 (Bankr. S.D.N.Y. 2007).

[6214] *Moody*, 971 F.2d at 1073.

[6215] *Boyer*, 587 F.3d at 794.

(b) Lehman's Countercyclical Strategy

In August 2006, Lehman decided to pursue a strategy to significantly increase its subprime lending and commercial real estate financing businesses.[6216] In 2007, as the sub-prime residential mortgage market deteriorated, Lehman made a countercyclical bet on commercial real estate on the assumption that the subprime crisis would not spill over into the commercial market.[6217] A significant element of Lehman's strategy was to monetize certain of these assets through syndication or securitization.[6218] Lehman described itself in its Form 10-Q for the third quarter of 2006 as the "market leader in mortgage and asset backed securitizations and other structured financing arrangements."[6219]

[6216] *See* E-mail from Jeffrey Goodman, Lehman, to Madelyn Antoncic, Lehman, *et al.* (Aug. 23, 2006) [LBEX-DOCID 1368052]; *see also* Ronald Marcus, U.S. Department of the Treasury, Office of Thrift Supervision, Examiner's Report of Lehman Brothers Holdings Inc. (July 7, 2008), at pp. 1-2 (describing the strategic decision to grow the balance sheet as an "outsized bet on real estate.").

[6217] Examiner's Interview of Richard S. Fuld, Jr. Sept. 30, 2009, at pp. 14-15; Examiner's Interview of Joseph Gregory, Nov. 13, 2009, at pp. 7-8; Examiner's Interview of Mark A. Walsh, Oct. 21, 2009, at pp. 7-9.

[6218] *See* Lehman Brothers Holdings Inc., Annual Report for FY 2007 as of Nov. 30, 2007 (Form 10-K) (filed on Jan. 29, 2008), at p. 104 ("LBHI 2007 10-K") (describing Lehman's "intent to sell through securitization or syndication activities, residential and commercial mortgage whole loans we originate, as well as those we acquire in the secondary market"); *see also* Binyamin Appelbaum, *et al.*, *Fed's approach to regulation left banks exposed to crisis*, Wash. Post, Dec. 21, 2009, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/12/20/AR2009122002580.html ("Rather than wait for borrowers to repay loans, banks were adopting a technique called securitization. The banks created pools of loans and sold investors the right to collect portions of the inflowing payments. The bank got its money upfront. Equally important, under accounting rules it was allowed to report that the loans had been sold, and therefore it did not need to hold any additional capital. But in many cases, the bank still pledged to cover losses if borrowers defaulted.").

[6219] Lehman Bros. Holdings Inc., Quarterly Report as of Aug. 31, 2006 (Form 10-Q) (filed on Oct. 10, 2006), at p. 18.

Timothy Geithner, the then-President of the FRBNY, described securitization in a June 9, 2008 speech as a $2.2 trillion parallel financial system outside of the traditional banking system.[6220] The assets so financed were assumed to be readily saleable at fair values, and "the liquidity supporting them was assumed to be continuous and essentially frictionless, because it had been so for a long time."[6221]

In 2007, it became apparent that the market for asset-backed securities ("ABS") began to become more illiquid in light of the weak performance of such securities that were backed by subprime mortgages:

> Asset-backed securities . . . experienced the greatest degree of stress in 2007. The loss of the value of subprime mortgages throughout the year led to growing uncertainty about the value of credit instruments such as collateralized debt obligations (CDOs) that often included such subprime mortgages in what investors and ratings agencies had previously considered high-quality assets.[6222]

FRBNY President Geithner described the state of the securitization markets beginning in late 2007 as follows: "The funding and balance sheet pressures on banks were intensified by the rapid breakdown of securitization and structured finance markets. Banks lost the capacity to move riskier assets off their balance sheets, at the

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[6220] FRBNY President Timothy F. Geithner, Reducing Systemic Risk In A Dynamic Financial System, Transcript of Remarks to The Economic Club (June 9, 2008), *available at* http://www.newyorkfed.org/newsevents/speeches/2008/tfg080609.html ("In early 2007, asset-backed commercial paper conduits, in structured investment vehicles, in auction-rate preferred securities, tender option bonds and variable rate demand notes had a combined asset size of roughly $2.2 trillion.").

[6221] *Id*.

[6222] Senior Supervisors' Group, *Observations on Risk Management Practices during the Recent Market Turbulence* (Mar. 6, 2008) at p. 1, *available at* http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf.

same time they had to fund, or to prepare to fund, a range of contingent commitments over an uncertain time horizon."[6223]

The disruptions in the securitization market put pressure on the balance sheets of major investment banks, as noted by S&P in a November 2007 report:

> Recent disruptions in the subprime market and its contagion effects into the leveraged finance, asset-backed commercial paper (ABCP), and CDO spaces have substantially curtailed market liquidity. The sudden loss of appetite for subprime and other high-yield exposure has significantly narrowed these markets, while uncertainty regarding asset valuations left many institutions unable to unwind exposures at fair market prices. . . As a result, the markets for these assets have considerably shrunk, while the spiral effects have led to concerns with respect to the broker-dealers' funding liquidity risk. [6224]

Lehman, in a September 2007 presentation to the Finance Committee of its Board of Directors, observed that the commercial paper, structured finance and other financial markets had experienced "significant turmoil in 2007."[6225] Such turmoil began with initial tremors in the sub-prime mortgage market at the end of 2006, and then spread with the failure of two hedge funds operated by Bear Stearns that were heavily exposed to sub-prime mortgage loans in June 2007.[6226] Lehman observed that, by July 2007, "the fear of contagion" had spread "to other markets causing a rout in all credit products, of

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[6223] FRBNY President Timothy F. Geithner, Transcript of Remarks to The Economic Club, New York City, New York, Reducing Systemic Risk In A Dynamic Financial System, (June 9, 2008), *available at* http://www.newyorkfed.org/newsevents/speeches/2008/tfg080609.html.

[6224] Diane Hinton, S&P, *Liquidity Management In Times Of Stress: How The Major U.S. Broker-Dealers Fare,* S&P RatingsDirect, Nov. 8, 2007, at pp. 2-3 [LBHI_SEC07940_439424].

[6225] Lehman, Presentation to the Finance Committee of the Board of Directors, Risk, Liquidity, Capital & Balance Sheet Update: Risk Updat*e* (Sept. 11, 2007), at p. 4 [LBEX-DOCID 505941].

[6226] *Id*.

every rating including all the way up to AAA bonds."[6227] Lehman concluded that the asset-backed commercial paper market was "facing challenging conditions, with very little liquidity" and that "[f]unding for almost any type of mortgage or ABS product dried up."[6228]

As Lehman executed its countercyclical strategy and the securitization and structured finance markets deteriorated, the size of Lehman's balance sheet increased. Lehman's reported gross assets grew from $504 billion at the end of FY 2006 to $691 billion by the end of FY 2007,[6229] and its net assets grew by a similar proportion, from $269 billion to $373 billion over the same time period.[6230] Although by late 2007 certain senior Lehman personnel identified the need for Lehman to reduce the firm-wide leverage, Lehman's balance sheet continued to grow through the end of the first quarter of 2008, with gross assets of approximately $786 billion and net assets of approximately $397 billion.[6231] Lehman's net leverage ratio, which measured the ratio of Lehman's net assets against its tangible equity capital base,[6232] increased from 14.5x at the end of fiscal

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[6227] *Id*.

[6228] *Id*.

[6229] LBHI 2007 10-K, at p. 29.

[6230] *Id*. Lehman calculated "net assets" by starting with "total assets" and excluding from that amount the following three categories: (i) cash and securities segregated and on deposit for regulatory reasons and other purposes; (ii) collateralized lending agreements; and (iii) identifiable intangible assets and goodwill. *Id.* at p. 30 n.3.

[6231] LBHI 10-Q (Apr. 9, 2008), at p. 72.

[6232] Lehman defined "tangible equity capital" as "stockholders' equity and junior subordinated notes minus identifiable intangible assets and goodwill." Tangible equity capital was used as the denominator in Lehman's net leverage ratio calculation. LBHI 2007 10-K, at p. 29.

year 2006 to 16.1x by the end of fiscal year 2007.[6233] Lehman noted that its net leverage ratio had "crept back toward the higher end of the peer group in recent years."[6234]

At the end of the second quarter of 2008, Lehman reported a quarter-over-quarter reduction of $146.6 billion of gross assets, and $68.9 billion of net assets.[6235] The asset reductions, together with the issuance of equity capital, contributed to the reduction in Lehman's gross leverage ratio to 24.3x and its net leverage ratio to 12.06x as of the end of the second quarter of 2008.[6236] As discussed elsewhere in this Report, Lehman's reported leverage ratios were enhanced (that is lowered) by its use of Repo 105 transactions.[6237] At the end of the second quarter of 2008, Lehman proclaimed, based on its reported numbers, that it had its "lowest net leverage ratio in its history as a public company,"[6238] and Lehman CEO Richard Fuld stated that Lehman's capital position had "never been stronger."[6239]

(c) Lehman's Repo Book and Liquidity Risk

The reported deleveraging of Lehman's balance sheet during the second quarter of 2008 allowed Lehman to project the appearance of capital adequacy to the extent

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[6233] *Id.*

[6234] Erin Callan, Lehman, Leverage Analysis [Draft] (Apr. 7, 2008), at p. 5 [LBEX-DOCID 1303158].

[6235] Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2008 (Form 10-Q) (filed on July 10, 2008), at pp. 56, 86 ("LBHI 10-Q (July 10, 2008)").

[6236] *Id.* at pp. 55, 56, 89.

[6237] See Section III.A.4, which discusses Lehman's use of Repo 105/108 transactions.

[6238] Lehman, Capital Adequacy & Liquidity Update (June 4, 2008), at p. 7, [LBHI_SEC07940_513590] ("Despite a forecast loss in Q2 '08, the actions taken by Lehman in the quarter will result in the strongest capital and liquidity positions the Firm has ever had.").

[6239] Final Transcript of Lehman Brothers Holdings, Inc. Second Quarter 2008 Earnings Call (June 16, 2008), at p. 4 [LBHI_SEC07940_519082].

measured in terms of the ratio of its assets to its tangible equity capital base. As noted above, however, Lehman's Global Head of Risk Control stated that "[l]iquidity is more important than capital,"[6240] and Lehman recognized that "[l]iquidity, that is ready access to funds, is essential to our businesses."[6241] Lehman was, like other investment banks, "heavily reliant upon wholesale funding sources" to finance the inventory on its balance sheet.[6242] Callan, in an interview after the Bear Stearns event, stated that "[l]iquidity is the thing that will kill you in a moment."[6243]

Accordingly, the analysis as to whether Lehman had "unreasonably small capital" must begin with Lehman's exposure to liquidity risk, while taking into account other metrics of capital adequacy. Lehman's liquidity risk arose primarily from its reliance upon short-term repo funding to support assets that would take longer to sell if they could not be financed, particularly in a stressed environment.[6244] The other metrics of capital adequacy that Lehman measured, such as Lehman's reported cash capital

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[6240] *See* E-mail from Paul Shotton, Lehman, to Chris O'Meara, Lehman (Apr. 15, 2008) [LBHI_SEC07940_768467].

[6241] LBHI 2007 10-K, at p. 17.

[6242] Diane Hinton, S&P, *Liquidity Management In Times Of Stress: How The Major U.S. Broker-Dealers Fare,* S&P RatingsDirect, Nov. 8, 2007, at p. 2 [LBHI_SEC07940_439424].

[6243] Maria Bartiromo, *Lehman CFO Erin Callan: Back from Ugly Monday*, Business Week, Mar. 20, 2008, *available at* http://www.businessweek.com/magazine/content/08_13/b4077023363140.htm?chan=magazine+channel_the+business+week.

[6244] *See, e.g,* Tobias Adrian, *et al.*, *The Federal Reserve's Primary Dealer Credit Facility*, 15 Current Issues In Economics and Finance, at pp. 3-4 (Aug. 2009) *available at* http://www.newyorkfed.org/research/current_issues ("Originally focused on the highest quality collateral—Treasury and agency debt—repo transactions by 2008 were making use of below-investment-grade corporate debt and equities and even whole loans and trust receipts. This shift toward less liquid collateral increased the risks attending a crisis in the market since, in the event of a crisis, selling these securities would likely take time and occur at a significant loss.").

surplus, its Equity Adequacy Framework and its CSE Capital Ratios, did not fully account for the nature and extent of Lehman's liquidity risk, especially following the Bear Stearns event.

(i) Bear Stearns Demonstrates the Liquidity Risk Associated with Repo Financing

Lehman was highly dependent upon repo funding,[6245] a form of secured lending structured as a sale of assets and forward commitment to repurchase the same or similar assets with a slight margin.[6246] Because repo funding is typically short-term, and credit is designed to be provided on an oversecured basis,[6247] it was generally viewed as a reliable form of short-term financing, even in a stressed environment.[6248] Robert Azerad, Lehman's Global Head of Asset and Liability Management, stated that, prior to the Bear Stearns event, liquidity risk managers were concerned that their firms would

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[6245] LBHI 2007 10-K, at p. 17 (discussing Lehman's reliance on "continuous access" to the repo market).

[6246] FRBNY, *Repurchase and Reverse Repurchase Transactions*, Fedpoint, *available at* http://www.newyorkfed.org/aboutthefed/fedpoint/fed04.html. The repo market has a long pedigree, dating back to the early 20th century when the Federal Reserve used repos in government securities to either drain or add liquidity to the banking system. *See* Moorad Choudhry, *The Repo Handbook* 6 (2002).

[6247] For each class or type of asset, there is a "haircut" provided by the liquidity provider. For lesser quality collateral, the haircut would be larger. In this manner, the repo counterparty in the event of a default was able to sell the collateral such that even if it was sold at less than par, so long as it was not sold for less than haircut, the repo counterparty would not suffer a loss.

[6248] *See* Lehman, Liquidity Stress Scenario Analysis (Apr. 21, 2008), at p. 8 [LBEX-DOCID 008608] (asserting that "[l]iquidity risk at the broker dealers is thought to be less of an issue" because the "[r]epo market is thought to be much more reliable than unsecured market" with a "[l]ow credit risk because of the collateral received by the lender and the haircut" and also due to the "[s]ophisticated nature of most lenders.").

lose access to unsecured forms of financing, but not necessarily access to repo funding.[6249]

The near collapse of Bear Stearns in March 2008 was a paradigmatic event because it demonstrated that repo funding, even when supported by relatively high quality assets, could prove unreliable in a crisis. In a number of presentations, Lehman quoted then-SEC Chairman Christopher Cox's observations and conclusions regarding the liquidity lessons learned from the Bear Stearns event, where he described the cause of the near collapse of Bear Stearns as beginning with a reluctance to deal with Bear on an unsecured basis, which extended to secured lending on less liquid and lower quality assets and later, an inability of Bear Stearns to obtain secured financing even on high-quality agency securities.[6250] Chairman Cox also observed that "[t]he Bear Stearns experience has challenged the measurement of liquidity in every regulatory approach, not only here in the United States but around the world."[6251] Azerad told the Examiner that the Bear Stearns event "shattered commonly held assumptions about the market."[6252]

[6249] Examiner's Interview of Robert Azerad, Sept. 23, 2009 (second interview), at p. 4.

[6250] Lehman, Liquidity Management At Lehman Brothers, Presentation to the S&P (May 15, 2008), at p. 20 [LBEX-DOCID 008669].

[6251] *Id.*; s*ee also* Lehman, Leverage, and Liquidity, Presentation to the Federal Reserve Update on Capital, (May 28, 2008), at p. 6 [LBHI_SEC07940_062581]; Lehman, Project Green: Liquidity & Liquidity Management [Draft] (June 2008), at p. 19 [LBHI_SEC07940_844120].

[6252] Examiner's Interview of Robert Azerad, Sept. 23, 2009 (second interview), at p. 4.

(ii) Quality and Tenor of Lehman's Repo Book

The nature and extent of Lehman's liquidity risk is demonstrated through a basic analysis of the composition of Lehman's repo book. Two key criteria that Lehman monitored were the quality of the repo collateral and the tenor, or term, of the repo agreements (*e.g.*, overnight). Lehman disclosed in its quarterly report, or form 10-Q, for the second quarter of 2008 that it had $188 billion of repo financing, $105 billion of which was secured by non-government, non-agency collateral.[6253] Lehman specifically tracked its repo collateral that was not government and agency fixed income securities — government and agency securities were perceived as highly liquid forms of collateral in virtually any market condition.[6254] As of May 30, 2008, the composition of Lehman's non-government, non-agency repo book was as follows:[6255]

Collateral Type	Amount ($billion)
Asset Backs - Investment Grade	25.4
Asset Backs - Non-Investment Grade	2.0
C1 - Investment Grade Convertibles	1.5
C2 - Non-Investment Grade Convertibles	2.3

[6253] LBHI 10-Q (Apr. 9, 2008), at pp. 84-85. Lehman thus had $83 billion of government and agency inventory that was used to generate short-term funding through the repo market, although $71 billion of this funding was used in "matched book" transactions to provide financing to Lehman's prime broker clients (through reverse repo transactions). The remaining $12 billion of cash generated through the repo market was cash for Lehman's liquidity pool. *See* E-mail from Robert Azerad, Lehman, to Thomas Luglio, Lehman, *et al.* (June 26, 2008) [LBHI_SEC07940_522788].

[6254] *See* FRBNY, *System Open Market Account*, Fedpoint (Mar. 2009), *available at* http:/www.newyorkfed.org/aboutthefed/fedpoint/fed27.html (describing how the New York Fed uses Open Market Operations to control the money supply by lending money to primary dealers in government securities in exchange for high quality securities as general collateral against the repo funds); *see also* FRBNY, *Understanding U.S. Government Securities Quotes*, Fedpoint (Aug. 2007), *available at* http://www.newyorkfed.org/aboutthefed/fedpoint/fed07.html ("Because the market for U.S. Government securities is both global and highly competitive, prices tend to be similar throughout the world.").

[6255] Lehman, Global Liquidity MIS (May 30, 2008) at p. 20 [LBEX-DOCID 1058911]. Note the total differs slightly from the sum of the parts, which we believe is due to rounding.

Corporates - Investment Grade	12.8
Corporates - Non-Investment Grade	8.2
EMG (Emerging Markets bonds)	7.1
Equities	23.4
Money Markets	7.3
Muni	2.2
Private Labels - High Yield	2.3
Private Labels - Investment Grade	9.9
Residential Whole Loan	1.1
Total	**105.3**

Lehman, for internal reporting purposes, divided its non-government, non-agency repo book into two categories: assets that were eligible to be funded by the Federal Reserve and European Central Bank (ECB), and non-central bank eligible assets. According to its internal analysis, from May 30, 2008 to July 3, 2008, Lehman's non-government, non-agency repo book ranged between $105 billion and $112 billion, and its non-government, non-agency repo book that was also non-central bank eligible ranged between $60 billion and $67 billion.[6256] In other words, approximately 60 percent of its non-government, non-agency repo book was composed of non-central-bank eligible assets – assets that are less liquid, by definition, because central banks would not accept them as collateral.

Based on the categorization of its non-government, non-agency repo book in the above table, Lehman was relying upon repo funding to finance certain of its less liquid non-investment grade and high yield assets. Further, by the fall of 2007, Lehman understood that the market was becoming less liquid for certain of its investment grade

[6256] Lehman, Liquidity Slides (July 29, 2008), at p. 8 [LBEX-DOCID 1300268].

assets. In a September 11, 2007 presentation to the Finance Committee of the Board of Directors, Lehman noted that the "fear of contagion" had spread from subprime mortgage loans to other credit products "of every rating including all the way up to AAA bonds."[6257] In February 2008, it was reported that "[t]he seizure in the credit markets caused by the collapse of subprime mortgages is making investors doubt even the AAA rated securities of companies with investment-grade credentials."[6258]

To the extent that repo funding, which is short-term in nature, was used to finance longer-term, less liquid assets, there was a maturity mismatch that could expose Lehman to liquidity risk. Lehman monitored the tenor of its non-government, non-agency repo funding, and in an internal presentation noted that, as of the end of the first quarter 2008, 56% of its repo funding was overnight, and an additional 18% had a term of less than one week.[6259] Lehman acknowledged that "[d]aily refinancing risk is higher than we would want."[6260] By the end of the second quarter of 2008, of its $105 billion non-government, non-agency repo book, Lehman was funding 42% ($43.9 billion) on an

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[6257] Lehman, Risk, Liquidity, Capital & Balance Sheet Update: Risk Update, Presentation to the Finance Committee of the Board of Directors (Sept. 11, 2007) at 4 [LBEX-DOCID 505941].

[6258] Abigail Moses, *Investment-Grade Defaults to Rise, Credit Models Show (Update 2)*, Bloomberg.com (Feb. 15, 2008), *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=aIy82dumycXg&refer=home.

[6259] Lehman, Funding Lehman Brothers, (Sept. 10, 2008), at p. 13 [LBHI_SEC07940_739985].

[6260] Lehman, Liquidity Update (Apr. 1, 2008), at p. 6 [LBEX-DOCID 1300141].

overnight basis, and an additional 19% ($19.7 billion) with a term of less than two weeks.[6261]

The risk accompanying reliance upon short-term funding to support long-term, illiquid assets was well recognized, particularly in the aftermath of the Bear Stearns crisis. For example, FRBNY President Geithner noted in his June 2008 speech:

> The scale of long-term risky and relatively illiquid assets financed by very short-term liabilities made many of the vehicles and institutions in this parallel financial system vulnerable to a classic type of run, but without the protections such as deposit insurance that the banking system has in place to reduce such risks. Once the investors in these financing arrangements—many conservatively managed money funds—withdrew or threatened to withdraw their funds from these markets, the system became vulnerable to a self-reinforcing cycle of forced liquidation of assets, which further increased volatility and lowered prices across a variety of asset classes.[6262]

Lehman internally measured and monitored its "repo book at risk," which assessed its repo book in terms of asset quality and tenor of funding in order to determine how much secured funding Lehman could expect to lose in a crisis.[6263] As of

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[6261] Lehman, 2008 Q2 Liquidity Metrics, Version 2, (June 14, 2008), at p. 18 [LBHI_SEC07940_601022].

[6262] FRBNY President Timothy F. Geithner, Reducing Systemic Risk In A Dynamic Financial System, Transcript of Remarks to The Economic Club (June 9, 2008), *available at* http://www.newyorkfed.org/newsevents/speeches/2008/tfg080609.html.

[6263] Shortly after the Bear Stearns event, Lehman recognized that in a stress event, a substantial portion of its repo book would be at risk, and Lehman modeled this impact. Lehman, Liquidity Stress Scenario Analysis (Apr. 21, 2008), at p. 5 [LBEX-DOCID 008608] (showing $25.3 billion net loss of secured funding on the first day of a stress event). As of June 2008, Lehman began internally measuring its "repo book at risk" in its performance of stress tests. *See, e.g.* "Apocalypse Now" liquidity scenario as of June 12, 2008 [LBEX-DOCID 022363]; "Apocalypse Now" Liquidity Scenario as of July 10, 2008 [LBEX-DOCID 1300118]. As of August 1, 2008, Lehman began internally tracking "repo at risk" in its daily liquidity MIS reports. *See, e.g.,* Lehman, Global Liquidity MIS (Aug. 1, 2008), at p. 14 [LBEX-DOCID 1058944] (showing $55.7 billion of "repo at risk"); Lehman, Global Liquidity MIS (Aug. 4, 2008), at p. 14 [LBEX-DOCID 1058945] (showing $56.9 billion of "repo at risk"). Lehman continued to track this "repo book at risk"

June 12, 2008, for example, Lehman projected it could lose, in a stressed environment, approximately $56.7 billion of repo capacity out of its $107.9 billion total repo book for non-government, non-agency collateral.[6264] Thus, after the Bear Stearns event, Lehman was increasingly aware of the nature and extent of its liquidity risk, both in terms of the quality of the repo book and the maturity mismatch.

(d) Deleveraging to "Win Back" Market Confidence

Notwithstanding the technical complexity of their day-to-day business, financial institutions cannot operate absent the fundamental ability to trade with third parties. That ability, in turn, requires those potential counterparties to have confidence in the financial institution — specifically, the institution's ability to satisfy its obligations to its counterparties. In this manner, as S&P noted in a May 2008 report, investment banks "rely on their reputations in all aspects of their business," from facilitating trading and financial advisory work, to finding new investments, to borrowing capital.[6265] Thus, the "most troublesome crisis that these firms can face … is a crisis of confidence in the firm."[6266] The importance of confidence and credibility to Lehman's franchise is evident in the materials Lehman used to train its traders, which emphasized that "[c]redibility

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metric through the week leading up to its bankruptcy filing on September 15, 2008. *See, e.g.,* Lehman, Liquidity Management MIS (Sept. 8, 2008), at p. 2 [LBEX-DOCID 022279] (showing $56.5 billion "repo at risk"); Lehman, Liquidity Update (Sept. 10, 2008), [LBHI_SEC07940_845894], at p. 8.

[6264] "Apocalypse Now" liquidity stress scenario as of June 12, 2008 [LBEX-DOCID 022363].

[6265] Matthew Albrecht, S&P, *Investment Services Industry Survey* (May 29, 2008), at p. 1.

[6266] *Id.*

takes years to earn, and one day to lose."[6267] Azerad confirmed that confidence is a very fleeting concept that could disappear in a day.[6268]

Given the nature and the extent of Lehman's liquidity risk, the next step in the "unreasonably small capital" analysis is to assess whether (and if applicable, when) Lehman could or should have anticipated that it could be faced with a loss of market confidence that would materially impair its ability to obtain financing.

Immediately following the near collapse of Bear Stearns, Lehman was widely viewed as one of the next most vulnerable investment banks.[6269] Eric Felder, Lehman's US head of Global Credit Products, in a March 26, 2008 e-mail to Herbert "Bart" McDade, the then-Global Head of Lehman's Capital Markets-Equities Group, explained the risk facing Lehman in light of Lehman's repo funding maturity mismatch and the size and illiquidity of Lehman's real estate-related investments:

[6267] Kentaro Umezaki, Lehman, Lehman Brothers - 1998 Liquidity Risk Case Study, at p. 13 [LBEX-DOCID 251244].

[6268] Examiner's Interview of Robert Azerad, Sept. 23, 2009 (second interview), at p. 3.

[6269] The assessment that Lehman was seen as the next most vulnerable was noted by Federal Reserve chairman Ben S. Bernanke, former Treasury Secretary Henry M. Paulson, Jr., and present Treasury Secretary and former FRBNY President Timothy F. Geithner in their interviews with the Examiner. Examiner's Interview of Ben S. Bernanke, Dec. 23, 2009, at p. 3; Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 3; Examiner's Interview of Henry M. Paulson, Jr., June 25, 2009, at p. 11. This view reflects reports in the financial press immediately following Bear Stearns. For example, on March 20, 2008, an article appeared on *Portfolio.com* stating, "After the [near] collapse [of Bear Stearns], Wall Street's attention naturally turned to the other investment banks, especially Lehman Brothers, perceived as the most vulnerable." Jesse Eisinger, *The Debt Shuffle: Wall Street cheered Lehman's earnings, but there are questions about its balance sheet*, Portfolio.com (Mar. 20, 2008), *available at* http://www.portfolio.com/news-markets/top-5/2008/03/20/Lehmans-Debt-Shuffle. Eric Felder forwarded the article to Ian Lowitt, with the note, "bunch of people looking at this article." E-mail from Eric Felder, Lehman, to Ian Lowitt, Lehman (Mar. 23, 2008) [LBHI_SEC07940_625905]. Lowitt responded, "Doesn't help." E-mail from Ian Lowitt, Lehman, to Eric Felder, Lehman (Mar. 23, 2008) [LBHI_SEC07940_625905].

> Every financial failure has been the result of not being match funded. I'm scared our repo is going to pull and our 7b over overnight [commercial paper] is going to go away mid april. . . . We need to set up for [commercial paper] going to zero and a meaningful portion of our secured repo fading (not because it makes sense but just because). . . . The reality of our problem lies in our dependence on repo and the scale of the real estate related positions which will take longer to sell.[6270]

In response to Felder's warnings, Ian Lowitt, who was then Lehman's co-chief administrative officer (and who would later become Lehman's CFO), reassured Felder by emphasizing the availability of the liquidity pool, Lehman's expectation that it would be able to obtain temporary funding from central banks, as well as ongoing efforts to deleverage the balance sheet:

> The [commercial paper] fading will just come out of the excess liquidity in holding company liquidity pool - so 32 bn goes to 24. LBI will be able to fund itself via the fed window in one way or another to get flat cash. LBIE is getting securities into form can pledge via bankhaus to the [European Central Bank], to the tune of 4 bn or so by mid April. There is a lot of term in the secured funding book. The deleveraging focus is now real. It will be tough but we are much more active than the others. . . . People are on it. Agree there will be another run, but believe it will be industry wide not Lehman specific. You are not Cassandra, cursed by Apollo to be able to see the future but have no one believe you !![6271]

Lehman's balance sheet, in terms of its size and composition, was a main focus of the market in late 2007 and early 2008, and Lehman was focused upon reducing its leverage numbers by raising equity and selling or otherwise transferring assets off of its balance sheet in order to engender market confidence. For example, Callan, Lehman's

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[6270] E-mail from Eric Felder, Lehman, to Herbert "Bart" McDade, Lehman (Mar. 26, 2008) [LBHI_SEC07940_326400-01].

[6271] E-mail from Ian Lowitt, Lehman, to Eric Felder, Lehman (Mar. 26, 2008) [LBHI_SEC07940_326400].

CFO at the time, stated in an internal April 7, 2008 presentation that deleveraging was designed to "win back the confidence of the market, lenders and investors."[6272] The presentation demonstrates that, as of April 2008, Lehman recognized that it had already lost some measure of market confidence, and in particular, the confidence of Lehman's lenders.

(e) Beginning in the Third Quarter of 2008, Lehman Could Have Reasonably Anticipated a Loss of Confidence Which Would Have Triggered Its Liquidity Risk

Prior to Lehman's earnings announcement for the second quarter of 2008, on June 2, 2008, S&P downgraded Lehman's long-term rating from "A+" to "A," expressing concern about "persistent dislocations in global capital markets [that] could further weigh on core operating performance for the securities industry as a whole."[6273] Although S&P acknowledged Lehman's "stable funding profile" and "excess liquidity position," S&P noted that Lehman's repo capacity "could be adversely affected if there is a change in market perception of the firm, however ill founded."[6274]

Lehman noted that in a June 3, 2008 conference call with S&P, the ratings agency referred to Lehman's capital raises during the quarter and stated that "Lehman does not

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[6272] Erin Callan, Lehman, Leverage Analysis [Draft] (Apr. 7, 2008), at p. 1 [LBEX-DOCID 1303158]. She also noted that, in addition to deleveraging, Lehman needed to "use more conservative term structures to fund less liquid securities (EMG, high yield, E2 and E3 equities)." *Id.* at p. 14.

[6273] *See* Diane Hinton, S&P, *Research Update: Lehman Brothers Holdings Inc. Rating Lowered To 'A' From 'A+'; Outlook Negative*, S&P RatingsDirect, June 2, 2008, at p. 2 [LBHI_SEC07940_512922], *available at* http://www2.standardandpoors.com/spf/pdf/events/fiart56308.pdf.

[6274] *Id*.

have a capital issue at this time."[6275] Lehman also stated its belief that the S&P downgrade did not fully "reflect or acknowledge Lehman's material improvement[s]" in its "all-time low for net leverage" or its significant reduction in its "exposure to high-risk assets."[6276]

Lehman recognized and anticipated the impact of this downgrade, and on June 4, 2008, responded by preparing a written presentation entitled, "Capital Adequacy & Liquidity," which was intended for Lehman's significant repo counterparties[6277] and in which Lehman downplayed the anticipated action as reflecting "industry concerns," insofar its ratings "relative to most of its direct peers did not change."[6278]

Prior to the opening of business on June 9, 2008, Lehman announced that it intended to raise $6 billion through offerings of common stock and non-cumulative mandatory convertible preferred stock, and that it expected to report a net earnings loss of $2.8 billion for the second quarter of 2008.[6279] These announcements were reported upon shortly before 7:00 a.m. EST on June 9, 2008 by the Wall Street Journal

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[6275] Lehman, Capital Adequacy & Liquidity (June 4, 2008), at p. 19 [LBHI_SEC07940_513590].

[6276] *Id*.

[6277] *Id.* at p. 18.

[6278] *See* also Diane Hinton, S&P, *Research Update: Lehman Brothers Holdings Inc. Rating Lowered To 'A' From 'A+'; Outlook Negative,* S&P RatingsDirect (June 2, 2008), at p. 2 [LBHI_SEC07940_512922], *available at* http://www2.standardandpoors.com/spf/pdf/events/fiart56308.pdf (stating that ratings were also lowered for Morgan Stanley and Merrill Lynch & Co., Inc.).

[6279] Lehman, Press Release: Lehman Brothers Announces Expected Second Quarter Results (June 9, 2008), at p. 1 [LBHI_SEC07940_035278-287]; Lehman, Press Release: Lehman Brothers Announces Offerings of Common Stock and Mandatory Convertible Preferred Stock (June 9, 2008), at p. 1 [LBHI_SEC07940_2218262-63].

MarketWatch.[6280] This loss was Lehman's first as a public company.[6281] Although the market had anticipated a loss, its size was nearly 10 times what many analysts had been predicting for Lehman.[6282] At 10:00 a.m., Lehman, led by its then-CFO Erin Callan, hosted a preliminary earnings call regarding its second quarter performance and financial condition.[6283] To offset the negative earnings report, Lehman emphasized that it had engaged in and successfully executed an "aggressive" deleveraging effort over the course of the second quarter of 2008, that a "large part of the reduction" occurred with "less liquid asset categories," and that it had raised $6 billion in new equity. [6284] Lehman also stated that the effect of these efforts was to reduce Lehman's gross leverage ratio to less than 25 times equity, and its net leverage ratio to less than 12.5 times equity.[6285] Notwithstanding the earnings loss, Lehman's position was that its goal for the quarter was to "bring down gross and net leverage," and that Lehman had

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[6280] Steve Gilsi, *Lehman Brothers to post $3 bln loss; sets $6 bln stock sale*, Wall Street Journal MarketWatch, June 9, 2008, *available at* http://www.marketwatch.com/story/lehman-brothers-to-post-3-bln-loss-sets-6-bln-stock-sale?siteid=bnbh.

[6281] Ben White, *et al*, *Lehman targets up to $6bn in fresh capital*, Financial Times (June 6, 2008), *available at* http://www.ft.com/cms/s/0/51c1624c-3417-11dd-869b-0000779fd2ac.html.

[6282] Susanne Craig, *Lehman Set to Raise $5 Billion Amid Losses*, Wall Street Journal, June 9, 2008, *available at* http://online.wsj.com/article/SB121296377617855623.html?mod=djemalertMARKET ("Until recently, most analysts who follow Lehman have been predicting a loss of about $300 million.").

[6283] Transcript of Lehman Brothers Holdings Inc. Second Quarter 2008 Preliminary Earnings Call (June 9, 2008) [LBHI_SEC07940_592160].

[6284] *Id.* at p. 2.

[6285] *Id.*

accomplished this goal.[6286] Thus, Lehman made its case for why the market should not lose confidence in its core franchise or capital position.

However, notwithstanding this presentation, on June 9, 2008, Fitch Ratings issued a ratings downgrade for Lehman, citing "increased earnings volatility, changes in its business mix due to contraction in the securitization and structured credit markets and the level of risky assets exposing earnings to challenges in hedge effectiveness."[6287] Fitch noted that "[d]espite [its] asset sales, Lehman's exposure to higher risk asset categories as a percent of Fitch core capital is higher than [its] peers."[6288] Further, Fitch expressed concern that Lehman's deleveraging was removing its "most attractive assets" from its balance sheet, "leaving a concentrated level of least desirable or more problematic assets."[6289] Moody's similarly changed Lehman's outlook from stable to negative on June 9, despite Lehman's June 6 announcement of its $6 billion equity raise.[6290] Moody's stated that its decision reflected its concern about "risk management decisions that resulted in elevated real estate exposures and the subsequent ineffectiveness of hedges to mitigate these exposures in the recent quarter."[6291]

[6286] *Id.* at p. 3.

[6287] Fitch Ratings Press Release: Fitch Downgrades Lehman Brothers' L-T & S-T IDRs to 'A+/F1'; Outlook Negative (June 9, 2008), *available at* http://www.pr-inside.com/fitch-downgrades-lehman-brothers-l-t-r633111.htm.

[6288] *Id.*

[6289] *Id*.

[6290] Ruby McDermid, *Moody's downgrades Lehman to negative from stable*, Wall Street Journal MarketWatch June 9, 2008, *available at* http://www.marketwatch.com/story/moodys-downgrades-lehman-to-negative-from-stable.

[6291] *Id.*

Following the preliminary earnings call on June 9, the market had an opportunity to reflect on the earnings announcement, Lehman's reported deleveraging and Lehman's $6 billion equity raise. There is evidence sufficient to support a determination that, notwithstanding Lehman's plan to "win back" the confidence of the market, its plan had not succeeded.

The price of Lehman's common stock could support a determination that the steps taken by Lehman throughout the second quarter and the first part of June did not result in increased market confidence. From the beginning of 2008 through the end of the second quarter of 2008, Lehman's common stock traded in range between a high of $66 per share on February 1, 2008 to a low of $31.75 on March 17, 2008, immediately after the near collapse of Bear Stearns. Starting in June 2008, Lehman's share price was approaching its 52-week low, would soon fall below $30 per share and would not again return to that level.[6292] On June 12, 2008, Lehman's stock opened at $21.35/share, and closed at $21.17/share — lows that Lehman had not reached since 1996 — and the volume on trading of Lehman's shares reached an all-time high of over 173 million — a level of trading that would only be eclipsed in Lehman's final week prior to the bankruptcy filing.[6293]

[6292] The last time Lehman's stock had traded below $30/share was in September and October 1998 — in the aftermath of the collapse of Long-Term Capital Management and the Russian Sovereign Debt Crisis. All historical pricing information is publicly available from sites such as Yahoo! Finance.

[6293] *Id*.

Press reports at that time are also an indicator of the declining confidence in Lehman. On June 11, 2008, Robert Azerad forwarded to Paolo Tonucci two articles from that day.[6294] The first article from *Business Week*, entitled, "Lehman: Independent for How Long?" concluded with a quote from an analyst: "Lehman is next. When you have a pack of dinosaurs, the slowest gets picked off."[6295] The second article, a commentary from Jonathan Weil of Bloomberg.com, stated:

> Lehman reported a $2.8 billion quarterly loss on June 9, the same day it said it had raised $6 billion in fresh capital. Investors seemed surprised, judging by the stock's 15 percent decline since then. They shouldn't have been. Wall Street stock analysts were predicting a much smaller loss. Yet Lehman's market capitalization, at $19.2 billion, is now almost $7 billion less than the company's $26 billion book value, or assets minus liabilities. That suggests that the market believes Lehman hasn't fully cleaned up its balance sheet and that the worst is still to come, management's assurances notwithstanding.[6296]

In his e-mail to Tonucci, Azerad described these articles as "[r]epresentative of the tone of the market."[6297]

On June 12, Lehman announced that it was replacing its long-standing President and COO, Joseph Gregory, as well as Callan.[6298] As described in official Lehman talking

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[6294] E-mail from Robert Azerad, Lehman, to Paolo Tonucci, Lehman (June 11, 2008) [LBHI_SEC07940_517806-809].

[6295] Ben Levisohn, *Lehman: Independent for How Long?* Business Week, June 11, 2008, attached to e-mail from Robert Azerad, Lehman, to Paolo Tonucci, Lehman (June 11, 2008) [LBHI_SEC07940].

[6296] E-mail from Robert Azerad, Lehman, to Paolo Tonucci, Lehman (June 11, 2008) [LBHI_SEC07940_517806-809] (Jonathan Weil, *Lehman's Greatest Value Lies In Lessons Learned*, Bloomberg.com (June 11, 2008), attached to email from Robert Azerad, Lehman, to Paolo Tonucci, Lehman (June 11, 2008) [LBHI SEC 07940].

[6297] E-mail from Robert Azerad, Lehman, to Paolo Tonucci, Lehman (June 11, 2008) [LBHI_SEC07940_517806].

points distributed to Lehman managers for internal distribution, these senior management changes were made in an effort to "regain the confidence" of investors and its business partners, and to repair the firm's "eroded" credibility.[6299]

Also, on June 12, 2008, one of Lehman's clearing banks, Citigroup, requested that Lehman provide it with a substantial cash deposit to cover its exposure to Lehman on an intra-day basis, in an initial amount of between $3 billion and $5 billion, which was later negotiated down to a $2 billion "comfort deposit."[6300] In an e-mail sent internally between Citigroup personnel on that date, Citigroup risk manager Thomas Fontana stated:

[6298] *See* Alistair Barr, *et. al, Lehman CFO Callan, COO Gregory ousted from posts*, MarketWatch, June 12, 2008, *available at* http://www.marketwatch.com/story/lehmans-cfo-and-coo-ousted-as-turmoil-takes-a-new-turn-2008612111300.

[6299] Lehman, President, COO, CFO Changes: Internal Talking Points (June 12, 2008), at p. 1 [LBEX-DOCID 362070], e-mail from George Creppy, Lehman, to Steven Hash, Lehman, *et al.* (June 12, 2008) [LBEX-DOCID 362233] (subject line: "For Internal Use by Managers: TPs/FAWs on Senior Mgmt Changes.").

[6300] *See* E-mail from Thomas Fontana, Citigroup, to Christopher Foskett, Citigroup, *et al.* (June 12, 2008) [CITI-LBHI-EXAM 00074930] ("After speaking with the CFO and Treasurer, we made a request for $5B in a cash deposit."); *see also* e-mail from Christopher Foskett, Citigroup, to John Havens, Citigroup, *et al*. (June 12, 2008) [CITI-LBHI-EXAM 00074930] ("I have been on the phone this morning with Ian Lowitt, new CFO of Lehman and Paolo Tonucci, global Treasurer. In order to keep our clearing capabilities at levels they require to efficiently operate, I have asked them to put up a cash deposit - as we did with Bear Stearns last summer - to offset any intra-day or end of day shortages that may occur. While disappointed, they have directed their team to put it in place."); *cf.* e-mail from Daniel J. Fleming, Lehman, to Ian Lowitt, Lehman (June 12, 2008) [LBEX-AM 008609-008610] ("Citibank is asking for a $3bn cash deposit tonight to cover intra-day exposures."). Ultimately, Lehman provided and Citigroup accepted a deposit in the amount of $2 billion. *See* E-mail from Thomas Fontana, Citigroup, to Richard Blaszkowski, Citigroup, *et al*. (June 12, 2008) [CITI-LBHI-EXAM 00051023] ("A lot of stress on the Lehman name in the market today. We took in a $2B deposit and re-sized the clearing lines."); e-mail from Daniel J. Fleming, Lehman, to Ian Lowitt, Lehman, *et al*. (June 12, 2008) [LBEX-AM 008608] ("Will be depositing $2bn with Citi tonight. No lien or right of offset, a straight overnight fed funds deposit.").

> Fuld oust[ed the] CFO and COO . . . . We have cut back clearing lines in Asia . . . .This is bad news. Market is saying Lehman can not make it alone. Loss of confidence is huge at the moment.[6301]

On the same date, Donald Kohn, the Federal Reserve Bank Vice Chairman, wrote to Federal Reserve Bank Chairman Ben Bernanke, noting that while Lehman had raised $6 billion through an equity offering that day, the additional injection of equity did not restore the market's confidence in Lehman, and that there was a "possibility" that "this is Thursday of BS [Bear Stearns] weekend, and equity holders could wake up Monday with no value."[6302] Kohn also noted that "Fuld really [had] no alternative plan at this point."[6303] Kohn provided Bernanke with a report of a joint call between the Federal Reserve, Treasury Department and the SEC that occurred on the afternoon on June 12, 2008 regarding Lehman, and noted that the discussion turned to "thinking about options in the event the slow erosion of confidence [in Lehman] turns into a rout and

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[6301] E-mail from Thomas Fontana, Citigroup, to Christopher Foskett, Citigroup, *et al*. (June 12, 2008) [CITI-LBHI-EXAM 00081606].

[6302] E-mail from Donald Kohn, FRBNY, to Ben S. Bernanke, Federal Reserve, *et al*. (June 12, 2008) [FRB to LEH Examiner 00073].

[6303] *Id.* Coincidentally, on June 12, 2008, the Economist magazine published an article titled, "Litterbin of Last Resort," criticizing the ECB for allowing investment banks to dump asset-backed securities, "like so much radioactive waste," and for sticking to its pre-crisis acceptance rules that were being "'gamed' or arbitraged" by investment banks, who were creating asset-backed securities that had no publicly traded value but were designed solely for pledging to ECB windows. *See* E-mail from Robert Azerad, Lehman, to Paolo Tonucci, Lehman, *et al.* (June 12, 2008) [LBEX-DOCID 008040]. Lehman had been internally concerned about its increasing reliance on its strategy of creating ABS solely for the purpose of pledging to the ECB, even discussing the possible "reputational issue" if the extent of its reliance became public. *See* e-mail from Carlo Pellerani, Lehman, to Robert Azerad, Lehman (May 12, 2008) [LBHI_SEC07940_336321]; *cf.* Carlo Pellerani, Lehman, ECB Strategy (June 2008) [LBHI_SEC07940_345777-786]. At the same time, however, Lehman's contingency plan in the event of a loss of repo funding relied upon increased funding through the ECB. *See* Lehman, Presentation to the Federal Reserve: Update on Capital, Leverage, and Liquidity (May 28, 2008), at pp. 7, 16 [LBHI_SEC07940_062581].

liquidity fled quickly."[6304] Kohn concluded that the Federal Reserve did not have "any options to provide confidence in the firm."[6305]

After the release of its second quarter 2008 financials, Fuld was receiving increasingly blunt pressure from Secretary Paulson and FRBNY President Geithner to sell Lehman or find a strategic partner.[6306] Secretary Paulson told the Examiner that Lehman's "devastating" announcement of its first-ever earnings loss in the second quarter of 2008 convinced Fuld that dramatic action was necessary to save Lehman.[6307] According to Secretary Paulson, the release of the numbers served as a "wake-up call" to Fuld who, at that point, "appreciated Lehman's fragility and comprehended that the future portended nothing better."[6308]

The Examiner finds that there is evidence sufficient to support a determination that, beginning early in the third quarter of 2008, there was a reasonable likelihood of Lehman losing the confidence of the markets in the near term, such that its ability to

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[6304] E-mail from Donald Kohn, FRBNY, to Ben S. Bernanke, Federal Reserve, *et al*. (June 12, 2008) [FRB to LEH Examiner 00073].

[6305] *Id*.

[6306] Examiner's Interview of Treasury Secretary Henry Paulson, June 25, 2009, at p. 14; Examiner's Interview of Treasury Secretary Timothy F. Geithner, Nov. 24, 2009, at p. 6. However, Federal Reserve Chairman Ben S. Bernanke told the Examiner that he was not of the view in the summer of 2008 that Lehman's failure was "inevitable." Examiner Interview of Chairman Ben S. Bernanke, Dec. 22, 2008, at p. 7.

[6307] Examiner's Interview of Treasury Secretary Henry Paulson, June 25, 2009, at pp. 13-14.

[6308] *Id.* at p. 14.

obtain financing to support its non-government, non-agency asset classes through the repo market was at risk.[6309]

(f) Lehman Was Not Sufficiently Prepared to Absorb a Liquidity Crisis Marked by a Sudden Loss of Non-Government, Non-Agency Repo Funding

The next step of the analysis is to determine whether Lehman was adequately prepared to manage the liquidity risk posed by the reasonably foreseeable loss of market confidence. After the Bear Stearns event, Lehman conducted liquidity stress tests that assumed Lehman would lose a certain measure of repo funding for non-government, non-agency assets over a four-week period. Each of Lehman's stress tests, other than one, predicted that they would survive.[6310] If these stress scenarios were founded upon reasonable and prudent assumptions, the results support the conclusion that Lehman was adequately prepared to handle such risks and it did not have unreasonably small capital. Conversely, if Lehman was only able to project survival under these stress scenarios through the use of assumptions that were imprudent or

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[6309] Selecting a precise date that a company has "unreasonably small capital" is a matter of judgment. As a matter of law, such precision is unnecessary: a fact-finder can examine the financial condition of the company for a "reasonable period of time" both before and after the date of the transfer in question. *See, e.g., Barrett v. Continental Ill. Nat'l Bank & Trust Co.*, 882 F.2d 1, 4 (1st Cir. 1989). The Examiner has focused on June of 2008 in light of the applicable facts and governing law.

[6310] The April 21 stress test, which was the first that Lehman presented to the Federal Reserve and SEC, showed Lehman surviving a four-week stress scenario with less than $500 million of liquidity. Lehman, Liquidity Stress Scenario Analysis (Apr. 21, 2008), at p. 5 [LBEX-DOCID 008608]. Lehman's next stress test, presented to the Federal Reserve and SEC on May 28, 2008, showed Lehman surviving the four-week stress event with more than $20 billion left in its liquidity pool. Lehman, Presentation to the Federal Reserve: Update on Capital, Leverage & Liquidity (May 28, 2008), at p. 13 [LBHI_SEC07940_062581]. However, Lehman Brothers was asked to restate its May 28th stress test results using more conservative assumptions, and as restated, Lehman Brothers would have shown failure by approximately $6 billion. *See* Lehman, Liquidity Stress Tests At Lehman Brothers (Aug. 8, 2008), at p. 3 [LBEX-DOCID 3211633].

unreasonable, then the result of these stress tests do not preclude a determination that Lehman was operating with unreasonably small capital. Furthermore, notwithstanding the liquidity stress tests, the Examiner has evaluated other metrics of capital adequacy that Lehman monitored and that purported to show Lehman's strong capital position to determine whether these metrics preclude a conclusion that Lehman was operating with "unreasonably small capital."

(i) Lehman's Liquidity Pool

As noted above, Lehman was well aware that a loss of short-term financing could impair its ability to continue operations. Lehman had experienced a liquidity crisis in 1998 following the Russian Sovereign Debt Crisis and the collapse of the hedge fund, Long-Term Capital Management.[6311] In response, Lehman adopted a "three dimension[al] funding framework" to guide its funding of assets and mitigate its liquidity risk (the "Funding Framework").[6312] One of the principal components of

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[6311] *See* Kentaro Umezaki, Lehman Brothers, 1998 - Liquidity Risk Case Study, at p. 7 [LBEX-DOCID 251244], attached to e-mail from Kentaro Umezaki, Lehman, to Rebecca Miller, Lehman (Sept. 5, 2007) [LBEX-DOCID 427653].

[6312] Lehman, Project Green - Liquidity & Liquidity Management [Draft] (June 2008), at p. 2 [LBHI_SEC07940_844120]. The principal components of Lehman's Funding Framework were the liquidity pool, the cash capital surplus, and the reliable secured funding model. The three components were designed to work in conjunction with each other. *See* LBHI 10-Q (July 10, 2008), at pp. 81-82. The reliable secured funding model was designed to address the risk of a loss of repo funding through a relationship-based strategy of Lehman obtaining a certain level of financing from counterparties the relationships of which with Lehman were sufficiently strong such that Lehman projected that these firms would continue to trade with Lehman during a stress event. *See* Lehman, Secured Liquidity Risk Model (Jan. 2006) [LBEX-DOCID 1313333]. The cash capital surplus principally measured the amount by which the sum of Lehman's long-term debt and equity capital exceeded Lehman's estimates of its less liquid and illiquid assets as well as the aggregate haircuts applied to such assets. In this sense, the cash capital model built upon the assumptions of the reliable secured funding model, insofar as the assessment of

Lehman's Funding Framework was the LBHI liquidity pool.[6313] The liquidity pool was designed to cover the loss of unsecured debt, specifically, the rolling off of commercial paper and the maturity of the current portion of long-term debt.[6314] Lehman reported a record liquidity pool of $44.6 billion and a record cash capital surplus of $15.0 billion as of May 31, 2008.[6315]

However, Lehman's liquidity pool was not, at least prior to the Bear Stearns event, primarily designed or sized to address a loss of repo funding. In its Annual Report for fiscal year 2007, Lehman disclosed that "[e]ven within the one-year time frame contemplated by our liquidity pool, *we depend on continuous access to secured financing in the repurchase and securities lending markets,* which could be impaired by factors that are not specific to Lehman Brothers, such as a severe disruption of the financial markets."[6316] In a March 2008 presentation to the Federal Reserve and the SEC, Lehman noted that the liquidity pool was primarily designed to cover the inability to

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which assets were "less liquid" (and therefore needed to be match-funded with cash capital). The liquidity pool was designed to cover the loss of unsecured debt, specifically, the rolling off of commercial paper and the maturity of the current portion of long-term debt. *See* Lehman, Liquidity Management At Lehman Brothers, Presentation to the Chicago Mercantile Exchange, [Draft] (June 5, 2008), at p. 10 [LBEX-DOCID 1300305] (describing the MCO or "maximum cumulative outflow" assumptions).

[6313] Lehman, Project Green - Liquidity & Liquidity Management [Draft] (June 2008), at p. 2 [LBHI_SEC07940_844120].

[6314] Lehman, Presentation to the Chicago Mercantile Exchange, Liquidity Management At Lehman Brothers [Draft] (June 5, 2008), at p. 10 [LBEX-DOCID 1300305] (describing the MCO or "maximum cumulative outflow" assumptions).

[6315] LBHI 10-Q (July 10, 2008), at pp. 81-82.

[6316] LBHI 2007 10-K, at p. 17 (emphasis added).

roll maturing, unsecured debt for one year, not the loss or reduction of repo funding, which was to be addressed with "[o]verfunding of less liquid asset classes."[6317]

Following the Bear Stearns event, Lehman made a "series of modifications" to its funding framework to bolster its "liquidity fortress" and to manage the liquidity risk presented by short term secured funding.[6318] Although Lehman acknowledged that a loss of short-term secured funding could result in "an impairment of the franchise," its liquidity pool was not part of its risk mitigation plan against the potential loss of secured funding: "Lehman Brothers manages its secured liquidity using a four-pronged risk mitigation strategy, which conservatively assumes: (a) *no reliance on Holdings' liquidity*; (b) no reliance on customer collateral or free credits."[6319]

[6317] Lehman, Presentation to Federal Reserve & SEC: Liquidity Management At Lehman Brothers (Mar. 26, 2008), at p. 10 [LBHI_SEC07940_057097]. Lehman would later describe "overfunding" as the "ability to absorb adverse changes in secured funding capacity in times of stress by reducing total collateral borrowed in or reallocating the higher quality, easy to fund treasury or agency securities." *See* LBHI 10-Q (July 10, 2008), at p. 84.

[6318] Lehman, Liquidity Management At Lehman Brothers (May 15, 2008), at pp. 12, 23 [LBEX-DOCID 008669]. Lehman stated that it would mitigate its secured funding risk by increasing "overfunding of less liquid asset classes," increasing its use of its captive banking entities, especially Lehman Brothers Bankhaus, and "transforming" its balance sheet through the use of securitization to "create liquid, investment grade securities out of a pool of less liquid collateral." *Id* at p. 12. Of these three modifications, overfunding was a major part of Lehman's post-Bear Stearns funding framework. In its Form 10-Q for the second quarter of 2008, Lehman reported that it had an overfunding cushion of $27 billion. LBHI 10-Q (July 10, 2008), at p. 84. By comparison, Lehman estimated that it could fund approximately $3 billion of its lost repo capacity through its captive banking entities, which is a fraction of the amount of "overfunding" it projected. *See* Lehman, Liquidity Management At Lehman Brothers (May 15, 2008), at pp. 12, 14 [LBEX-DOCID 008669]. Lehman noted that its ability to transform the balance sheet through the securitization and structured finance markets (which were largely moribund by summer 2008) would take 1 to 2 weeks. *Id.* at 24.

[6319] Lehman, Presentation to Federal Reserve & SEC: Liquidity Management At Lehman Brothers (Mar. 26, 2008), at p. 11 [LBHI_SEC07940_057097] (emphasis added); *see also* Lehman, Liquidity Management At Lehman Brothers (May 15, 2008), at p. 12 [LBEX-DOCID 008669].

However, in its quarterly report for the second quarter of 2008, Lehman disclosed, for the first time, that the LBHI liquidity pool could be available, "[a]s a last resort," as a mitigant against "the loss of secured funding capacity."[6320] Lehman provided an assessment of its repo book at risk, starting with its non-government, non-agency repo book of $105 billion, and excluding certain asset classes that it considered to be relatively liquid even under stressed conditions, and disclosed that its projected loss of $32 billion of repo capacity "may be mitigated by the liquidity pool available to the Company."[6321]

(ii) Liquidity Stress Tests

Following the Bear Stearns event, Lehman met with the FRBNY and the SEC on several occasions to discuss the results of successive versions of its liquidity stress tests.[6322] With one exception noted below, Lehman reported that it survived the stress tests, and beginning with its May 28, 2008 stress test report, Lehman reported that it

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[6320] LBHI 10-Q (July 10, 2008), at p. 84. Previously, Lehman had only made general statements that its liquidity pool was "sized to cover expected cash outflows" associated with an "anticipated impact of adverse changes on secured funding, either in the form of a greater difference between the market and pledge value of the assets (also known as 'haircuts') or in the form of reduced borrowing availability." *See, e.g.,* LBHI 2007 10-K, at p. 56; LBHI 10-Q (Apr. 9, 2008), at p. 65.

[6321] LBHI 10-Q (July 10, 2008), at pp. 84-85.

[6322] E-mail from Michael Hsu, SEC, to Paolo Tonucci, Lehman, *et al.* (Apr. 9, 2008) [LBHI_SEC07940_477096] (noting that the SEC was looking for Lehman and its peers to agree upon 'the principle of a new liquidity standard" which he described as "a 30-day 'bulletproof' liquidity survival window"); Joint Request of SEC and FRBNY: Liquidity Scenarios for CSEs (May 20, 2008) [LBHI_SEC07940_505195]; *see also* Lehman, Liquidity Stress Scenario Analysis (Apr. 21, 2008), at p. 5 [LBEX-DOCID 008608]; Lehman, Presentation to the Federal Reserve Update on Capital, Leverage & Liquidity (May 28, 2008), at p. 13 [LBHI_SEC07940_062581]; Lehman, Presentation to the Federal Reserve & SEC: Updated Stressed Liquidity Scenario (July 2, 2008), at p. 10 [LBEX-DOCID 1300104]; Lehman, Liquidity Stress Tests At Lehman Brothers (Aug. 8, 2008), at p. 3 [LBEX-DOCID 3211633].

survived the stress tests by a margin exceeding $10 billion at the end of the four week projection period.[6323]

These stress tests were based on Lehman's own projections, and in substantial part, employed assumptions determined by Lehman.[6324] Courts have recognized that a company's own projections "tend to be optimistic," and therefore, a fact-finder should not simply take them at face value.[6325] Accordingly, the key inquiry is whether the projection itself was based upon prudent and reasonable assumptions.[6326]

The assumptions employed by the stress tests had a material impact on the test results. For example, Lehman's stress test presented to the FRBNY and the SEC on May 28, 2008, assumed that Lehman's liquidity position would benefit over the four-week projection period due to the "positive impact" of $16.0 billion of "balance sheet reduction," and a $10.0 billion reduction in prime broker customer funding.[6327] This

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[6323] The April 21 stress test, which was the first that Lehman presented to the Federal Reserve and SEC, showed Lehman surviving a four-week stress scenario with less than $500 million left of its original liquidity position. Lehman, Liquidity Stress Scenario Analysis (Apr. 21, 2008), at p. 5 [LBEX-DOCID 008608]. Lehman's next stress test, presented to the Federal Reserve and SEC on May 28, 2008, showed Lehman surviving the four-week stress event with more than $20 billion left in its liquidity pool. Lehman, Presentation to the Federal Reserve Update on Capital, Leverage & Liquidity (May 28, 2008), at p. 13 [LBHI_SEC07940_062581]. However, Lehman Brothers was asked to restate its May 28th stress test results using more conservative assumptions, and as restated, Lehman Brothers would have shown failure by approximately $6 billion. *See* Lehman, Liquidity Stress Tests At Lehman Brothers (Aug. 8, 2008), at p. 3 [LBEX-DOCID 3211633].

[6324] Examiner's Interview of Irina Veksler, Sept. 11, 2009, at. p. 6; Examiner's Interview of Laura M. Vecchio Apr. 16, 2009, at p. 5.

[6325] *Moody v. Security Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1073 (3rd Cir. 1992).

[6326] *MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co.*, 910 F. Supp 913, 944 (S.D.N.Y. 1995); *see also In Re Iridium Operating LLC*, 373 B.R. at 347.

[6327] Lehman, Presentation to the Federal Reserve Update on Capital, Leverage & Liquidity (May 28, 2008), at pp. 13-14 [LBHI_SEC07940_062581].

stress test projected that Lehman would survive a liquidity stress event with $20.7 billion of its available liquidity at the end of the four-week period.[6328] At the request of the regulators, Lehman subsequently conducted the stress test without these assumptions.[6329] Without the benefit of these assumptions, the restated stress test demonstrated that Lehman would have failed the May 28, 2008 stress test by $6 billion.[6330] In this manner, altering two assumptions had a $26.7 billion effect on the test's result.

A second demonstration of the impact of a liquidity stress test's assumptions on the result can be found in the independent stress tests developed by the FRBNY. In May 2008, the FRBNY generated two stress test scenarios which modeled how Lehman would respond to a "Bear Stearns" and "Bear Light" scenarios.[6331] The "Bear Stearns" scenario assumed a run on the bank in all business areas, and the "Bear Light" scenario assumed that the run was 35 percent as strong as the "Bear Stearns" scenario.[6332] These stress tests projected that Lehman would fail the "Bear Stearns" scenario by $84 billion and the "Bear Light" scenario by $15 billion.[6333] In June 2008, the FRBNY ran another

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[6328] *Id.* at p. 13.

[6329] Lehman, Liquidity Stress Tests At Lehman Brothers (Aug. 8, 2008), at p. 3 [LBEX-DOCID 3211633]; *see also* e-mail from Robert Azerad, Lehman, to Laura M. Vecchio, Lehman, *et al.* (Aug. 8, 2008) [LBEX-DOCID 3207542] (noting that the restated stress test was "the follow-up to last week's meeting with the Fed.").

[6330] Lehman, Liquidity Stress Tests At Lehman Brothers (Aug. 8, 2008), at p. 1 [LBEX-DOCID 3211633].

[6331] Bill Brodows, FRBNY, *et al.*, Primary Dealer Monitoring: Initial Assessment of CSEs (May 12, 2008), at p. 9 [FRBNY to Exam 000017].

[6332] *Id*.

[6333] *Id*. at p. 11.

stress test with assumptions that were generally consistent with the May 2008 Bear Light scenario.[6334] According to the FRBNY's projections, the June 2008 stress test showed that Lehman would fail in a reasonably foreseeable stress event by a margin of $15 billion.[6335]

There is sufficient evidence to support the determination that certain of the material assumptions employed in Lehman's tests were not reasonable. For example, Lehman assumed that it would not be able to issue any unsecured commercial paper during the term of the four-week stress event. This assumption was based on the reasonable determination that Lehman would not be able to obtain unsecured debt during a liquidity stress event. Lehman, however, did not apply this determination consistently throughout the scenario. As discussed in Section III.A.5.i of this Report, at the time the stress tests were conducted, Lehman's clearing banks provided a measure of unsecured credit on an intra-day basis.[6336] Given that Lehman deemed the loss of unsecured financing a reasonable and necessary assumption under its stress scenarios,[6337] it was inconsistent not to apply that assumption to the unsecured credit provided by the clearing banks.

[6334] FRBNY, Primary Dealer Monitoring: Liquidity Stress Analysis (June 25, 2008, revised June 26, 2008) [FRBNY to Exam 000033].

[6335] *Id.* at p. 2.

[6336] *See* Section III.A.5.b.1.b, noting that the Net Free Equity metric was "the market value of Lehman securities pledged to JPMorgan plus any unsecured credit line JPMorgan extended to Lehman minus cash advanced by JPMorgan to Lehman."

[6337] *See, e.g.,* LBHI 10-Q (July 10, 2008), at p. 85. ("Most of the Company's [stress] scenarios assume complete disruption of unsecured funding markets (*i.e.* the inability to issue new unsecured debt).") *See*

Furthermore, there are sufficient facts to demonstrate that its assumption that its clearing banks would continue to provide unsecured credit on an intra-day basis during a stress event was unreasonable. By February 2008, Lehman's primary clearing bank JPMorgan had expressed concern to Lehman about its intra-day exposure to Lehman.[6338] Additionally, as noted above, on June 12, 2008, Lehman's foreign exchange clearing bank, Citigroup, initially requested that Lehman provide it a "comfort deposit" of between $3 billion and $5 billion to mitigate Citigroup's perceived intra-day exposure.[6339] Further, on June 19, 2008, Lehman provided $5.4 billion in collateral to

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also Lehman, Liquidity Stress Scenario Analysis (Apr. 21, 2008), at p. 3 [LBEX-DOCID 008608] (noting that loss of unsecured funding is a "key assumption."); Lehman, Presentation to the Federal Reserve Update on Capital, Leverage & Liquidity (May 28, 2008), at p. 6 [LBHI_SEC07940_062581] (distinguishing the Bear Stearns event by noting that Lehman had "[n]o reliance on short-term unsecured funding" and that its liquidity framework "assumes that unsecured debt cannot be rolled in a liquidity event"); Lehman, Presentation to the Federal Reserve & SEC: Updated Stressed Liquidity Scenario (July 2, 2008), at p. 5 [LBEX-DOCID 1300104] (noting a complete inability to roll unsecured debt such as commercial paper and letters of credit at maturity).

[6338] E-mail from Janet Birney, Lehman, to Daniel J. Fleming, Lehman, *et al.* (Feb. 26, 2008) [LBHI_SEC07940_436414]. JPMorgan was specifically concerned that Lehman's repo counterparties were not valuing the collateral correctly, and assessed increasing haircuts against the repo collateral in the triparty repo book accordingly.

[6339] *See* e-mail from Thomas Fontana, Citigroup, to Christopher Foskett, Citigroup, *et al.* (June 12, 2008) [CITI-LBHI-EXAM 00074930] ("After speaking with the CFO and Treasurer, we made a request for $5B in a cash deposit."); *see also* e-mail from Christopher Foskett, Citigroup, to John Havens, Citigroup, *et al*. (June 12, 2008) [CITI-LBHI-EXAM 00074930] ("I have been on the phone this morning with Ian Lowitt, new CFO of Lehman and Paolo Tonucci, global Treasurer. In order to keep our clearing capabilities at levels they require to efficiently operate, I have asked them to put up a cash deposit - as we did with Bear Stearns last summer - to offset any intra-day or end of day shortages that may occur. While disappointed, they have directed their team to put it in place."); *cf.* e-mail from Daniel J. Fleming, Lehman, to Ian Lowitt, Lehman (June 12, 2008) [LBEX-AM 008609-008610] ("Citibank is asking for a $3bn cash deposit tonight to cover intra-day exposures."). Ultimately, Lehman provided and Citigroup accepted a deposit in the amount of $2 billion. *See* e-mail from Thomas Fontana, Citigroup, to Richard Blaszkowski, Citigroup, *et al*. (June 12, 2008) [CITI-LBHI-EXAM 00051023] ("A lot of stress on the Lehman name in the market today. We took in a $2B deposit and re-sized the clearing lines."); e-mail from Daniel J. Fleming, Lehman, to Ian Lowitt, Lehman, *et al*. (June 12, 2008) [LBEX-AM 008608] ("Will be depositing $2bn with Citi tonight. No lien or right of offset, a straight overnight fed funds deposit.").

address JPMorgan's intra-day exposure.[6340] In fact, at the time of LBHI's bankruptcy, Lehman had provided more than $16 billion in the aggregate to its clearing banks to secure their intra-day exposure — a liquidity outflow that Lehman failed to account for in any amount in its liquidity stress tests.[6341]

Lehman also failed to take into account the temporary liquidity cost of "operational friction," which Lehman knew would be present in a stress event. Operational friction includes the temporary impact on liquidity arising from the difference in timing between Lehman's delivery of payment of the account balance to clients and the time it took Lehman to sell and process payment for these assets.[6342]

Azerad acknowledged that Lehman was aware that operational friction would get worse in a stress event.[6343] In the ordinary course of its business, Lehman employed two sources of funding to address the temporary liquidity impact of operational friction – commercial paper and the broker-dealer's "operational cash cushion."[6344] While these

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[6340] E-mail from Craig Jones, Lehman to John Feraca, Lehman (June 19, 2008) [LBEX-AM 001775]. Jones informed Feraca: "Today we moved several unencumbered assets (Sasco, Spruce, Pine, Fenway) to LCPI's DTC box at Chase to generate an additional $5.4 billion of NFE. This will help us absorb the increase in intra-day margining that Chase wants us to implement."

[6341] Paolo Tonucci & Robert Azerad, Liquidity Of Lehman Brothers (Oct. 7, 2008), at p. 9[LBHI_SEC07940_844701].

[6342] Lehman, Presentation to S&P, Liquidity Management At Lehman Brothers (May 15, 2008), at p. 17 [LBEX-DOCID 008669] (defining operational friction as "change in lock ups, transfer of positions across depots, change in secured funding, etc.").

[6343] Examiner's Interview of Robert Azerad, Sept. 23, 2009 (second interview), at p. 9.

[6344] Lehman, Presentation to the Chicago Mercantile Exchange, Liquidity Management At Lehman Brothers [Draft] (June 5, 2008), at p. 24 [LBEX-DOCID 1300305] (Lehman assumed that it could "[u]se term commercial paper to mitigate short-term liquidity outflows such as unforeseen operational friction (fails)"); *see also* Lehman, Presentation to the Federal Reserve Update on Capital, Leverage, and Liquidity

sources were available outside of a stress event, Lehman's own stress tests assumed that neither of these would be available during a stress event.

As noted above, the tests assumed that Lehman would not be able to issue commercial paper during the stress event.[6345] Lehman's broker-dealers were structured to not require liquidity infusions from LBHI in order to operate in the ordinary course of their business, and their prime broker business, in particular, was designed to be "self-sufficient."[6346] However, in a stress event, Lehman projected that "the largest liquidity stress would be felt at the broker dealers, which because they could not roll maturing repos, would experience significant cash outflows."[6347] For example, in the April 21 scenario, Lehman projected that its main broker-dealers, LBI and LBIE, would lose $33.1 billion of repo capacity on the first day of a liquidity stress event and a total of $57.3 billion after four weeks.[6348] In an internal version of the stress test done on June 12, 2008, Lehman projected that LBI and LBIE would lose $21.8 billion of repo capacity

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(May 28, 2008), at pp. 7, 16 [LBHI_SEC07940_062581] (stating that Lehman "[i]ncreased our CP program to mitigate risk of operational friction in a very volatile environment" following Bear Stearns).

[6345] *See, e.g.*, Lehman, Presentation to the Federal Reserve & SEC Updated Stressed Liquidity Scenario (July 2, 2008), at p. 3 [LBEX-DOCID 1300104] ("Inability to roll unsecured debt"); *see also* Joint Request of SEC and FRBNY: Liquidity Scenarios for CSEs (May 20, 2008), at p. 2 [LBHI_SEC07940_505195-96] (identifying commercial paper as an area of potential impact in a stress event).

[6346] Lehman, Presentation to S&P, Liquidity Management At Lehman Brothers (May 15, 2008), at p. 17 [LBEX-DOCID 008669].

[6347] Lehman, Liquidity Stress Scenario Analysis (Apr. 21, 2008), at p. 5 [LBEX-DOCID 008608]; *see also* "Apocalypse Now" liquidity stress scenario as of June 12, 2008 [LBEX-DOCID 022363]; *cf.* Paolo Tonucci & Robert Azerad, Change In Liquidity Week Of September 8, 2008 (Sept. 24, 2008), at p. 4 [LBHI_SEC07940_740011] ("During the week of September 8, LBI and LBIE, Lehman's U.S. and European broker dealers, respectively, experienced a loss of liquidity, which required Holdings to provide liquidity support, resulting in an increase of their payables to Holdings.").

[6348] Lehman, Liquidity Stress Scenario Analysis (Apr. 21, 2008), at p. 5 [LBEX-DOCID 008608].

on the first day of a liquidity event, and $33.9 billion over four weeks.[6349] As Lehman acknowledged in its April 21 stress test, LBI and LBIE would have to "borrow cash from the Holding companies" to compensate for the lost repo funding.[6350] Thus, it was unreasonable for Lehman to assume that broker-dealers, which it projected would require substantial infusions of liquidity during the stress event, would have the necessary liquidity to mitigate the impact of operational friction.

Despite the absence of these funding sources, and the foreseeable logistical challenges of covering the concurrent withdrawal of assets by Lehman's prime broker customers in a stress event, Lehman's stress test projections made no allowance for operational friction. Azerad acknowledged that Lehman believed there would be a liquidity impact due to operational friction, but because it was difficult for them to model or estimate precisely, they did not take it into account at all in their projections.[6351] During the week prior to LBHI's bankruptcy filing, Lehman experienced a $4 billion liquidity outflow arising from the "temporary impact of the unwinding of the prime broker business."[6352] On September 24, 2008, Tonucci and Azerad prepared a post-mortem analysis after the bankruptcy petition showing that after it released its

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[6349] "Apocalypse Now" liquidity stress scenario as of June 12, 2008 [LBEX-DOCID 022363].

[6350] Lehman, Liquidity Stress Scenario Analysis (Apr. 21, 2008), at p. 5 [LBEX-DOCID 008608].

[6351] Examiner's Interview of Robert Azerad, Sept. 23, 2009 (second interview), at pp. 9-10.

[6352] Paolo Tonucci & Robert Azerad, Change In Liquidity Week Of September 8, 2008 (Sept. 24, 2008), at p. 4 [LBHI_SEC07940_740011]. A post-mortem prepared by Azerad and Tonucci showed there was a total $9 billion loss attributable to operational friction, including the $4 billion prime broker unwind, a $3 billion liquidity outflow due to "[p]ending payments between LBI and LBIE," a $1 billion "[i]ncrease in margin requirements," and a $1 billion effect of "repo rebalancing." *Id.*

third quarter 2008 earnings on September 9, 2008, its "prime broker customers started pulling their long and short balances from LBIE to other prime brokers," that the "speed of their withdrawal coupled with their request for same-day transfers . . . resulted in operational frictions as Lehman's operations group was struggling processing these requests," and that the resulting operational friction "worsened our liquidity position … at a critical point for Lehman."[6353]

Therefore, because there is sufficient evidence to support a determination that Lehman could have reasonably foreseen the substantial effect that operational friction arising from the withdrawal of customer accounts would have on its liquidity, even if on a temporary basis, it was unreasonable for Lehman not to take the impact of operational friction into account in its liquidity stress event planning. Lehman knew or should have known that the factors that it assumed would mitigate an increase in operational friction would not have that effect in a stress event. In view of the foregoing, there is sufficient evidence to support a determination that the stress tests employed two assumptions which, given the information available to Lehman when the tests were developed, were not reasonably constructed and that LBHI and the LBHI Affiliates identified below were operating with unreasonably small capital during the period beginning early in the third quarter of 2008 and ending the date of each respective bankruptcy filing.

[6353] *See* Paolo Tonucci & Robert Azerad, Liquidity Of Lehman Brothers (Oct. 7, 2008), at p. 13 [LBHI_SEC07940_844701].

(iii) Other Capital Adequacy Metrics

There are other metrics bearing upon capital adequacy such as Lehman's cash capital surplus, which was at a record $15.0 billion as of September 2, 2008 and "near record levels" as of September 10, 2008,[6354] its Equity Adequacy Framework, which showed that it had sufficient equity to avoid bankruptcy provided it could liquidate all its assets in an orderly wind-down,[6355] and its CSE Capital Ratio, which had substantially improved by the end of the second quarter of 2008.[6356] Although these metrics provide some evidence that Lehman could have reasonably believed it was engaged in business with adequate capital, these metrics do not preclude a determination that Lehman was not adequately capitalized against the specific, foreseeable and likely liquidity risk arising from its reliance on short-term repo funding to support less liquid and illiquid inventory, and the other contingent costs that might arise in a liquidity stress event.

a. Cash Capital Surplus

Lehman tracked and reported a metric of capital adequacy called its "cash capital surplus," which it defined as its measure of "long-term funding sources over long-term

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[6354] Lehman, 2008 Q3 Liquidity Metrics, Version 1 (Sept. 2, 2008), at p. 8 [LBEX-DOCID 1300336]; Lehman, Funding Lehman Brothers (Sept. 10, 2008), at p. 10 [LBHI_SEC07940_739985].

[6355] Lehman, Equity Adequacy Framework (May 19, 2008), at p. 1 [LBEX-DOCID 1302799].

[6356] *Compare* LBHI 10-Q (July 10, 2008), at p. 103 (showing a Tier 1 CSE Capital ratio of 10.7 percent and a Total Risk-Based Capital Ratio of 16.1 percent), *with* Lehman, Presentation to the Executive Committee, The Firm's Equity Adequacy [Draft] (Oct. 2007), at p. 15 [LBEX-DOCID 2489685] (showing a Tier 1 Capital Ratio of 7.0 percent and a Total Capital Ratio of 10.5 percent).

funding requirements."[6357] In theory, if a company's long-term capital needs are covered by sources of long-term capital (including debt and equity), its risk of a liquidity mismatch is manageable because its long-term needs mature with its long-term capital sources.[6358]

The existence of Lehman's "cash capital surplus" does not preclude a determination that Lehman was engaged in business with "unreasonably small capital" because it was based on assumptions about the normal functioning of the repo market to support less liquid inventory even under adverse market conditions.[6359] Lehman's Cash Capital Model explicitly assumed that there would only be an impairment of secured funding, not a complete loss for certain asset classes, and that such impairment would be addressed by the liquidity pool.[6360]

b. Equity Adequacy Framework

Another measure of capital adequacy was Lehman's "Equity Adequacy Framework." The Equity Adequacy Framework was an attempt to measure the "estimated amount of capital required to allow the Firm to reorganize and restructure

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[6357] LBHI 10-Q (July 10, 2008), at p. 82.

[6358] Lehman, Presentation to the Chicago Mercantile Exchange, Liquidity Management At Lehman Brothers [Draft] (June 5, 2008), at p. 7 [LBEX-DOCID 1300305] (noting that under its principle of "match funding," its assets and liabilities would have "self-funding and self-liquidating characteristics.").

[6359] Lehman calculated the size of the "long inventory haircut" as the average difference between the market value of the collateral pledged and secured financing proceeds received for a specific asset category "in a normal market environment." Lehman, GFS Training: Cash Capital Module (Jan. 2006), at pp. 4, 15 [LBEX-DOCID 1682556]. Lehman's cash capital model did not assume that Lehman's repo counterparties would simply stop funding certain asset classes entirely.

[6360] "Since Cash Capital is raised to fund only the normal market haircut . . . , Lehman funds contingent haircut widening requirement with short term funds (current portion of LTD or STD)." *Id.* at 27.

without resorting to bankruptcy in case of a severe and prolonged crisis."[6361] An important assumption behind this orderly liquidation scenario was that Lehman relied upon the sufficiency of its liquidity pool to "ensure[] we have sufficient time (one year) to arrange for disposition of assets or restructuring of liabilities."[6362]

Although the orderly liquidation scenario envisioned by the Equity Adequacy Framework is some evidence that Lehman was adequately capitalized, the Equity Adequacy Framework analysis did not properly account for the market reaction in a stressed liquidity event, given Lehman's business model and the importance of market confidence to its day-to-day operation and survival.[6363] Lehman could not expect to conduct an orderly and complete liquidation of its inventory and assets without a market reaction, especially given the swiftness of the near collapse of Bear Stearns.[6364]

[6361] Lehman, Equity Adequacy Framework (May 19, 2008), at p. 2 [LBEX-DOCID 1302799].

[6362] *Id.* at 3.

[6363] Matthew Albrecht, S&P, *Investment Services Industry Survey* (May 29, 2008), at p. 1 (noting that investment banks "rely on their reputations in all aspects of their business," from facilitating trading and financial advisory work, to finding new investments, to borrowing capital, and that the "most troublesome crisis that these firms can face . . . is a crisis of confidence in the firm.").

[6364] Although following the Bear Stearns event, the Federal Reserve created new facilities designed to support the liquidity of non-commercial banks – namely, the Primary Dealer Credit Facility (PDCF) and the Term Securities Lending Facility (TSLF) – through which financial institutions holding less liquid collateral could obtain temporary loans or temporary exchanges for more liquid forms of collateral, such as government and agency securities, Lehman admitted that use of such facilities was seen as carrying a "stigma" that would undermine market confidence. Examiner's Interview of Robert Azerad, Sept. 23, 2009 (second interview), at p. 11 (noting that use of the PDCF window carried a "stigma."); *see also* U.S. Department of the Treasury, Office of Thrift Supervision, Examiner-in-Charge Ronald S. Marcus, Report of Examination of Lehman Brothers Holdings Inc. (May 19, 2008), at p. 2 (describing the PDCF as a "last resort line of credit."); e-mail from Donald Kohn, FRBNY, to Ben S. Bernanke, Federal Reserve (June 11, 2008) [FRB to LEH Examiner 000069] (noting that if Lehman accessed the PDCF window, such usage "might be the kiss of death in any case."). Further evidence shows that in its final week prior to its bankruptcy filing, Lehman did not utilize the PDCF window to stave off bankruptcy. The SEC and Federal Reserve, in their joint request to CSEs to perform liquidity stress tests following the Bear Stearns

Thus, the mere fact of a reported equity adequacy surplus does not, without more, preclude a determination of "unreasonably small capital."

c. CSE Capital Ratio

In December 2005, Lehman submitted itself to supervision under the SEC as a CSE. This supervision subjected Lehman to certain minimum capital requirements, including the reporting of a capital adequacy measurement consistent with the standards adopted by the Basel Committee on Banking Supervision.[6365] By 2008, Lehman was required to measure and disclose its Total Risk-Based Capital Ratio, which was essentially a measure of Lehman's equity capital and subordinated debt divided by its risk-weighted assets, although it also measured its Tier 1 Capital Ratio, which was a similar metric that used a narrower definition of equity capital.[6366] Lehman was also required to notify the SEC if its Total Risk-Based Capital Ratio fell below 10 percent.[6367]

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event, asked CSEs to model their stress test projections without reliance upon the PDCF or TSLF. *See* Joint Request of SEC and FRBNY: Liquidity Scenarios for CSEs (May 20, 2008), at p. 1 [LBHI_SEC07940_505195].

[6365] LBHI 10-Q (July 10, 2008), at p. 102.

[6366] *Id.* at p. 101.

[6367] *Id.* Total Risk Based Capital was the sum both Tier 1 and Tier 2 capital. Tier 1 Capital was composed of Lehman's common stockholders' equity, less (i) Lehman's identifiable intangible assets and goodwill; (ii) deferred tax assets dependent upon future taxable income; (iii) cumulative gains or losses, net of taxes, that arise from application of fair value accounting on Lehman's financial debt liabilities, and which are attributable to Lehman's credit spread, and (iv) other deductions, including Lehman's investments in insurance subsidiaries, but plus (x) unrestricted securities issued by Lehman, including perpetual, non-cumulative preferred securities and (y) restricted securities used by Lehman. Tier 2 Capital includes all components of Tier 1 Capital plus senior and subordinated notes, generally including qualifying senior and unsecured notes that are unsecured and have maturities greater than five years. *Id.* at 101-102.

There was substantial correlation between Lehman's Equity Adequacy, CSE Capital Adequacy and Net Leverage Ratio metrics.[6368]

However, like its improved net leverage ratios as of the second quarter of 2008, Lehman's CSE Capital Ratio metrics do not preclude a finding that Lehman was engaged in business with "unreasonably small capital." Given the nature of Lehman's enterprise, Lehman's ability to operate was primarily a function of its liquidity risk, not necessarily the value of its assets as compared to its liabilities.[6369] Metrics of capital adequacy such as the CSE Capital Ratio, the net leverage ratio, the Equity Adequacy Framework and the Cash Capital Surplus were essentially snapshots of Lehman's capital structure at a given point in time. However, it is difficult to measure liquidity risk with such metrics.[6370] As Paul Shotton, one of Lehman's most senior risk managers, recognized in the aftermath of the Bear Stearns event, "[e]quity-sufficiency metrics need

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[6368] Lehman, Equity Adequacy Framework (May 19, 2008), at p. 8 [LBEX-DOCID 1302799] (recognizing a "close alignment between [the] EAF and CSE" metrics); Lehman, Presentation to the Executive Committee, The Firm's Equity Adequacy [Draft] (Oct. 2007), at p. 12 [LBEX-DOCID 2489685] (noting that the net leverage ratio and CSE Capital ratio were "complementary" capital adequacy metrics).

[6369] E-mail from Paul Shotton, Lehman, to Chris O'Meara, Lehman (Apr. 15, 2008) [LBHI_SEC07940_768467] ("Liquidity is more important than capital; most entities which go bankrupt do so because they run out of financing, not because the value of their assets falls below the value of their liabilities.").

[6370] *See* Peter Neu & Leonard Maltz, *Liquidity Risk Management* 3 (John Wiley & Sons 2007) ("Retrospective and concurrent measures of liquidity have little value. Prospective views are critical."). *See also* Ethan Penner, "*Can the Financial Markets Make a Comeback*?" Wall Street Journal, Aug. 27, 2007, p. A11 (attributing maxim, "liquidity is an illusion … always there when you don't need it, and rarely there when you do," to former Drexel Burnham Lambert CEO Michael Milken). A similar statement was voiced by Lehman's Paul Shotton in his April 15, 2008 e-mail to Chris O'Meara: "Liquidity is the ultimate useless concept — plentifully available when it's not needed, never present when it is." *See* e-mail from Paul Shotton, Lehman, to Chris O'Meara, Lehman (Apr. 15, 2008) [LBHI_SEC07940_768467]. Both comments illustrate the principle that liquidity cannot be measured with a static metric.

to be based on anticipated liquidity-availability during stressed market periods, not on normal-market experience."[6371] Therefore, these static capital adequacy metrics do not preclude a determination that Lehman was engaged in business with "unreasonably small capital" to the extent they are not based upon projections of liquidity under stressed market conditions.

(g) LBHI Affiliate "Unreasonably Small Capital" Analysis

In the preceding Section of the Report, the Examiner concludes that, pursuant to a debtor-by-debtor analysis, there is sufficient evidence to support a determination that certain LBHI Affiliates were either solvent or insolvent, but that there was insufficient evidence to determine the solvency of others.[6372] However, the financial condition of "unreasonably small capital" is distinct from insolvency, such that an entity might be solvent and yet still have "unreasonably small capital."[6373] Thus, a separate debtor-by-

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[6371] E-mail from Paul Shotton, Lehman, to Chris O'Meara, Lehman (Apr. 15, 2008) [LBHI_SEC07940_768467] ("Liquidity is more important than capital; most entities which go bankrupt do so because they run out of financing, not because the value of their assets falls below the value of their liabilities.").

[6372] See Section III.B.3.c of this Report for a discussion of LBHI Affiliate solvency.

[6373] *Boyer v. Crown Stock Distrib., Inc.*, 587 F.3d 787, 794 (7th Cir. 2009) ("The difference between insolvency and 'unreasonably small' assets in the LBO context is the difference between being bankrupt on the day the LBO is consummated and having at that moment such meager assets that bankruptcy is a consequence both likely and foreseeable."); *see also Moody*, 971 F.2d at 1070 ("Because an inability to generate enough cash flow to sustain operations must precede an inability to pay obligations as they come due, unreasonably small capital would seem to encompass financial difficulties short of equitable insolvency."); *Brandt v. Hicks, Muse & Co., Inc. (In re Healthco Int'l)*, 208 B.R. 288, 302 (Bankr. D. Mass. 1997) (describing the "unreasonably small capital" standard as "connot[ing] a condition of financial debility short of insolvency (in either the bankruptcy or equity sense), but which makes insolvency reasonably foreseeable"); *MFS/Sun Life Trust*, 910 F. Supp. at 944 ("The test is aimed at transferees that leave the transferor technically solvent but doomed to fail."); *In re Vadnais Lumber Supply, Inc.*, 100 B.R. 127, 137 (Bankr. D. Mass. 1989) (noting that "unreasonably small capital[] . . . encompasses difficulties which are short of insolvency in any sense but are likely to lead to insolvency at some time in the future").

debtor analysis is warranted to determine which, if any, of the LBHI Affiliates was engaged in business with "unreasonably small capital."

A determination that LBHI was operating with "unreasonably small capital" has implications upon whether any of LBHI's Affiliates were also operating with "unreasonably small capital." Courts have held that where a parent company is left with "unreasonably small capital" to operate its business, its subsidiaries would also be left in that same financial condition to the extent they were not independently funded.[6374] This is especially true in cases where there is a centralized cash management system between parent company and affiliates on a consolidated enterprise basis,[6375] or where there is direct or indirect funding support from a parent to its subsidiaries or affiliates.[6376]

The Examiner's analysis of whether the LBHI Affiliates may have had "unreasonably small capital" focused on those entities that had significant operations dependent on funding and/or capital support from LBHI since the LBHI Affiliates' capital adequacy is directly linked to that of LBHI.[6377] The Examiner finds that the eight

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[6374] *In re TOUSA, Inc.*, -- B.R. --, Bankr. No. 08-10928, 2009 WL 3519403, at 14 (Bankr. S.D. Fla. Oct. 30, 2009). *See also Ingalls v. SMTC Corp. (In re SMTC Mfg. of Tex.)*, Bankr. No. 04-16354-CAG, Adv. No. 06-1283, 2009 WL 2940161, at *56-58 (Bankr. W.D. Tex. Sept. 11, 2009).

[6375] *In re TOUSA, Inc.*, 2009 WL 3519403, at *31.

[6376] *See Teleglobe USA, Inc. v. BCE Inc. (In re Teleglobe Commc'ns Corp.)*, 392 B.R. 561, 602-603 (Bankr. D. Del. 2008) (holding that the test for subsidiary solvency should not exclude "the funding support actually given" by the immediate corporate parent until the point when it would no longer be reasonable to expect such support).

[6377] See Section III.B.3.c of this Report, which provides the Examiner's Debtor-by-Debtor analysis of the solvency of the LBHI Affiliates.

LBHI Affiliates that relied on LBHI for funding and/or credit support were CES Aviation, CES Aviation V, CES Aviation IX, LCPI, LBSF, LBCS, LOTC and LBCC. The Examiner therefore concludes that there is sufficient evidence to support a colorable basis for finding that these entities had "unreasonably small capital" beginning early in the third quarter of 2008 and at all times through each applicable petition date. The Examiner also observes that there exists evidence that would support a contrary finding. As conflicting evidence exists, a finder of fact will need to consider carefully all available evidence in determining whether LBHI and the LBHI Affiliates had "unreasonably small capital." The Examiner expresses no opinion as to what determination a finder of fact would make in considering this element.

e) Insider Preferences Against LBHI (Third Bullet)

(1) Summary

This Section of the Report discusses insider preferences against LBHI. The Examiner identified LBSF, LBCS and LCPI as those LBHI Affiliates for which a determination could be made of insolvency or borderline solvency beginning on June 1, 2008. The Examiner tailored the preference analysis to colorable claims that these LBHI Affiliates might have against LBHI. Generally, the Examiner identified cash transfers to LBHI not in connection with safe-harbored activity as preferential if the cash was transferred "for or on account of an antecedent debt." The Examiner's findings are as follows:

There is evidence to support a finding for each element of a preference claim under Section 547(b) of the Bankruptcy Code in an action by LBSF against LBHI. There is also evidence to support a finding for each element of the new value and ordinary course defenses that LBHI could assert. Any conclusion would be determined by a trier of fact.

There is evidence to support a finding for each element of a preference claim under Section 547(b) of the Bankruptcy Code in an action by LBCS against LBHI. There is also evidence to support a finding for each element of the new value and ordinary course defenses that LBHI could assert. Any conclusion would be determined by a trier of fact.

The Examiner has been unable to determine whether there is evidence to support a finding for each element of a preference claim under Section 547(b) of the Bankruptcy Code in an action by LCPI against LBHI because the Examiner, as discussed below, has been unable to trace the material movement of money between LCPI and LBHI that was not in connection with a safe-harbored event.

The Examiner has not analyzed whether CES Aviation LLC, CES Aviation V LLC, and CES Aviation IX LLC have colorable preference claims against LBHI because these entities' claims would be relatively insignificant compared to the potential claims of other LBHI Affiliates; the Examiner determines that it would be an imprudent use of estate resources to further investigate any potential claims.

Because the Examiner determined that the remaining LBHI Affiliates were not insolvent or on the borderline of solvency on May 31, 2008, the Examiner, for reasons stated below, did not investigate whether there was evidence to support each element of a preference claim under Section 547(b) of the Bankruptcy Code in an action against LBHI.

(2) Legal Summary

This Section addresses whether any LBHI Affiliate has colorable claims against LBHI for potential insider preferences arising under the Bankruptcy Code or state law.[6378] The LBHI Affiliate is the debtor seeking to avoid a preference payment; LBHI is the insider or creditor receiving that payment.[6379] A successful preference claim under

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[6378] Some courts have found that "state preference law is an adjunct to, and supplemental of, those powers specifically provided for in the Bankruptcy Code which enable the trustee to avoid certain transfers." *Perkins v. Petro Supply Co.* (*In re Rexplore Drilling, Inc.*), 971 F.2d 1219, 1222 (6th Cir. 1992); *see also Provident Hosp. Training Ass'n v. GMAC Mortgage Corp.* (*In re Provident Hosp. & Training Ass'n)*, 79 B.R. 374, 379 (Bankr. N.D. Ill. 1987) (recognizing availability of state preference law as a means of attacking a transfer under section 544(b)); *Associated Grocers of Neb. Coop., Inc. v. Am Home Prod. Corp.* (*In re Associated Grocers of Neb. Coop., Inc.*), 62 B.R 439, 445 (D. Neb. 1986). *But see Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198 (9th Cir. 2005) (finding that state preference law was preempted by section 547).

The Examiner reviewed preference law in New York and Delaware. The Examiner concluded that New York does not have a preference statute available to the trustee. *Cf. Sharp Int'l Corp. v. State Street Bank and Trust Co.* (*In re Sharp Int'l Corp.*), 403 F.3d 43, 54-55 (2d Cir. 2005) (explaining that preferential payments to non-insiders are not fraudulent conveyances and are not avoidable under New York law). Delaware does have a preference statute, *see* DEL. CODE 10 § 7387 (1995), but it is unclear whether the Delaware statute could be used by the trustee in these cases because it has been applied narrowly by Delaware courts. *See Dodge v. Wilmington Trust Co.*, 1995 WL 106380, at *2-4 (Del. Ch. 1995) (noting that Delaware's preference statute had "not been cited by a Delaware court since 1917" and refusing to broaden its reach beyond assignments in trust). The Examiner's focus in identifying potentially preferential transfers, therefore, is on transfers subject to avoidance under Section 547 of the Bankruptcy Code.

[6379] *See* 11 U.S.C. §§ 101(2)(A), (31)(B)(iii), (31)(E).

Section 547 of the Bankruptcy Code requires[6380] the debtor[6381] to prove: "a transfer of an interest of the debtor in property-- (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made (A) on or within 90 days before the date of filing of the petition; or (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and (5) that enables such creditor to receive more than such creditor would receive if (A) the case were a case under Chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title."[6382] LBHI is an insider of LBHI Affiliates. Consequently, the applicable reachback period for insider preferences is one year.

The Bankruptcy Code presumes insolvency "on and during the 90 days immediately preceding the date of the filing of the petition."[6383] The creditor can rebut the presumption of insolvency "by introducing evidence that tends to suggest that the debtor was solvent at the time the transfer was made."[6384]

[6380] For a more detailed discussion of the law of preferences, see Appendix 1, Legal Issues, at Section IV.A.D.

[6381] Section 1107 of the Bankruptcy Code gives the debtor in possession all the rights of a trustee with exceptions not relevant here.

[6382] 11 U.S.C. § 547(b).

[6383] 11 U.S.C. § 547(f). See Section III.B.3.c of this Report, which discusses each Debtor's solvency.

[6384] 5 Collier on Bankruptcy, ¶ 547.12 (15th ed. 2005).

The Examiner Order refers to "colorable claims against LBHI" and does not mention any potential defenses that LBHI could assert. The Examiner recognizes, however, that in the context of preference claims under Section 547(b) of the Bankruptcy Code, it is important to consider potential defenses that could be raised by a defendant under Section 547(c). The debtor has the burden of proving the elements of a preference claim, and the creditor has the burden of proving any defense to such a claim.[6385] There are many potential defenses that defendant-creditors may assert,[6386] but the Examiner has limited the discussion of potential defenses to those that appear to be colorable based on a review of the Debtors' books and records.

In addition to the defenses discussed above, the "safe harbors" of the Bankruptcy Code protect qualifying transfers from being avoided as preferential.[6387]

(3) Sources of Potential Preferential Activity

Upon initial investigation, most of the activity at Lehman was in respect of transfers that were protected, or exempt from avoidance, by the Bankruptcy Code's safe harbor provisions. Therefore, even if such transfers satisfied the criteria for preferential transfers pursuant to Section 547 of the Bankruptcy Code, they could not be avoided pursuant to Section 546. In light of this determination, the Examiner focused the investigation on activity not in connection with transfers protected by the safe harbors.

[6385] 11 U.S.C. § 547(g).

[6386] *See* 11 U.S.C. § 547(c).

[6387] For a more detailed discussion of the Bankruptcy Code's safe harbor provisions, see Appendix 1, Legal Issues, at Section IV.E.

The Examiner identified the movement of cash between LBHI and its Affiliates for or on account of an antecedent debt that was not in connection with securities contracts, commodities contracts, forward contracts, repo agreements, or swap agreements.[6388] The Examiner identified three sources of cash transfers that are potentially not in connection with safe-harbored activity: (1) "funding" activity[6389] in GCCM, which was the manual movement of cash between bank accounts owned by affiliates and bank accounts owned by LBHI; (2) "quasi-funding" activity, which was automatic funding-like activity occurring in GCCM when LBHI acted as central banker by receiving or extending value on behalf of its affiliates; and (3) "trust receipt" activity, which was the movement of money recorded through Lehman's MTS trading system. Each source of activity will be discussed in turn.

First, GCCM funding activity refers to the manual movement of cash between bank accounts owned by affiliates and bank accounts owned by LBHI.[6390] Although

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[6388] See Section III.B.2.c of this Report, which addresses the operation of Lehman's cash management system.

[6389] Funding activity, as referred to in this Section of the Report, is similar to what is often referred to as cash sweeps, but it is non-directional. As discussed in Section III.B.2.b of this Report, the Examiner defines "cash sweeps" to mean the transfer of cash that occurred between September 15, 2008 and the date that the applicable LBHI Affiliate commenced its Chapter 11 case from (i) an LBHI Affiliate to LBHI or (ii) a third party to LBHI for the benefit of an LBHI Affiliate (it does not include the settlement of pre-existing obligations).

[6390] The Examiner's investigation of potential preferences related to funding activity assumes that money transferred from an LBHI Affiliate to LBHI removed the money from the affiliate's estate. The Examiner, for the purposes of this preference analysis, assumes that the affiliate would not have a section 541/542 claim against LBHI. *See Amdura Nat'l Distrib. Co. v. Amdura Corp.* (*In re Amdura Corp.*), 75 F.3d 1447 (10th Cir. 1996) (concluding that money held by parent-debtor in a cash management system was not property of subsidiary-debtor under section 541 of the Bankruptcy Code); *Southmark Corp. v. Grosz* (*In re Southmark Corp.*), 49 F.3d 1111 (5th Cir. 1995) (concluding that money held by parent debtor pursuant to a cash

GCCM referred to such activity as funding activity, which this Section of the Report adopts, the Examiner bifurcates funding activity into the following two categories: up-funding, which refers to transfers of money from affiliates to LBHI (commonly referred to as cash sweeps), and down-funding, which refers to transfers from LBHI to affiliates. The purpose of up-funding was to concentrate Lehman's cash at LBHI. Lehman's Treasury Group sought to fund each affiliate's account to $0.00 by the end of the day.[6391] Although Lehman invested the concentrated money overnight, the Examiner has observed no evidence suggesting that up-funding activity was in connection with any safe-harbored event.[6392] The Examiner expresses no opinion in this Section of the Report, however, on whether down-funding is protected by the safe harbors, as the Examiner Order does not task the Examiner to investigate claims that LBHI may have against affiliates for potential insider preferences.[6393]

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management system was property of parent-debtor's estate for purposes of preference analysis when parent-debtor made payment on behalf of subsidiary-debtor); *Enron Corp. v. Port of Houston Auth.* (*In re Enron Corp.*), 2006 WL 2385194, at *6-7 (Bankr. S.D.N.Y. June 2, 2006); *cf. R² Inv. v. World Access, Inc.* (*In re World Access, Inc.*), 301 B.R. 217, 263-71 (Bankr. N.D. Ill. 2003) (discussing at length ownership of concentration account); *Cassirer ex rel. Estate of Schick v. Herskowitz* (*In re Schick*), 234 B.R. 337 (Bankr. S.D.N.Y. 1999); *see generally* Derek Feagans, *Concentration Accounts and Bankruptcy: "Where O'Where did the Bankruptcy Estate Go?,"* 67 U. MO. KAN. CITY L. Rev. 145 (1998).

[6391] Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 2. Fleming noted many exceptions to the general policy of funding accounts to zero. For example, if LBI had extra money at the end of the day it was "trapped" because LBI could not lend to LBHI on an unsecured basis like other Lehman entities.

[6392] *Id.* The Examiner has observed no evidence suggesting that up-funding is in connection with a Protected Contract. For a more detailed discussion of the Bankruptcy Code's safe harbor provisions, see Appendix 1, Legal Issues, at Section IV.E.

[6393] *See* 11 U.S.C. § 741(7)(A)(v) (extension of credit to settle a securities transaction is a "securities contract"). No reported cases have been found interpreting Section 741(7)(A)(v). The Examiner addressed down-funding in the context of LBHI's new value defense, however, because new-value calculations do not exclude safe-harbored activity. *See* 11 U.S.C. § 547(c)(4).

Second, quasi-funding activity refers to automatic funding-like activity occurring in GCCM when LBHI acted as central banker by receiving or extending value on behalf of affiliates. In other words, when LBHI acted as central banker, GCCM created many automatic quasi-funding transactions that were coupled with activity that is potentially protected by the safe harbors. Quasi-funding activity takes many forms, but it follows the basic premise that Lehman attempted to reduce the movement of cash between bank accounts that eventually up-funded to LBHI.[6394] Quasi-funding activity is coupled with an event that, absent GCCM, would have required the movement of cash in a different way.[6395] The Examiner and his financial advisors have been unable to catalogue all types of quasi-funding activity,[6396] but several examples are described in the following paragraphs.

[6394] See Section III.B.2 of this Report, which discusses the concept of funding trees in GCCM.

[6395] GCCM referred to this activity as "intercompany" activity. Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at pp. 3-4.

[6396] The Examiner has not categorically determined whether quasi-funding is in connection with safe-harbored activity because there are so many permutations of activity generated by GCCM. Whether the safe harbors apply to quasi-funding activity will depend on how expansively the phrase "in connection with" found in each of the safe harbor provisions of Sections 546(e), (f), (g), and (j) is interpreted. One court has stated that a "natural reading of 'in connection with' suggests a broader meaning similar to 'related to.'" *Interbulk, Ltd. v. Louis Dreyfus Corp.* (*In re Interbulk Ltd.*), 240 B.R. 195, 202 (Bankr. S.D.N.Y. 1999). Another court, in interpreting this phrase, held that prejudgment attachments that a party to pre-petition swap agreements obtained in state court actions brought to recover for the debtor's alleged breach of the swap agreements were transfers made "in connection with" swap agreements, and were therefore protected by Section 546(g) because the actions taken by the party stemmed from the failure of the swap agreements. *Casa de Cambio Majapara S.A. de C.V. v. Wachovia Bank, N.A. (In re Casa de Cambio Majapara S.A. de C.V.)*, 390 B.R. 595 (Bankr. N.D. Ill. 2008). Although no court has addressed any limitation on the "in connection with" language, it cannot be boundless. In any event, the Examiner notes the tension between the safe-harbor's expansive "in connection with" language and the general proposition that courts look to substance over form in the context of preference identification. *E.g.*, *Dean v. Davis*, 242 U.S. 438, 443 (1917) ("Mere circuity of arrangement will not save a transfer which effects a preference from being invalid as such."); *Nat'l Bank of Newport v. Nat'l Herkimer County Bank*, 225 U.S. 178,

When Lehman implemented GCCM, it sought to limit the number of bank accounts that it needed to maintain. But Lehman determined that it was less cumbersome to convert existing affiliate bank accounts into "no-credit" accounts than it was to close them and provide new payment instructions to third-parties.[6397] When money was deposited into "no-credit" bank accounts, it was automatically forwarded to and deposited into an LBHI bank account. In substance, therefore, deposits into "no-credit" accounts represented two distinct transactions: a counterparty remits a payment to the affiliate (transaction number one, which is potentially a safe-harbored activity), and Lehman up-funds the money to LBHI at the end of the day (transaction number two, which is an up-funding activity).[6398] Indeed, Lehman employees noted that it would be a distinction without a difference to consider quasi-funding activity to be

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184 (1912) ("It is not the mere form or method of the transaction that the [bankruptcy] act condemns, but the appropriation by the insolvent debtor of a portion of his property to the payment of a creditor's claim, so that thereby the estate is depleted and the creditor obtains an advantage over other creditors."); *Pacific N. Oil, Inc. v. Erickson* (*In re Seaway Express Corp.*), 940 F.2d 669 (Table), 1991 WL 136238, at *2 (9th Cir. 1991) ("In determining whether a transfer has been a preference, a bankruptcy court must look through form to substance, and treat the transaction according to its real nature." (citations omitted)); *Katz v. First Nat'l Bank of Glen Head*, 568 F.2d 964, 970-71 (2d Cir. 1977) (looking beyond form to substance in preference action); *cf. Orr v. Kinderhill Corp.*, 991 F.2d 31, 35 (2d Cir. 1993) (noting in context of fraudulent transfer under New York law that "[i]n equity, substance will not give way to form, and technical considerations will not prevent substantial justice from being done" (citation omitted)).

[6397] The Examiner understands that these accounts may also be referred to as subaccounts.

[6398] Quasi-funding activity could work in the opposite direction - that is, LBHI could pay an obligation owed by an affiliate. In other words, this functioned in the same way as having LBHI forward the money on an unsecured basis to the LBHI Affiliate (transaction number one), and then having the LBHI Affiliate remit the payment to the counterparty (transaction number two).

anything other than funding activity,[6399] and the resulting accounting entries would be the same. In fact, before Lehman implemented GCCM, activity occurred this way.[6400]

There are many other examples of quasi-funding activity outside the context of no-credit accounts. For example, it was common practice for an affiliate to direct counterparties to remit settlement payments to LBHI because it was easier for LBHI to keep the cash and adjust the affiliate's intercompany obligation to LBHI than it was to direct counterparties to pay the affiliate and up-fund later. Or, for example, if the payor and payee of a transaction were both Lehman affiliates, and their bank accounts were on the same funding tree (that is, their respective bank accounts would ultimately up-fund to LBHI at the end of the day), cash would not move in respect of that transaction and each affiliate's intercompany obligation to LBHI would be adjusted accordingly.

The Examiner bifurcates quasi-funding activity into the following two categories: quasi-up-funding, which refers to GCCM activity that caused an affiliate's antecedent debt to LBHI to shrink because LBHI kept money or value that was owed to an affiliate, and quasi-down-funding, which refers to GCCM activity that caused an affiliate's antecedent debt to LBHI to grow because it represents an extension of credit given by LBHI.

[6399] Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 4. See Section III.B.2.c.3 of this Report, which discusses the distinctions between in-house virtual bank accounts and real-world bank accounts.
[6400] Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 4.

Third, the Examiner's financial advisors reviewed MTS, Lehman's age-old fixed income trading platform, for potential preferential activity that occurred outside of GCCM. Although Lehman's goal was to move all of Lehman's cash management functions to GCCM,[6401] LBHI continued to fund its affiliates in different ways through a multitude of extraordinarily complex source systems and trading platforms at the time of its bankruptcy.[6402] Lehman created securities known as "trust receipts" in MTS that funded certain affiliate bank accounts tied to that system.[6403] The Examiner's financial advisors reviewed MTS, where appropriate, to identify potential preferential activity.

The identification of cash transfers not in connection with safe-harbored activity was very difficult outside of GCCM, and Daniel J. Fleming, Lehman's former Head of Global Cash and Collateral Management, could not identify all potential sources of funding activity, nor could he identify all the systems used to transfer money between Lehman's 3000-plus bank accounts.[6404] Notwithstanding the scope and diligence of the investigation, the Examiner recognizes that the data available are likely incomplete and

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[6401] Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 3.

[6402] See Section III.B.2.c of this Report, which discusses Lehman's cash management system. GCCM was fully integrated in Europe and partially integrated in the United States. It was not integrated in Asia.

[6403] Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 6; Examiner's Interview of Ada Shek, Nov. 24, 2009, at p. 8. The Examiner has found no evidence that funding through "trust receipts" was improper. The use of trust receipts is discussed in greater detail later in the Report. The LEC for LCPI, which was a primary LBHI Affiliate that utilized trust receipts, would manually allocate the funding associated with trust receipts to the general ledger intercompany funding account between LCPI and LBHI at the end of each month. Examiner's Interview of Ada Shek, Nov. 24, 2009, at pp. 8-9. Moreover, the trade detail in the MTS system labels these transactions as "unsecured intercompany funding." Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010).

[6404] Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 8.

that money moved through Lehman in ways not identified in this Section of the Report. Accordingly, it is possible that potential preferential activity may have occurred outside what is captured by funding and quasi-funding activity in GCCM, and trust receipts in MTS.

(4) Determinations and Assumptions on Section 547(b) Elements

The Examiner determined that it was prudent to focus the preference analysis on LBHI Affiliates that were either insolvent or on the borderline of insolvency, because proof of insolvency at the time any preferential transfer is made is a required element of a preference claim. Only six LBHI Affiliates were insolvent or on the borderline of insolvency for significant portions of the twelve months before their respective filing dates, which is illustrated by the following chart:[6405]

Balance Sheet Solvency for Borderline and Insolvent Debtor Entities
Fiscal Years 2007 and 2008

	CES Aviation	CES Aviation V	CES Aviation IX	LBCS	LBSF	LCPI
	Solvency Determination	Solvency Determination	Solvency Determination	Solvency Determination	Solvency Determination	Solvency Determination
September-07	Borderline	Insolvent	Insolvent	Borderline	Borderline	Borderline
October-07	Borderline	Insolvent	Insolvent	Borderline	Borderline	Borderline
November-07	Borderline	Insolvent	Insolvent	Borderline	Borderline	Borderline
December-07	Borderline	Insolvent	Insolvent	Borderline	Borderline	Borderline
January-08	Borderline	Insolvent	Insolvent	Borderline	Borderline	Borderline
February-08	Borderline	Insolvent	Insolvent	Borderline	Borderline	Insolvent
March-08	Borderline	Insolvent	Insolvent	Borderline	Borderline	Borderline
April-08	Borderline	Insolvent	Insolvent	Borderline	Borderline	Insolvent
May-08	Borderline	Insolvent	Insolvent	Borderline	Borderline	Insolvent
June-08	Borderline	Insolvent	Insolvent	Borderline	Borderline	Insolvent
July-08	Insolvent	Insolvent	Insolvent	Borderline	Borderline	Insolvent
August-08	Insolvent	Insolvent	Insolvent	Borderline	Borderline	Borderline

[6405] See Section III.B.3.c of this Report, which discusses each LBHI Affiliate's solvency during the pre-petition period.

Given the complexity of Lehman's numerous source systems and the substantial cost of analyzing them, the Examiner has determined that it would be prudent to limit the analysis to the period between June 1, 2008 and each debtor's respective filing date,[6406] which is referred to as the "Defined Preference Period." Moreover, because the assets of the aviation entities were relatively insignificant when compared to the other LBHI Affiliates, the Examiner focused the analysis on LBSF, LBCS, and LCPI. As the Examiner also focused his analysis on the Defined Preference Period, this Report does not address colorable preference claims that LBSF, LBCS, and LCPI may have against LBHI in respect of pre-Defined Preference Period transfers.

In light of the Examiner's conclusion that there is insufficient evidence to rebut the presumption of insolvency pursuant to Section 547(g) of the Bankruptcy Code with respect to LOTC and LBCC after September 12, 2008, the Examiner considered conducting a preference analysis with respect to those LBHI Affiliates. The Examiner notes, as the Defined Preference Period for LBSF, LBCS, and LCPI began on June 1, 2008, there was a sufficient universe of potentially preferential transfers to warrant the expenditure of resources to analyze such transfers. Conversely, the applicable period for LOTC and LBCC would only begin after September 12, 2008; thus the universe of

[6406] As discussed in greater detail in Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010), p. 4, there was no "funding" activity recorded in GCCM during October 2008. There was some activity in GCCM relating to quasi-funding in October 2008 that did not exceed $10 million for LBSF and LBCS combined. *Id.* at pp. 13, 16. The Examiner's financial advisors disregarded activity in October 2008 for the purposes of this preference analysis.

potential preferential transfers for LOTC and LBCC would be much smaller and would consist of a type likely to be shielded by the safe harbor provisions of the Bankruptcy Code. At the same time, the cost of conducting such a review for LOTC and LBCC would be material because of the complexity of Lehman's financial reporting systems, the dislocation caused by LBHI's bankruptcy filing on September 15, 2008, and the resulting disruption in Lehman's financial reporting systems. Consequently, the Examiner determined that it would not be a prudent use of resources to conduct a preference analysis for LOTC and LBCC.

The Examiner made the following determinations with respect to certain elements of a Section 547(b) claim (these determinations apply to all preference claims that could be asserted by LBSF, LBCS, and LCPI, as discussed herein). First, the Examiner concludes, in the context of funding, that the transferring LBHI Affiliate had a colorable "interest . . . in [the] property" transferred. This was evidenced by the accounting records[6407] (including virtual account titles in the cash management system[6408]), and the lack of any evidence suggesting that the transferring entity did not have an interest in the property transferred.

Second, LBSF, LBCS, and LCPI had significant antecedent debt obligations to LBHI. This is evidenced by intercompany credit balances with, or obligations to, LBHI

[6407] *E.g.*, *In re Schick*, 234 B.R. at 342-43 (discussing whether funds in debtor's bank account were owned by debtor for purposes of section 541 of the Bankruptcy Code).

[6408] See Section III.B.2.c of this Report, which discusses in-house virtual accounts in GCCM.

on the books and records of LBSF, LBCS, and LCPI. Similarly, the books and records of LBHI reflect debit balances with, or receivables from, LBSF, LBCS, and LCPI. The Examiner has observed no evidence suggesting these intercompany payables to LBHI represented anything other than debt obligations.[6409]

Third, the Examiner concludes that up-funding and quasi-up-funding transactions represented payments "for or on account" of the antecedent debt because the liability on the books and records of LBSF, LBCS, and LCPI was reduced when the transfers were made. Similarly, the receivable on the books and records of LBHI was reduced when the transfers were made.[6410] For the same reason, the Examiner concludes that the payments made by LBSF, LBCS, and LCPI benefited LBHI.[6411]

Furthermore, the Examiner assumed for the purposes of this analysis that LBHI received more from any preferential activity than it would have received under a hypothetical Chapter 7 liquidation. Before making this assumption, however, the Examiner first considered whether all or any part of the debt that was satisfied would have been on account of a secured obligation by virtue of Section 553's preservation of

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[6409] *See, e.g.*, *Celotex Corp. v. Hillsborough Holdings Corp.* (*In re Hillsborough Holdings Corp.*), 176 B.R. 223, 248-50 (M.D. Fla. 1994) (finding that, under the circumstances of the case, the intercompany account payables were debt obligations and not equity investments); *cf. Amdura Corp. v. Ryder Truck Rental, Inc.* (*In re Amdura Corp.*), 151 B.R. 557, 559-60 (Bankr. D. Colo. 1993).

[6410] LCPI, LBSF, and LBCS (as well as the other LBHI Affiliates) had multiple intercompany accounts with LBHI. However, unsecured funding was always recorded in the same intercompany account on the books and records (the account numbers all began with "12620"). Ernst and Young Walkthrough Template (Nov. 30, 2009), at p. 6 [EY-SEC-LBHI-CORP-GAMX-07-033384].

[6411] *See generally Bank of Am. Nat'l Trust & Sav. Assoc. v. 203 N. LaSalle St. P'ship*, 526 U.S. 434 (1999) (discussing "on account of" language in a different context under the Bankruptcy Code).

setoff rights. *Braniff Airways, Inc. v. Exxon Co., U.S.A.*[6412] addressed the concept of "permissible preference[s]" by virtue of Section 506(a) of the Bankruptcy Code, which affords secured status to claims of setoff under Section 553(a).[6413] The Examiner concludes that LBHI does not have an argument that such preferential transfers would be on account of a secured claim by virtue of any setoff right under the rationale of *Braniff Airways*.[6414]

[6412] 814 F.2d 1030 (5th Cir. 1987).

[6413] *Id.* at 1034.

[6414] LBHI's books and records reflect multiple intercompany accounts with its affiliates. Similarly, many of the affiliates' books and records reflect multiple intercompany accounts with LBHI. In many cases, however, the books and records of an affiliate reflect both payables and receivables with LBHI and the books and records of LBHI reflect both payables and receivables with any particular affiliate. The apparent mutuality of obligations raises the question of whether an LBHI Affiliate could prove the hypothetical liquidation analysis under Section 547(b)(5) of the Bankruptcy Code given the secured status of mutual debts under Sections 553 and 506. In other words, if LBHI was indebted to an affiliate for more than the affiliate was indebted to LBHI, the affiliate may not satisfy its Section 547(b)(5) burden because LBHI's right of setoff under Section 553 would have encompassed any preference payment amount had the preference not been made. *See Braniff Airways*, 814 F.2d at 1035; *cf. Brooks Farms v. U.S. Dep't of Agric.* (*In re Brooks Farms*), 70 B.R. 368, 372-73 (Bankr. E.D. Wis. 1987); *In re Revere Copper and Brass, Inc.*, 32 B.R. 577, 583 n.3 (Bankr. S.D.N.Y. 1983). The Examiner reviewed the intercompany account balances on LBHI's books and records against the intercompany account balances on LBSF, LBCS, and LCPI's books and records for August and September 2008. The Examiner also reviewed Schedules B and F from LBHI, LBSF, LBCS, and LCPI's Amended Schedules and Statements, which address *inter alia* intercompany receivables and unsecured intercompany payables, respectively. The schedules for LBCS, LBSF, and LCPI can be found at docket numbers 3061, 3066, and 3067, respectively, and the Amended Schedules for LBCS, LBSF, and LCPI can be found at docket numbers 3939, 3921, and 3927, respectively. As illustrated in Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010) at ex. 1, LBSF, LBCS, and LCPI all owed LBHI significantly more than LBHI owed LBSF, LBCS, or LCPI, respectively, at the end of September 2008. As such, the Examiner has observed no evidence suggesting that LBHI owed LBSF, LBCS, and LCPI more than it was owed on September 15, 2008. Therefore, the Examiner has concluded that LBSF, LBCS, and LCPI will not be precluded from proving a hypothetical liquidation analysis as required by Section 547(b)(5) of the Bankruptcy Code under the rationale of *Braniff Airways*.

(5) Scope of Defenses Under Section 547(c)

The Examiner analyzed the "new value" and "ordinary course" defenses under Sections 547(c)(4) and 547(c)(2) of the Bankruptcy Code, respectively, for funding and quasi-funding activity, where appropriate.[6415]

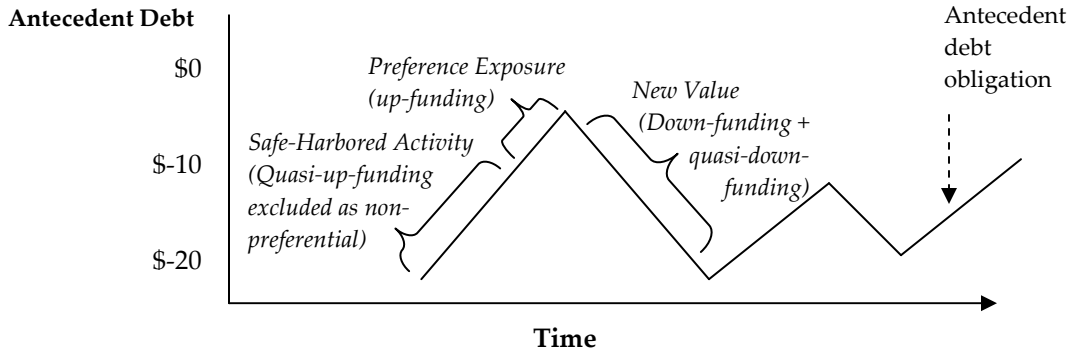
New Value Defense. The new value defense provides that a creditor may deduct from any liability it owes a debtor as a result of a preferential transfer any amount of "new value" that it gave the debtor after the preferential transfer occurred.[6416] For example, if a debtor pays a creditor $100 on day one in respect of an antecedent debt and all other criteria for a preference are satisfied, and on day two, the creditor extends new credit worth $90 that is not subsequently repaid by the debtor, only $10 of the $100 payment is a preference.[6417]

[6415] The Examiner does not address whether LBHI may assert multiple defenses under Section 547(c) of the Bankruptcy Code. *See G.H. Leidenheimer Baking Co. v. Sharp* (*In re SGSM Acquisition Co., LLC*), 439 F.3d 233, 242 n.7 (5th Cir. 2006).

[6416] Section 547(c)(4) provides that "[t]he trustee may not avoid under this section a transfer -- . . . (4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor— (A) not secured by an otherwise unavoidable security interest; and (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor."

[6417] If there were multiple extensions of new value, the Examiner applied the well-established rule that extensions can be applied to any preceding preferential transfer and not just the immediately preceding preferential transfer. *See Williams v. Agama Sys., Inc.* (*In re Micro Innovations Corp.*), 185 F.3d 329, 336-37 (5th Cir. 1999) (discussing the majority and minority rules for "new value," and adopting majority rule, which permits the crediting of new value against any prior preference and not only the immediately preceding one); *see also In re SGSM Acquisition Co., LLC*, 439 F.3d at 241-43; *Katz v. Stark Trust* (*In re Van Dyck/Columbia Printing*), 289 B.R. 304, 315 (D. Conn. 2003); 5 Collier on Bankruptcy ¶ 547.04[4][d] (15th ed. 2008); *cf. In re Adelphia Bus. Solutions, Inc.*, 341 B.R. 415, 426 (Bankr. S.D.N.Y. 2003) (recognizing new value defense in the context of a cash management system).

How quasi-funding will be characterized in relation to the safe harbors, however, appears to be an issue of first impression - that is, whether such funding is safe-harbored, not safe-harbored, or somewhere in-between.[6418] Therefore, the Examiner's financial advisors constructed three models to calculate LBHI's preference exposure net of new value.[6419] First, the Examiner's financial advisors calculated LBHI's preference exposure solely by considering up-funding activity as preferential and down-funding activity as new value. Second, the Examiner's financial advisors calculated LBHI's preference exposure by considering only up-funding activity as preferential, but gave LBHI new value credit for both down-funding and quasi-down-funding activity. The following chart illustrates this calculation:

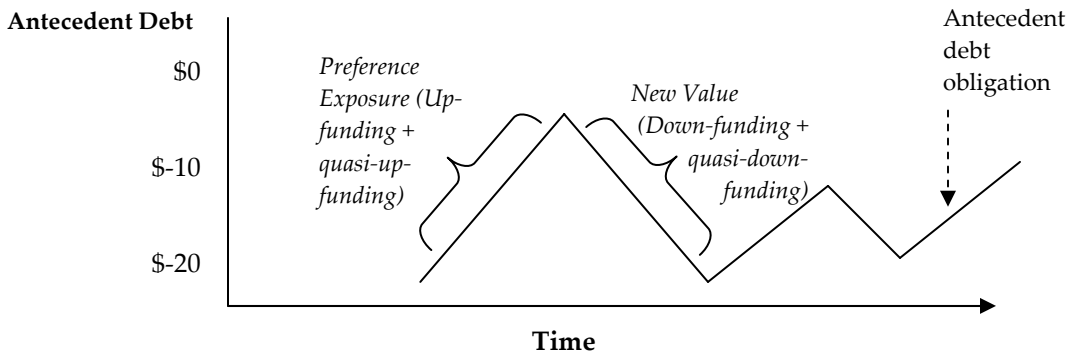


Third, the Examiner's financial advisors calculated LBHI's preference exposure by considering up-funding and quasi-up-funding as preferential, but gave LBHI new

[6418] Each day there were many quasi-funding transactions between LBHI and LBSF, LBCS and LCPI. For the purposes of this analysis, however, the Examiner grouped them all together, even though each one is potentially unique.

[6419] These are referred to as models one, two, and three in Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010).

value credit for both down-funding and quasi-down-funding activity. The following illustrates this calculation:



Ordinary Course Defense. The ordinary course defense permits creditors to argue that debts were incurred in the ordinary course and payments on account of those debts were made in the ordinary course of business between the parties.[6420] The

[6420] Section 547(c)(2) provides that "[t]he trustee may not avoid under this section a transfer -- . . . (2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was— (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or (B) made according to ordinary business terms." 11 U.S.C. § 547(c)(2). The Examiner addressed subsection 547(c)(2)(A) and not subsection (B), which discusses whether the payments were "made according to ordinary business terms."

The purpose of section 547(c)(2) "is to leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy." *Savage & Assocs., P.C. ex rel. Teligent, Inc. v. Mandl* (*In re Teligent, Inc.*), 380 B.R. 324, 340 (Bankr. S.D.N.Y. 2008) (quoting H.R. Rep. No. 95-595, at 373 (1977)). In determining whether the debt was incurred in the ordinary course of business, the court will look to other transactions between the parties. *Jacobs v. Matrix Cap. Bank* (*In re AppOnline.com, Inc.*), 315 B.R. 259, 283 (Bankr. E.D.N.Y. 2004). "In determining whether a transfer is made in the ordinary course of business, a court may consider (i) the prior course of dealing between the parties, (ii) the amount of the payment, (iii) the timing of the payment, (iv) the circumstances of the payment, (v) the presence of unusual debt collection practices, and (vi) changes in the means of payment." *In re Teligent*, 380 B.R. at 340. "[T]he cornerstone of this element of a preference defense is that the creditor needs [to] demonstrate some consistency with other business transactions between the debtor and the creditor." *In re Schick*, 234 B.R. at 348 (quoting *WJM, Inc. v. Mass. Dep't of Pub. Welfare*, 840 F.2d 996, 1011 (1st Cir. 1988)) (alteration in original). "The creditor must establish a 'baseline of dealings' to

Examiner has not located any authority that discusses ordinary course defenses in preference actions asserted by debtor-affiliates against their debtor-parents in the context of complex cash management systems, which is the primary source of potential preferential activity here.[6421] Nonetheless, repeated transfers made to a debtor's corporate parent on account of an antecedent debt that resulted from continual extensions of credit for operating purposes have been upheld as unavoidable ordinary course transfers in other cases.[6422]

(6) Findings for LBSF

The following chart illustrates LBHI's preference exposure to LBSF during the Defined Preference Period:

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enable the court to compare the payment practices during the preference period with the prior course of dealing." *Id.*

[6421] *Cf. In re Adelphia Bus. Solutions, Inc.*, 341 B.R. at 426 (recognizing ordinary course defense in the context of a cash management system); *In re Hillsborough Holdings Corp.*, 176 B.R. at 247-50 (recognizing ordinary course defense in context of piercing the corporate veil when parent swept cash from subsidiaries).

[6422] *E.g.*, *Waldschmidt v. Ranier* (*In re Fulghum Constr. Corp.*), 872 F.2d 739 (6th Cir. 1989) (upholding ordinary course defense when debtor made repeated payments to parent-partnership to reduce antecedent debt obligation that was created by more than 100 extensions of credit for various purposes including operating expenses); *CCI Constr. Inc. v. Allfirst Bank (In re CCI Constr. Co.)*, 371 B.R. 83 (Bankr. M.D. Pa. 2007) (discussing ordinary course defense in context of revolving unsecured cash management facility with bank lender); *Redmond v. Ellis County Abstract & Title Co.* (*In re Liberty Livestock Co.*), 198 B.R. 365 (Bankr. D. Kan. 1996) (discussing ordinary course and new value defenses on running account balance between related companies).

Preferential Activity	Preference Exposure without New Value during the Defined Preference Period	Preference Exposure Net of New Value during the Defined Preference Period	
		Down-funding New Value Only	Down-funding and Quasi-down-funding New Value
Up-funding Only	$19.4 billion	$3.8 billion	$636 million
Up-funding and Quasi-up-funding	$29.4 billion	n/a	$718 million

In addition, there is evidence supporting LBHI's ordinary course defense. In short, there is evidence to support each element of a preference claim, but there is also evidence to support each element of the new value and ordinary course defenses.[6423]

Discussion of Preferential Transfers. On June 1, 2008, LBSF had an antecedent debt owed to LBHI of approximately $7.5 billion.[6424] The intercompany accounts between LBSF and LBHI experienced significant activity after that day. The intercompany account activity resulted from funding and quasi-funding activity that

[6423] See Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010) for a detailed and lengthy discussion of the models developed, methodologies used, and assumptions made in reaching these calculations.

[6424] As illustrated in Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010) at ex. 2, LBHI and LBSF had multiple intercompany accounts. Not every intercompany account was used for funding activities - that is, some accounts represented repo or derivative liabilities or receivables, and they were generally in connection with safe-harbored activity. The $7.5 billion obligation noted above was derived from the sum of the intercompany obligations based on the two accounts in the general ledger that were used for funding and quasi-funding activities in GCCM. One account was between LBHI-New York and LBSF, and the other account was between LBHI (UK) and LBSF. If the other intercompany accounts between LBSF and LBHI were included, the obligation would be larger. Inclusion of the other accounts was unnecessary for the preference analysis, however, because the total dollar amount of every potential preferential transfer was less than the outstanding liability from the sum of these two funding accounts on the day each transfer was made.

was observed in GCCM.[6425] The Examiner has observed nothing suggesting that up-funding was related to trades, repos, or similar activity, and the Examiner understands that it was performed on an unsecured basis for the purpose of concentrating cash at LBHI. During the Defined Preference Period, there was $19.4 billion and $10.1 billion in up-funding and quasi-up-funding activity, respectively.[6426] Together, this amounts to $29.4 billion in potentially preferential activity.

New Value Defense. LBHI's new value defense captures the majority of LBSF's preference claim. The Examiner's financial advisors calculated LBHI's new value defense in three ways as noted above. First, the Examiner's financial advisors calculated LBHI's preference exposure solely by considering up-funding activity as preferential and down-funding activity as new value. LBHI's exposure to LBSF during the Defined Preference Period under this calculation is $3.8 billion.[6427] Second, the Examiner's financial advisors calculated LBHI's preference exposure by considering up-funding activity as preferential, but gave LBHI new value credit for both down-funding and quasi-down-funding activity. LBHI's exposure to LBSF during the Defined

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[6425] Daniel J. Fleming noted that "funding" activity for LBSF occurred in an LBI bank account in which LBSF was clearing its derivative payment activity from RISC, another Lehman trading platform (it is unclear whether LBHI or LBHI (UK) provided the funds for this account). This "funding" activity would not be captured in the "funding" column because LBSF did not own the account into and from which the money was transferred. Nonetheless, Fleming noted that this activity was likely captured in the quasi-funding activity column. As for LBSF generally, Fleming noted that "funding" activity may have occurred in other regions, but he could not identify how it may have been captured by Lehman's systems. Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 8.

[6426] Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010).

[6427] *Id.*

Preference Period under this calculation is $636 million.[6428] Third, the Examiner's financial advisors calculated LBHI's preference exposure by considering up-funding and quasi-up-funding as preferential, but gave LBHI new value credit for both down-funding and quasi-down-funding activity. LBHI's exposure to LBSF during the Defined Preference Period under this calculation is $718 million.[6429]

Ordinary Course Defense. There is evidence for LBHI to assert an ordinary course defense even if the new value defense does not preclude recovery.

Based on LBHI and LBSF's books and records, the debts incurred by LBSF appear to be in the ordinary course of business between LBHI and LBSF. There is consistent funding activity between LBHI and LBSF during the two years prior to LBSF's bankruptcy. During the year prior to bankruptcy, the number of down-funding transactions ranged from thirty-two to sixty-three per month, and during the two years prior to bankruptcy, the number of down-funding transactions ranged from seven to sixty-three per month.[6430] Such down-funding activity is consistent with LBHI's role as central banker within the Lehman enterprise. Similarly, there is consistent quasi-down-

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[6428] *Id.*

[6429] *Id.* LBHI's preference exposure to LBSF under the second and third calculations resulted from up-funding that occurred at the end of the day on September 12, 2008. Although such a potential preference may not be covered under the new value defense, this fact pattern is similar to that described in *In re Fulghum Constr. Corp.* 872 F.2d 739, which addressed this issue under the ordinary course defense.

[6430] Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010) at exs. 18-21. The low number of funding transactions (either up- or down-funding) prior to May 2007 is consistent with the Examiner's understanding that GCCM was in the implementation phases.

funding activity.[6431] The Examiner has observed no evidence suggesting that down-funding or quasi-down-funding was not in the ordinary course of business between LBHI and LBSF.

Similarly, the Examiner has reviewed the non-exhaustive factors courts use when determining whether payments made on account of an antecedent debt are in the ordinary course of business between the debtor and the transferee.[6432] Upon review of those factors, there is evidence to support LBHI's defense. As a threshold matter, former Lehman employees stated that it was Lehman's goal to up-fund each affiliate's bank account to $0.00 at the end of each day,[6433] which is not inconsistent with the books and records. The Examiner and his financial advisors reviewed funding activity dating back to June 2006; funding activity (both up- and down-funding) regularly occurred in significant amounts in every month before LBSF's bankruptcy.[6434] The Examiner has not identified anything in the Defined Preference Period that deviated from this historical practice. Finally, the Examiner has observed no evidence that LBSF's potentially preferential transfers were made in anticipation of bankruptcy, or that they were done because of unusual debt practices by LBHI. In short, there is evidence to support a

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[6431] Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010) at ex. 1.

[6432] The Examiner has not reviewed the alternative grounds for relief under Section 547(c)(2)(B), namely whether the purported preference payments were "made according to ordinary business terms."

[6433] Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 2. The notable exception to this practice was with LBI.

[6434] Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010) at exs. 18-20.

finding that such activity was "recurring, customary, and designed" to facilitate LBSF's business.[6435] The Examiner has therefore determined that there is evidence for LBHI to assert a defense under Section 547(c)(2) of the Bankruptcy Code. Any conclusion would be determined by a trier of fact.

(7) Findings for LBCS

The following chart illustrates LBHI's preference exposure to LBCS during the Defined Preference Period:

Preferential Activity	Preference Exposure without New Value during the Defined Preference Period	Preference Exposure Net of New Value during the Defined Preference Period	
		Down-funding New Value Only	Down-funding and Quasi-down-funding New Value
Up-funding Only	$3.3 billion	$643 million	$15 million
Up-funding and Quasi-up-funding	$4.3 billion	n/a	$633 million

In addition, there is evidence supporting LBHI's ordinary course defense. In short, there is evidence to support each element of a preference claim, but there is also evidence to support each element of the new value and ordinary course defenses.[6436]

Discussion of Preferential Transfers. On June 1, 2008, LBCS had an antecedent debt owed to LBHI of approximately $2.2 billion.[6437] The intercompany accounts

[6435] *In re Fulghum Constr. Corp.*, 872 F.2d at 745.

[6436] See Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010) for a detailed and lengthy discussion of the models developed, methodologies used, and assumptions made in reaching these calculations.

between LBCS and LBHI experienced significant activity after that day. The intercompany account activity resulted from funding and quasi-funding activity that was observed in GCCM. The Examiner has observed nothing to suggest that up-funding was related to trades, repos, or similar activity, and evidence suggests that it was performed on an unsecured basis for the purpose of concentrating cash at LBHI. During the Defined Preference Period, there was $3.3 billion and $1.0 billion in up-funding and quasi-up-funding activity, respectively.[6438] Together, there was $4.3 billion in potentially preferential activity.

New Value Defense. LBHI's new value defense captures the majority of the amount of LBCS's preference claim. The Examiner's financial advisors calculated LBHI's new value defense in three ways as noted above. First, the Examiner's financial advisors calculated LBHI's preference exposure solely by considering up-funding activity as preferential and down-funding activity as new value. LBHI's liability to

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[6437] As illustrated in Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010) at ex. 1, LBCS and LBHI had multiple intercompany accounts. Not every intercompany account was used for funding activities - that is, some accounts represented repo or derivative liabilities or receivables, and they were generally in connection with safe-harbored activity. The $2.2 billion obligation noted above was derived from the sum of the intercompany obligations based on the two accounts in the general ledger that were used for funding and quasi-funding activities in GCCM. If the other intercompany accounts between LBCS and LBHI were included, the obligation would be larger. Inclusion of the other accounts was unnecessary for the preference analysis, however, because the total dollar amount of every potential preferential transfer was less than the outstanding liability from the sum of these two funding accounts on the day each transfer was made.

[6438] Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010), at ex. 6.

LBCS during the Defined Preference Period under this calculation is $642 million.[6439] Second, the Examiner's financial advisors calculated LBHI's preference exposure by considering up-funding activity as preferential, but gave LBHI new value credit for both down-funding and quasi-down-funding activity. LBHI's exposure to LBCS during the Defined Preference Period under this calculation is $15 million.[6440] Third, the Examiner's financial advisors calculated LBHI's preference exposure by considering up-funding and quasi-up-funding as preferential, but gave LBHI new value credit for both down-funding and quasi-down-funding activity. LBHI's exposure to LBCS during the Defined Preference Period under this calculation is $633 million.[6441]

Ordinary Course Defense. There is evidence for LBHI to assert an ordinary course defense in the event that the new value defense does not preclude recovery.

Based on LBHI and LBCS's books and records, the debts incurred by LBCS appear to be in the ordinary course of business between LBHI and LBCS. There is consistent funding activity between LBHI and LBCS during the sixteen months prior to LBCS's bankruptcy. During the sixteen months prior to bankruptcy, the number of down-funding transactions ranged from nine to thirty-seven per month.[6442] This down-funding activity is consistent with LBHI's role as central banker within the Lehman

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[6439] *Id.*

[6440] *Id.*

[6441] *Id.*

[6442] *Id.* at exhs. 9-11. The low number of funding transactions (either up- or down-funding) prior to May 2007 is consistent with the Examiner's understanding that GCCM was in the implementation phases.

enterprise. Similarly, there is consistent quasi-down-funding, although such activity was less frequent before February 2008.[6443] The Examiner has observed no evidence suggesting that down-funding or quasi-down-funding was not in the ordinary course of business between LBHI and LBCS.

Similarly, the Examiner has reviewed the non-exhaustive factors courts use when determining whether payments made on account of an antecedent debt are in the ordinary course of business between the debtor and the transferee.[6444] Upon a review of those factors, there is evidence to support LBHI's ordinary course defense. As a threshold matter, former Lehman employees stated that it was Lehman's goal to up-fund each affiliate's bank account to $0.00 at the end of each day,[6445] which is not inconsistent with the books and records. The Examiner reviewed funding activity dating back to April 2007; funding activity (both up- and down-funding) regularly occurred in every month before LBCS's bankruptcy. The Examiner has not identified anything in the Defined Preference Period that deviated from this historical practice. The Examiner does note, however, that quasi-up-funding exceeds quasi-down-funding

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[6443] Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010) at ex. 12. The low number of quasi-funding transactions (either up- or down-quasi-funding) prior to February 2008 is consistent with the Examiner's understanding that GCCM was in the implementation phases.

[6444] The Examiner has not reviewed the alternative grounds for relief under Section 547(c)(2)(B), which is whether the purported preference payments were "made according to ordinary business terms."

[6445] Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 2. The notable exception to this practice was with LBI.

for the first time in August 2008, which deviates from the prior months.[6446] Finally, the Examiner has observed no evidence that LBCS's potentially preferential transfers were made in anticipation of bankruptcy, or that they were done because of unusual debt practices by LBHI. In short, there is evidence to support a finding that such activity was "recurring, customary, and designed" to facilitate LBCS's business.[6447] The Examiner thus determines that there is evidence for LBHI to assert a defense under Section 547(c)(2) of the Bankruptcy Code. Any conclusion would be determined by a trier of fact.

(8) Findings for LCPI

The Examiner has been unable to determine whether there is evidence to support a finding for each element of a preference claim under Section 547(b) of the Bankruptcy Code in an action by LCPI against LBHI because the Examiner's financial advisors have been unable to trace the material movement of money between LCPI and LBHI that was not in connection with a safe-harbored event.

Discussion of Preferential Activity. On June 1, 2008, LCPI had an antecedent debt of at least $35.2 billion to LBHI,[6448] and there was significant activity in the

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[6446] Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010) at ex. 22.

[6447] *In re Fulghum Constr. Corp.*, 872 F.2d at 745.

[6448] As illustrated in Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010) ex. 3, LCPI and LBHI had multiple intercompany accounts. Not every intercompany account was used for funding activities - that is, some accounts represented repo or derivative liabilities or receivables. The $35.2 billion obligation noted above was derived from the sum of the intercompany obligations based on the two accounts in the general ledger that were used for funding and quasi-funding

intercompany accounts between LCPI and LBHI after that day. Similar to LBSF and LBCS, the Examiner attempted to identify funding and quasi-funding activity as the primary source of potential preferential activity. However, identifying and analyzing potential preferential activity for LCPI proved considerably more complicated than for LBSF and LBCS. Consequently, the Examiner has been unable to identify and analyze all potential sources of preferential activity.

As a threshold matter, LCPI's main operating account was not tied to GCCM, and therefore, there was no "funding" activity in GCCM during the Defined Preference Period. There was, however, significant "quasi-funding" activity flowing through GCCM, which primarily came from a source system called Loan IQ.[6449] The Examiner concludes not to include quasi-funding activity in the preference analysis for LCPI, however, because payments flowing from Loan IQ through GCCM consisted of principal and interest payments, among other things, on loans in which LCPI had a nominal interest. Moreover, other quasi-funding activity was *de minimis* when compared to the other sources of potential preferential activity the Examiner identified. Unlike LBSF and LBCS, the Examiner looked beyond GCCM and focused on two specific sources of potential preferential activity: transfers made on account of trust

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activities. Examiner's Interview of Ada Shek, Nov. 24, 2009, at pp. 8-9. One account was between LBHI-New York and LCPI, and the other account was between LBHI (UK) and LCPI. If the other intercompany accounts between LCPI and LBHI were included, the obligation would be larger.

[6449] Loan IQ "is a fully integrated global, multi-currency system for the processing and administration of the commercial bank loan product." Lehman, GTS: Operations Technology - Loan IQ Homepage on Lehman Live, at p. 1 [LBEX-LL 3356457].

receipts in the MTS trading system, and payments made to LBHI resulting from capital infusions made into LCPI by LBI.

Trust Receipts. As noted in Section III.B.2.c of this Report, prior to 2002, Lehman's infrastructure for cash management was decentralized and fragmented.[6450] There were numerous systems used to transfer and manage cash,[6451] and this fragmentation was a driving factor behind the creation of GCCM. At the time of LBHI's bankruptcy, however, GCCM was only partially integrated, and the implementation process was rolled-out by source system or trading platform. MTS, one of Lehman's primary trading platforms used primarily for domestic fixed-income securities, was not integrated into GCCM. MTS was an antiquated trading platform[6452] and its functionality was limited to buys, sells, repos, reverse repos, borrowings, and pledgings.[6453] MTS did not have payment functionality, and unlike some of Lehman's other trading platforms that settled transactions through GCCM, settlements from MTS flowed through FPS, an entirely separate payment and settlement system.

Because MTS was outdated, Lehman used "trust receipts," which were dummy securities created in MTS, to fund certain bank accounts that were tied to MTS.[6454] Trust

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[6450] Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 3.
[6451] *Id.*
[6452] MTS was used by Lehman before it merged with Shearson in 1984. *Id.* at 6.
[6453] *Id.*
[6454] *Id.* at p. 7.

receipts were used to overcome MTS's limited functionality as a trading system,[6455] and the Examiner has discovered no evidence suggesting that their use was for an improper purpose. Trust receipts had different security names or IDs, which were used for different funding and recordation purposes, and some examples include "Trust 01," "Trust 15," or "Trust 24."[6456] During the Defined Preference Period, LCPI primarily used "Trust 86" and "Trust 89."

Historically, LCPI's main operating account was resident in MTS, although LCPI opened accounts on other systems over time.[6457] Therefore, the Examiner understands that to move cash between LBHI and LCPI, a "funding" transaction needed to be executed in MTS. Because MTS had limited functionality, however, Lehman used the repo and reverse repo functions. The Examiner has discovered no evidence suggesting that anyone at Lehman considered trust receipts to be repos or reverse repos, and all evidence points to the contrary. The Examiner understands that settlements from the MTS system into LCPI's bank account occurred through the FPS settlement system.[6458] This process is roughly equivalent to the funding functions that existed in GCCM.

The Examiner's financial advisors identified all Trust 86 and Trust 89 activity in MTS during the Defined Preference Period and have performed an analysis on such

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[6455] *Id.* at p. 6.

[6456] Lehman used more than a hundred different trust receipts and eventually started recycling them. *Id.* at p. 6 n.2.

[6457] *Id.* at p. 7.

[6458] The transaction was also booked in Treasury Workstation, a software platform utilized by Lehman's Treasury Group.

activity, which is discussed in considerable detail in the attached appendix.[6459] The Examiner's financial advisors reviewed data in GCCM (for LBHI cash receipt information, even though MTS and GCCM were not tied together), GSSR (Lehman's bank account reconciliation software that showed bank account transactions), Treasury Workstation (a suite of applications utilized by Lehman Treasury Group for various funding functions), and MTS (Lehman's fixed income trading system). The Examiner's financial advisors attempted to trace the movement of money and to identify the purpose associated with trust receipts used by LCPI. To complete this task, access to certain FPS data, which contained settlement and payment data for MTS, as well as certain "pre-settlement" data, is required because this information is understood to contain netting information before transfer instructions were created between LCPI and LBHI bank accounts. Barclays would not grant the Examiner's financial advisors access to FPS because the Examiner understands that Barclays could not adequately segregate Lehman legacy data.[6460] The Examiner's financial advisors have further advised that a review of the "pre-settlement" data could potentially require a lengthy and costly investigation. Accordingly, the Examiner cannot make a determination about whether LCPI has a colorable preference claim against LBHI on account of trust receipts.

[6459] Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010) at pp. 18-22.

[6460] Appendix 6, Duff & Phelps, Data Systems Access (Feb. 1, 2010), at p. 33.

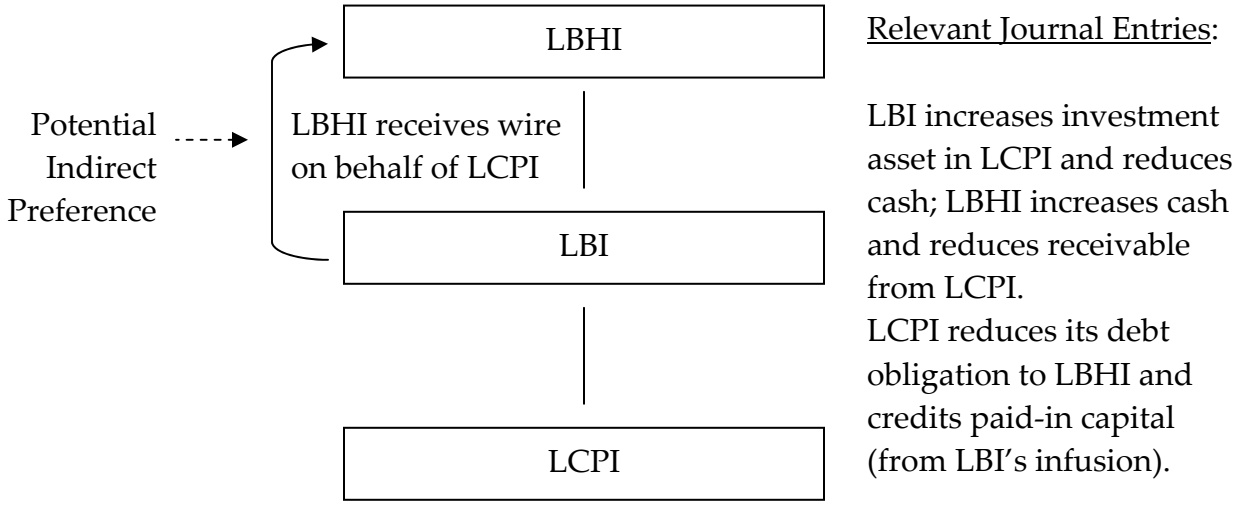
LCPI Capital Infusions. As noted above, LCPI received multiple capital infusions from LBI, its parent, over the course of the several months prior to its bankruptcy filing.[6461] Generally, when a company receives a capital infusion it records an asset (in many instances cash) and paid-in capital on its books and records. When LBI infused capital into LCPI, however, LCPI never received an asset on its books and records because the individuals instructing the transfer indicated that LCPI did not have a bank account to receive LBI's infusion.[6462] Instead, LBI transferred the cash in respect of the capital infusion to LBHI, which received the cash on LCPI's behalf.[6463] Because LCPI had a significant intercompany obligation to LBHI, the transfer from LBI to LBHI was recorded as satisfying part of that obligation in the amount of the capital infusion.[6464] The following illustrates the flow of cash and journal entries:

[6461] See Section III.B.3.c.3.a, which discusses capital infusions.

[6462] E-mail from Jeffrey Su, Lehman, to Arthur Miller, Lehman, *et al*., (May 30, 2008), at p. 1 [LBEX-DOCID 276482]; e-mail from Hui Wang, Lehman, to Helen Chu, *et al*., Lehman (Aug., 28, 2008), at p. 1 [LBHI_SEC07940_552712]. It was confirmed on multiple occasions, however, that LCPI did have its own bank accounts. Examiner's Interview of Daniel F. Fleming, Dec. 17, 2009, at p. 8. LCPI's schedules that were filed with the U.S. Bankruptcy Court also confirm that LCPI had bank accounts. *See* Amended Schedules of Assets and Liabilities for Lehman Commercial Paper Inc., *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. June 15, 2009).

[6463] Daniel J. Fleming noted that if LCPI had received the cash it would have eventually up-funded to LBHI anyway. In other words, he noted that it did not matter if LCPI or LBHI received the money because LBHI would eventually receive the money at the end of the day. Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 8.

[6464] *See* E-mail from Hui Wang, Lehman, to Helen Chu Lehman, *et al*., (Aug. 28, 2008), at pp. 1-2 [LBHI_SEC07940_552712].



There were two capital infusions during the Defined Preference Period: one in July 2008 for $275 million and one in August 2008 for $900 million.[6465] The Examiner has located internal e-mails relating to the $900 million infusion.[6466] The $900 million transfer could represent an indirect preference even if LCPI never had the infused cash in its bank account because the transfer reduced LCPI's antecedent debt owed to LBHI.[6467]

Although the Examiner Order did not direct the Examiner to analyze potential defenses to claims, it is important to note that money flowed between LCPI and LBHI (and between LBI and LBHI) in significant amounts on an almost daily basis through

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[6465] As noted above, these amounts were determined by noting the change in Additional-Paid-In-Capital as reported in Lehman's Hyperion financial system.

[6466] The Examiner located documentation for the May 2008 capital infusion but it was outside the Defined Preference Period. *See* E-mail from Jeffrey Su, Lehman, to Arthur Miller, Lehman, *et al*., (May 30, 2008), at p. 1 [LBEX-DOCID 276482].

[6467] *E.g., Warsco v. Preferred Technical Group*, 258 F.3d 557, 564 (7th Cir. 2001) ("As the explicit language of the Bankruptcy Code makes clear, however, the transfer need not be made directly by the debtor; indirect transfers made by third parities to a creditor on behalf of the debtor may also be avoidable under the Code." (citing *Dean v. Davis*, 242 U.S. 438, 443 (1917) ("Mere circuity of arrangement will not save a transfer which effects a preference from being invalid as such.")).

trust receipts and potentially other means. For example, $900 million was a common dollar amount for transfers between affiliates, and the Examiner's financial advisors identified at least three $900 million payments from LBI to LBHI on August 28, 2008.[6468] The Examiner's financial advisors also identified two transfers from LCPI to LBHI on August 29, 2008 (one was for $900 million and one was for $104 million).[6469] As such, the $900 million potential indirect preference is likely one in a very large series of transfers between LCPI and LBHI (and between LBI and LBHI). This makes analyses of new value and ordinary course defenses very relevant for purposes of determining the benefit of a claim to recover these transfers. Because the costs of performing this accounting would be substantial, the Examiner did not trace the movement of cash associated with trust receipts (nor has it been confirmed whether the $900 million potential preference is mutually exclusive of transfers occurring through the use of trust receipts) or perform the other accounting necessary to conclude a new value or ordinary course analysis under Sections 547(c)(2) or (4) with respect to these transfers.[6470]

[6468] *See* Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010) , at ex. 25.

[6469] *Id*. The $900 million transfer from LCPI to LBHI was between different bank accounts than those identified on the e-mails instructing the wire transfers.

[6470] As discussed in Section III.B.3.c.3 of this Report, the Examiner concluded that the August 2008 capital infusion was sufficient to render LCPI solvent. Indeed, members of Lehman's LEC group would meet regularly to predict the amount of capital that LCPI and other entities needed. Examiner's Interview of Ada Shek, Nov. 24, 2009, at p. 7. The May and July 2008 infusions were insufficient to establish solvency, but in August 2008 infusion was sufficient. The Examiner concluded, however, that the August 2008 capital infusion was sufficient to render LCPI "borderline" solvent, such that its ratio of equity to assets was 0.4%. The Examiner has not, however, obtained sufficient and reliable post-August 2008 information to make a determination as to LCPI's solvency after August 31, 2008. Thus, the Examiner recognizes that

f) Preferences Against Non-LBHI Lehman Affiliates (Fourth Bullet)

As with the previous Section discussing insider preferences against LBHI, the Examiner identified LBSF, LBCS and LCPI as those LBHI Affiliates that were insolvent or on the borderline of insolvency beginning on June 1, 2008. There is a significantly larger population of potential intercompany relationships from which potential preferences could be identified, however. Although LBSF, LBCS and LCPI did not maintain extensive intercompany accounts with each affiliate, the list of potential intercompany relationships is extensive.

The approach for identifying non-LBHI preferences was similar to that with LBHI, as discussed above, but LBHI Affiliates generally did not provide funding to each other.[6471] This created problems in identifying potential preferences that were not in connection with safe-harbored activity. To be sure, the Examiner's financial advisors reviewed GCCM and confirmed that no "funding" activity for LBSF, LBCS, and LCPI was located in that system. Fleming did note, however, that LCPI may have funded some of its subsidiaries through MTS, and there was significant trust receipt activity

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all post-August 2008 transfers may be subject to an extensive solvency determination by a trier of fact. *See, e.g., Matson v. Strickland* (*In re Strickland*), 230 B.R. 276, 283 (Bankr. E.D. Va. 1999) (noting that "[e]vidence of insolvency on the date of the alleged preference is the critical issue and proof of insolvency on any other date is insufficient"). Because the Examiner has observed that Lehman may have over-marked some of its assets, the Examiner included post-infusion transfers within the preference analysis and makes no distinction between transfers made while LCPI was "insolvent" or while it was "borderline" solvent.

[6471] Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 2. Funding activities, as described under the section addressing insider preferences against LBHI, were the primary source of interest for insider preferences because most activity at Lehman was in respect of safe-harbored activity. See Section III.B.3.e of this Report, which discusses the rationale for identifying funding activities.

involving LCPI with both LBHI and other affiliates.[6472] The Examiner's financial advisors identified every counterparty for trust receipts involving LCPI and other Lehman entities during the Defined Preference Period, which can be found in the attached appendix.[6473]

The Examiner's financial advisors attempted to trace the movement of cash associated with trust receipts between LCPI and LBHI. The Examiner's financial advisors primarily reviewed GCCM, GSSR, Treasury Workstation, and MTS. The Examiner did not have access to certain FPS data, which would purportedly contain the settlement and payment data for MTS. As explained above, the Examiner received data regarding Lehman's "pre-settlement" function very late in the investigation and has not reviewed such data for these purposes.

g) Avoidance Analysis of LBHI and LBHI Affiliates Against Financial Participants and Pre-Chapter 11 Lenders (Fourth and Eighth Bullets)

(1) Summary

This Section of the Report addresses: (1) the fourth bullet of the Examiner Order, regarding whether any LBHI Affiliate has colorable claims against LBHI or any other entities for potentially voidable transfers or incurrences of debt; and (2) the eighth bullet of the Examiner Order, which covers "the transactions and transfers, including but not

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[6472] See Section III.B.3.e.8 of this Report, which discusses trust receipt activity and how it was the result of a software limitation in MTS.

[6473] Appendix 22, Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010), at ex. 26.

limited to the pledging or granting of collateral security interest among the debtor and the pre-Chapter 11 lenders and/or financial participants including but not limited to, JPMorgan Chase, Citigroup, Inc., Bank of America, the Federal Reserve Bank of New York and others."[6474] The Examiner has consulted with the parties in interest, reviewed issues identified by those parties, conducted his own independent review and examination and exercised his discretion as to which issues to include in this analysis.

First, with respect to the fourth bullet, the Examiner has not identified any LBHI Affiliate that has a colorable claim against LBHI under Sections 548 or 544 and state law for potentially voidable transfers or incurrences of debt. Because of the magnitude of the data and the costs involved in reviewing every transfer that occurred during the applicable look-back periods, the Examiner and his financial advisors developed a set of criteria designed to pull suspect transfers from the information contained in Lehman's APB trading database ("APB"). The APB contains over five terabytes of data. The Examiner's financial advisors applied their methodology to determine whether any trades or other activity could potentially be avoidable as against an identified group of counterparties. Upon review of that analysis, the Examiner did not find any colorable claims belonging to an LBHI Affiliate or LBHI. The Examiner did, however, identify trades involving thirty-seven securities that belonged to LBI that warranted further investigation and has provided that information to the SIPA Trustee. The Examiner

[6474] A complete discussion of Lehman's dealings with pre-Chapter 11 lenders and/or financial participants and potential colorable state law claims against them is discussed in Section III.A.5 of this Report.

concluded that further analysis of data in the APB would not be cost-effective. The Examiner also sought to test his review of the Debtors' transfers by examining cash disbursements identified on the Debtors' Statement of Financial Affairs ("SOFA"). The Examiner was not able to complete his analysis because the Debtors have been unable to provide the back-up data for these transfers in the time-frame necessary to allow the Examiner to reach conclusions about the transfers identified on the SOFA.

Second, with respect to the eighth bullet, the Examiner reviewed various guaranties entered into by LBHI shortly before its bankruptcy filing and transfers of collateral in connection with those guaranties and concludes that there are colorable claims against JPMorgan and Citi to avoid the guaranties that they received from LBHI and certain related transfers under Sections 547(b), 548 and 544 and state law. The Examiner believes that such claims are subject to substantial defenses including, but not limited to, that the transfers of collateral to JPMorgan or Citi are protected from avoidance based upon the safe-harbor provisions of the Bankruptcy Code. The Examiner finds insufficient evidence to support the existence of colorable claims against FRBNY, BNYM, HSBC and the CME Group ("CME"). The Examiner elected not to examine the BofA transactions for purposes of determining whether colorable claims exist with respect to these transactions due to the fact that these transactions are the subject of ongoing litigation. The Examiner was unable to reach a conclusion with respect to a $200 million collateral transfer to Standard Bank because of the lack of

information showing whether a Lehman Chapter 11 Debtor was the source of this collateral transfer.[6475]

(2) APB Analysis

Lehman kept systematic records of trades in its APB database, which consolidated trade records from multiple Lehman trading systems. The APB database is extensive and it contains over five terabytes of data.[6476] When the Examiner's financial advisors obtained access to the database, the scope of information that the database contained was unclear. The Examiner's objective was to identify patterns of trading behavior, trades of interest or other activity after August 1, 2008 that warranted further investigation, such as trades with indicia of actual fraud under Section 548(a)(1)(A) or other potentially avoidable activity. The Examiner's financial advisors' methodology is described in detail in Appendix 23, Duff & Phelps, Analysis of APB, Journal Entry, Cash Disbursement and JPMorgan Collateral (Feb. 1, 2010).

The Examiner first identified a population of trading counterparties consisting of large banks and clearing houses, potentially related parties, and counterparties trading

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[6475] The Examiner notes that claims analyzed herein arising under Sections 547(b), 548 and 544 and state law are dependent upon an analysis of Lehman's financial condition as of the time of these transfers. Because the Examiner was directed only to determine if these claims were colorable, the Examiner's financial advisors have limited their analysis to a determination as to whether evidence exists to support a finding of the requisite financial condition.

[6476] Appendix 23, Duff & Phelps, Analysis of APB, Journal Entry, Cash Disbursement and JPMorgan Collateral (Feb. 1, 2010).

in illiquid assets.[6477] The Examiner's financial advisors then applied two selection methodologies. First, the Examiner's financial advisors excluded all non-principal trades, Level 1 and most Level 2 assets, and trades involving exchange-listed assets. This yielded 30,000 trades for further review. Second, the Examiner's financial advisors identified trades involving either (1) asset-backed securities, (2) non-investment grade debt securities, or (3) Lehman's own debt or equity securities as being the most appropriate to review. Further, the Examiner's financial advisors scrutinized individual transactions exceeding $50 million regardless of these criteria and generally included such trades for subsequent testing. This yielded 5,100 trades for further review.

After this population of trades was identified, the Examiner's financial advisors classified the trades by counterparty; this analysis is discussed at length in Appendix 23, Duff & Phelps, Analysis of APB, Journal Entry, Cash Disbursement and JPMorgan Collateral (Feb. 1, 2010). From these approximately 5,100 trades, the Examiner's financial advisors then identified those trades where a price discrepancy of over 30% to the then-current market value existed to Lehman's detriment. This yielded thirty-seven trades of interest that required further investigation.

The first step in investigating these thirty-seven trades was to identify the prior owner of the securities to determine which Lehman entity received a potentially unfair

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[6477] The fourteen selected counterparties were Bank of America, Barclays, Citi, HSBC, JPMorgan, BNYM, FRBNY, Standard Bank, R3 Capital Management, One William Street, Fortress Investment Group, Blackrock, BlueMountain Capital and Stark Investments. Narrowing the field of APB by date only, beginning August 1, 2008, yielded over one million trades.

price (the APB database did not permit this query to be conducted in the first instance). The Examiner's financial advisors discovered, however, that no LBHI Chapter 11 Affiliate owned any of the thirty-seven securities identified under this methodology between August 1 and September 19, 2008. In many cases, however, LBI (a Chapter 7 Affiliate) was the owner. Because this matter is outside of the scope of the Examiner Order, the Examiner contacted the SIPA Trustee and provided him with the information that the Examiner discovered so that he may investigate these trades further. Because this methodology did not yield any LBHI Affiliate transactions warranting further review (*i.e.*, there was never an interest of the Debtor in the property), the Examiner ceased the analysis under the APB Approach as it did not appear that further analysis would be cost-effective or result in the identification of colorable claims.[6478]

[6478] The Examiner's financial advisors also attempted to analyze significant manual journal entries (with a gross balance of greater than $500 million) that were entered into the general ledger between September 1, 2007 and September 12, 2008. There were 138 manual journal entries that satisfied this criteria and it was determined that they potentially could represent one or more of the following activities: (1) third-party asset transfers; (2) forgiveness of debt; (3) equity transfers; or (4) any unusual or indistinguishable activity. Completion of this analysis was dependent upon assistance from Barclays and the Debtors with specific knowledge regarding the purpose of the entries. The Examiner attempted to gain such supporting documentation for the 138 selected entries and to schedule interviews with the controllers responsible for preparation of these entries. Based on communications with the Debtors and the conclusion that the Examiner's financial advisors would be too reliant on third parties to complete this analysis, the Examiner ceased this methodology prior to completion. For a complete discussion of the analysis conducted by the Examiner's financial advisors, see Appendix 23, Duff & Phelps, Analysis of APB, Journal Entry, Cash Disbursement and JPMorgan Collateral (Feb. 1, 2010).

(3) Cash Disbursement Analysis

In addition to the APB analysis, the Examiner and his financial advisors reviewed the Debtors' SOFA schedules. In order to identify payments most likely to represent avoidable transactions, the following selection criteria were applied to identify activity of interest. First, the Examiner's financial advisors identified payments made to counterparties that satisfy one or more of the following criteria: (1) the counterparty is a major bank/clearing house, (2) the counterparty conducts a significant volume of trades, and (3) the counterparty is involved in transactions with illiquid assets. There were thirteen such counterparties. Second, the Examiner's financial advisors identified payments to creditors that were opaquely described (for example, "ATTN FUNDS MANAGEMENT") or that received $1 billion or more in total payments during the period reflected in the SOFA Schedules 3b. Third, the Examiner's financial advisors identified six additional payments because the term "collateral" was included in the creditor's name.

The foregoing selection criteria yielded 416 payments representing disbursements of approximately $160 billion. The Debtors provided assistance to the Examiner's financial advisors in identifying the Lehman cash settlement system used to transact each payment. Pursuant to an analysis of the cash settlement systems, however, the Examiner's financial advisors determined that 192 of the 416 payments were likely related to transactions subject to the safe-harbor provisions of the

Bankruptcy Code because there is evidence that these payments pertain to either repo transactions (51) or derivatives payments (141). The Examiner's financial advisors were unable to resolve the remaining selected payments (224) because the Debtors' post-petition managers were unable to provide the Examiner with the necessary data prior to the filing of this Report. For the complete discussion of the analysis conducted by the Examiner's financial advisors, see Appendix 23, Duff & Phelps, Analysis of APB, Journal Entry, Cash Disbursement and JPMorgan Collateral (Feb. 1, 2010).

(4) Pledged Collateral Accounts Analysis

In the period prior to the bankruptcy, certain counterparties that provided clearing services or other credit to Lehman requested increases in pledged collateral as a prerequisite for continuing to extend credit. Such pledges of collateral often involved cash disbursements, which are subject to the Cash Disbursement Analysis. However, in circumstances where assets were seized from accounts subject to lien, no cash or trade record exists. With access to a firm's pledged collateral accounts, it is possible to identify seized assets and trace the assets back to the original legal entity that provided the assets used for collateral. The Examiner was provided with limited access to certain Lehman pledged accounts at JPMorgan. For a summary of findings relating to tracing certain securities believed to be held in pledged accounts at JPMorgan at September 12, 2008, see Appendix 23, Duff & Phelps, Analysis of APB, Journal Entry, Cash

Disbursement and JPMorgan Collateral (Feb. 1, 2010). This pledged collateral account analysis also did not yield any colorable avoidance claims.[6479]

(5) Avoidance Analysis for Certain Pre-Chapter 11 Lenders and Financial Participants

(a) JPMorgan Avoidance Analysis

(i) Background

JPMorgan acted as LBI's (LBHI's U.S. broker-dealer subsidiary) principal clearing bank for securities trading and triparty repo agreements. In that role, JPMorgan assisted LBI's clearance and settlement of securities and LBI's funding through triparty repos.

Beginning in early 2008, JPMorgan began the process of revamping its approach to dealing with its credit risk to Lehman. To protect itself, JPMorgan requested additional collateral, sought amendments to its agreements with Lehman to strengthen its rights in the event of a Lehman default and made changes to its procedures for dealing with Lehman. The Examiner's analysis of claims arising under the Bankruptcy Code to avoid the transfers of this additional collateral or the incurrence of obligations focused on two sets of agreements that JPMorgan and LBHI entered into on August 29,

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[6479] The pledged collateral account analysis provides further detail with respect to LBHI's pledge of Spruce, Freedom, Pine, Kingfisher, and Verano, all asset backed securities, to JPMorgan. *See* Appendix 23, Duff & Phelps, Analysis of APB, Journal Entry, Cash Disbursement and JPMorgan Collateral (Feb. 1, 2010); *see also* Appendix 18, Lehman Collateral at JPM. LCPI appears to have sold these securities to LBHI via principal trades. *See* Appendix 23, Duff & Phelps, Analysis of APB, Journal Entry, Cash Disbursement and JPMorgan Collateral (Feb. 1, 2010) (containing trade information for many of these securities). As such, the transfers of these securities from LCPI to LBHI would be protected from avoidance by the safe-harbor provisions of the Bankruptcy Code as a "transfer" in connection with a "securities contract."

2008 and September 10, 2008. The facts upon which this analysis is based are set forth in greater detail in Section III.A.5.b, but are summarized herein to the extent necessary to assist the reader in understanding the Examiner's conclusions.

In August 2008, JPMorgan requested that Lehman enter into new agreements in part because JPMorgan wanted a guaranty from LBHI. In addition, JPMorgan requested the new agreements given concern by JPMorgan and Lehman counterparties that additional Lehman subsidiaries that were not party to the Clearance Agreement were conducting operations through JPMorgan's clearing system.[6480] The parties ultimately executed three documents on August 29, 2008 (though dated August 26, 2008):[6481] (1) an amendment to a clearance agreement (the "August Amendment to the Clearance Agreement");[6482] (2) a guaranty (the "August Guaranty);[6483] and (3) a security agreement (the "August Security Agreement," collectively, the "August Agreements").[6484]

In late August and September 2008, Lehman's deteriorating financial condition became increasingly apparent.[6485] Reports began to surface that The Korea

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[6480] Examiner's Interview of Daniel J. Fleming, Apr. 22, 2009, at p. 5; Examiner's Interview of Paul W. Hespel, Apr. 23, 2009, at p. 3.

[6481] *See* e-mail from Paul W. Hespel, Goodwin Procter, to Nikki G. Appel, JPMorgan, *et al.* (Aug. 29, 2008) [JPM-2004 0004629].

[6482] *See* Amendment to Clearance Agreement (Aug. 26, 2008) [JPM-2004 0005856].

[6483] Guaranty (Aug. 26, 2008) [JPM-2004 0005879].

[6484] Security Agreement (Aug. 26, 2008) [JPM-2004 0005867].

[6485] *See e.g.*, Andrew Ross Sorkin, *Struggling Lehman Plans to Lay Off 1,500*, N.Y. Times, Aug. 28, 2008 (Lehman shares lost 73% of their value between January 2008 and the end of August 2008); *see also* e-mail from Ricardo S. Chiavenato, JPMorgan, to David A. Weisbrod, JPMorgan (Aug. 22, 2008) [JPM-2004

Development Bank ("KDB") had abandoned (or was likely to abandon) its acquisition talks with Lehman,[6486] and Lehman's stock price had dropped significantly.[6487] Shortly before 9:00 p.m. on September 9, JPMorgan sent draft guaranty and security agreements to Andrew Yeung, in-house counsel at Lehman.[6488] A draft amendment to the Clearance Agreement arrived later that night.[6489] The parties ultimately executed three key documents on September 10, 2008: (1) an Amendment to the Clearance Agreement (the "September Amendment to the Clearance Agreement");[6490] (2) an amended Guaranty (the "September Guaranty");[6491] and (3) an amended Security Agreement (the "September Security Agreement," and collectively, the "September Agreements").[6492]

The Examiner concludes that there are colorable claims to avoid the September and August Guaranties as constructive fraudulent obligations under Sections 548 and

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0061226] ("Lehman may face serious problems next week if it is not acquired . . . and its losses are large.").

[6486] Francesco Guerrera, *et al.*, *Equities Suffer as Lehman Shares Fall 45%*, Fin. Times, Sept. 9, 2008 ("Lehman's shares fell after a newswire report cited an unnamed Korean government official as saying that Korea Development Bank, a state-run lender, had decided not to invest in Lehman."); Susanne Craig, *et al.*, *Korean Remarks Hit Lehman*, Wall St. J., Sept. 9, 2008 ("A KDB official said the comments [by the Chairman of South Korea's Financial Services Commission] would likely be strong enough to deter the bank from pursuing a Lehman deal . . . .").

[6487] Examiner's Interview of Richard S. Fuld, Jr., May 6, 2009, at p. 11; Examiner's Interview of Donna Dellosso, Feb. 27, 2009, at p. 4; Susanne Craig, *et al.*, *Lehman Faces Mounting Pressures*, Wall St. J., Sept. 10, 2008, at A1; Susanne Craig, *et al.*, *Korean Remarks Hit Lehman*, Wall St. J., Sept. 9, 2008.

[6488] E-mail from Jeffrey Aronson, JPMorgan, to Andrew Yeung, Lehman, *et al.* (Sept. 9, 2008) [JPM-2004 0005594]; Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4.

[6489] E-mail from Jeffrey Aronson, JPMorgan, to Andrew Yeung, Lehman, *et al.* (Sept. 9, 2008) [JPM-2004 0005039]. A draft Aurora Guaranty and draft Control Agreement were sent with the draft Amendment to the Clearance Agreement as well. *See id*.

[6490] Amendment to Clearance Agreement (Sept. 9, 2008) [JPM-2004 0005861].

[6491] Guaranty (Sept. 9, 2008) [JPM-2004 0005813].

[6492] Security Agreement (Sept. 9, 2008) [JPM-2004 0005873].

544 and New York state law.[6493] In addition, the Examiner concludes that there are colorable claims to avoid as much as $6.9 billion of the $8.6 billion in collateral that LBHI transferred to JPMorgan to secure the September Guaranty under Sections 547(b), 548 and 544 and state law, but that the claims to avoid the collateral transfers may be defeated by the defenses under Sections 546(e), (f), (g) and (j).[6494]

(ii) Avoidability of the September Agreements and Transfers in Connection with the September Agreements

The September Amendment to the Clearance Agreement expanded JPMorgan's lien on the Lehman parties' accounts and secured their existing or future indebtedness, obligations and liabilities of any kind to JPMorgan, whether arising under the Clearance Agreement or not.[6495] The September Guaranty expanded LBHI's liability to JPMorgan making it the guarantor of all obligations and liabilities of all direct or indirect subsidiaries of LBHI to JPMorgan and its affiliates of whatever nature, irrespective of

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[6493] Although Section 548 of the Code authorizes the avoidance of the incurrence of an obligation as constructively fraudulent if less than reasonably equivalent value is exchanged and the debtor is either (a) insolvent, or (b) undercapitalized or (c) unable to pay its debts as such debts are expected to mature, the New York Uniform Fraudulent Conveyance Act only allows for the avoidance of the incurrence of an obligation if the debtor is insolvent or has a subjective intent not to pay such debts as such debts are expected to come due. *Compare* 11 U.S.C. § 548(a), *with* McKinney's Debtor and Creditor Law § 274 (2010); *see also In re M. Fabrikant & Sons, Inc.*, 394 B.R. 721, 734 n.13 (Bankr. S.D.N.Y. 2008) ("By its terms, section 274 ("unreasonably small capital") applies to conveyances but not obligations ...."). For a more detailed discussion of the elements of a fraudulent transfer or a preference claim, see Appendix 1, Legal Issues, at Sections IV.A, IV.D.

[6494] For a complete discussion of potential colorable state law claims against JPMorgan, *see* Section III.A.5.b.

[6495] Amendment to Clearance Agreement (Sept. 9, 2008), at p. 1 [JPM-2004 0005861].

whether they accrued pursuant to the Clearance Agreement.[6496] The September Security Agreement expanded the definition of accounts in which JPMorgan held a security interest to include all Lehman accounts at JPMorgan or its affiliates.[6497]

a. Avoidability of the September Guaranty as a Constructive Fraudulent Obligation

1. There Is Evidence To Support A Finding That LBHI Incurred an Obligation Within the Applicable Look-Back Periods When it Executed the September Guaranty

The Examiner has concluded that there is evidence to support a finding that LBHI incurred an obligation within the applicable look-back periods set forth in Section 548 or New York state law when it entered into the September Guaranty. *Rubin v. Manufacturers Hanover Trust Co.*[6498] is the seminal decision addressing whether the incurrence of obligations under a guaranty may be avoided as a constructive fraudulent obligation. *Rubin* held that the execution of a guaranty itself is not the incurrence of an obligation but that the obligation is incurred when the loan is made to the primary obligor, thereby creating a contingent liability for the guarantor.[6499] Here, the September Guaranty required LBHI to guarantee "all obligations and liabilities of the Borrowers to the Bank of whatever nature, whether now existing or hereafter incurred."[6500] As of

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[6496] Guaranty (Sept. 9, 2008), at p. 1-2 [JPM-2004 0005813].
[6497] Security Agreement (Sept. 9, 2008), at p. 1 [JPM-2004 0005873].
[6498] *Rubin v. Manufacturers Hanover Trust Co.,* 661 F.2d 979 (2d Cir. 1981).
[6499] *Id.* at 990-91.
[6500] Guaranty (Sept. 9, 2008), at p. 1 [JPM-2004 0005813].

September 9, 2008, the Lehman entities (which included LBI and all of LBHI's direct or indirect subsidiaries) owed obligations to JPMorgan. Thus, upon execution of the September Guaranty on September 10, 2008, LBHI had a contingent liability to repay JPMorgan if one of the Lehman entities could not repay JPMorgan. Thus, LBHI incurred an obligation to JPMorgan within the two-year look back period of Section 548(a) and the six-year look back period under New York law.[6501]

2. There Is Evidence To Support A Finding That LBHI Received Less Than Reasonably Equivalent Value or Did Not Receive Fair Consideration in Exchange for Granting JPMorgan the September Guaranty

The Examiner has concluded that there is evidence to support a finding that LBHI did not receive reasonably equivalent value or fair consideration in exchange for incurring the additional obligations imposed upon it by the September Guaranty. Reasonably equivalent value or fair consideration "means more than just the 'good and valuable' consideration needed to support a simple contract."[6502] Instead, consideration is "fair" or "reasonably equivalent" if, in exchange for incurring the obligation, the debtor receives property of a reasonably equivalent value or is relieved of an antecedent obligation.[6503] The focus of this analysis is upon LBHI and whether LBHI and its

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[6501] McKinney's Civil Practice Law and Rules § 213 (2010); *Island Holding, LLC v. O'Brien*, 775 N.Y.S.2d 72, 74 (Sup. Ct. 2004).

[6502] *Rubin*, 661 F.2d at 991.

[6503] *Id.; see also Liebowitz v. Parkway Bank & Trust Co. (In re Image Worldwide, Ltd.)*, 139 F.3d 574, 580 (7th Cir. 1998). Section 548 defines value to mean "property, or satisfaction or securing of a present or antecedent debt of the debtor …" 11 U.S.C. § 548(d).

creditors received something of value when, on the eve of its Chapter 11 filing, LBHI took on additional debt. In this analysis, *Rubin* permits the consideration of both direct and indirect benefits received by the entity that incurs the obligation, and subsequent case law has expanded that concept.[6504] The economic benefits, both direct and indirect, "must be measured and then compared to the obligations that the bankrupt incurred."[6505] "The touchstone is whether the transaction conferred realizable commercial value on the debtor reasonably equivalent to the realizable commercial value of the assets transferred [or obligation incurred]. Thus, when a debtor is a going concern and its realizable going concern value after the transaction is equal to or exceeds its going concern value before the transaction, reasonably equivalent value has been received."[6506] In this case, that measurement would occur on September 10, 2008, because as of the execution of the September Guaranty on September 10, JPMorgan had made outstanding loans to LBHI subsidiaries.[6507]

Although LBHI became a "Customer" under the JPMorgan Clearance Agreement when that Agreement was amended on August 29, 2008, the clearance services provided under the August Amendments to the Clearance Agreement were provided to LBHI subsidiaries and affiliates. Because the services JPMorgan provided under the

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[6504] *See, e.g.*, *Liebowitz*, 139 F.3d at 577-82 (general discussion of direct and indirect benefits in the context of corporate family guaranties).
[6505] *Mellon Bank, N.A. v. Metro Comm'cns, Inc.*, 945 F.2d 635, 647 (3d Cir. 1991).
[6506] *Id*. at 647.
[6507] *Rubin*, 661 F.2d at 990-91.

Clearance Agreement were all used by LBHI's subsidiaries, the possible direct benefits to LBHI from the September Guaranty are limited to (1) the potential increase in the value of its subsidiaries' stock as a result of LBHI's credit support of the subsidiaries' obligations to JPMorgan and (2) any additional capital that the subsidiaries were able to access as a result of any loans that were guaranteed. Possible indirect benefits to LBHI may include (1) the strengthening of the corporate group as a whole and (2) the increased ability to access other capital as a result of JPMorgan's continued agreement to extend credit to LBI in connection with clearing trades and otherwise.[6508] Possible indirect benefits also may include the additional time provided to LBHI to find a solution to its financial problems as a result of forestalling JPMorgan's possible withdrawal of credit from LBI.[6509] Prospective benefits, however, must be measured "by the likelihood that the debtor will actually realize those benefits."[6510] Thus, a "buying of

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[6508] *Cf. Liebowitz*, 139 F.3d at 581 (noting that in general courts uphold cross-stream guarantees when the transaction strengthens the viability of the corporate group).

[6509] *See Commerce Bank of Kansas City, N.A. v. Achtenberg*, No. 90-0950-CV-W-6, 1993 WL 476510, *4 n.5 (W.D. Mo. Nov. 10, 1993) (suggesting that a parent company may benefit in the form of giving a subsidiary a "'fighting chance' to escape insolvency" by guaranteeing "a large loan to marginally insolvent company."); *but see Liebowitz*, 139 F.3d at 581-82 (finding no reasonably equivalent value where, by paying of the affiliate's debts, the debtor kept the affiliate out of bankruptcy but bankrupted itself).

[6510] *Silverman v. Paul's Landmark (In re Nirvana Restaurant Inc.)*, 337 B.R. 495, 504 (Bankr. S.D.N.Y. 2006) (citations omitted); *but see Official Committee of Unsecured Creditors of Tousa, Inc. v. Citicorp North America, Inc. (In re Tousa, Inc.)*, No. 08-10928-JKO, 2009 WL 3519403 at *78 (Bankr. S.D. Fla. Oct. 30, 2009) ("hoped for" benefits insufficient).

time" benefit needs to be measured by the likelihood that LBHI would find a solution to its financial problems.[6511]

To be considered in a reasonably equivalent value analysis, indirect benefits, like direct benefits, must be quantifiable.[6512] With respect to the benefits realized from the ability to borrow additional money, the Third Circuit has stated this additional borrowing ability

> has considerable value in the commercial world. To quantify that value, however, is difficult. Quantification depends on the business opportunities the additional credit makes available to the borrowing corporation and on other imponderables in the operation or expansion of its business.[6513]

In this case, LBHI provided a "downstream guaranty" – a guaranty by a parent corporation of the debts of its wholly-owned subsidiaries. Downstream guaranties are typically viewed as less vulnerable to avoidance than fraudulent transfers as the parent corporation presumably increases its own value (through the increased value of its subsidiaries) by providing a guaranty to a lender so that capital can flow to its subsidiaries.[6514]

[6511] *See* 337 B.R. at 504. (holding that guaranty was a "sunk cost" and debtor "did not receive a benefit by throwing good money after bad" where chance that affiliate, a restaurant, would open and make enough to pay its own expenses, including those guaranteed by the debtor, was highly speculative).

[6512] *See Liebowitz*, 139 F.3d at 578; *Metro Commc'ns*, 945 F.2d at 646-48.

[6513] *Metro Commc'ns,* 945 F.2d at 646-48. The Third Circuit found that by failing to present evidence of what the indirect benefit of an increased ability to borrow money was worth and instead contending, without expert support, that the indirect benefits had no value, the plaintiff failed to satisfy its burden of proof as to lack of reasonably equivalent value. *Id*. at 650.

[6514] *See Achtenberg,* 1993 WL 476510 at *4 (downstream guaranties to a solvent subsidiary are presumed to be reasonably equivalent value); *see also Lawrence Paperboard Corp. v. Arlington Trust Co. (In re Lawrence*

If, however, the subsidiaries were insolvent at the time of the guaranty, the guaranty may not provide direct value to the parent as the guaranty would not increase the value of the subsidiaries and would instead only serve to create an additional claim against the parent that would dilute the recovery of the parent-guarantor's creditors.[6515] The Seventh Circuit noted in a recent case that "'[o]ne theme that permeates the authorities upholding guaranty obligations: that the guaranty at issue was the result of arm's length negotiations at a time when the common enterprise was commercially viable.'"[6516]

The first question to be asked is what LBHI gave up as a result of entering into the September Guaranty. Previously, on August 29, 2008, LBHI had agreed to guarantee the obligations of only certain of its subsidiaries (LBI, LBCPI, LBOTC, LBIE and LBJ) under the August Amendment to the Clearance Agreement. The September Guaranty expanded the subsidiaries covered by LBHI's guaranty to include all of its subsidiaries and expanded its obligations to include all of their obligations, not just those arising under the Clearance Agreement.[6517] The *ex post* effect of the September

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Paperboard Corp.), 76 B.R. 866, 871 (Bankr. D. Mass. 1987); *Garrett v. Falkner (In re Royal Crown Bottlers of North Ala., Inc.),* 23 B.R. 28, 30 (Bankr. N.D. Ga. 1982).

[6515] *See, e.g., Achtenberg*, 1993 WL 476510 at *4 (stating that it "can hardly be said that the debtor's net worth has been preserved and the interests of the creditors not injured when the debtor guarantees a loan to an insolvent entity").

[6516] *Liebowitz,* 139 F.3d at 577-78 (quoting Williams, *The Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercorporate Guaranties: Fraudulent Transfer Law as a Fuzzy System*, 15 Cardozo L. Rev. 1403, 1438 (1994)).

[6517] Examiner's Interview of Andrew Yeung, Mar. 13, 2009, at p. 4. *Compare* Guaranty (Sept. 9, 2008), at p. 1 [JPM-2004 0005813], with Guaranty (Aug. 26, 2008), at p.1 [JPM-2004 0005879].

Guaranty was an increase of LBHI's exposure by an estimated $4.2 billion, assuming the validity of JPMorgan's underlying claims.[6518]

LBHI's increased exposure as a result of the expanded September Guaranty occurred in two ways. First, in the case of LBHI's obligations with respect to JPMorgan derivatives contracts, LBHI had already guaranteed such claims on an unsecured basis and the September Agreements transformed this pre-existing obligation into a secured debt.[6519] Second, the September Guaranty imposed upon LBHI new obligations for which it previously had no responsibility. The estimated $4.2 billion increase in exposure was principally attributable to: (1) JPMorgan derivatives claims of $3.08 billion; (2) other investment bank and treasury and security services claims of $390 million; and (3) asset management exposure claims of $750 million.[6520]

The $4.2 billion increase in exposure (assuming the validity of JPMorgan's underlying claims) represents the total additional debt guaranteed, or that became secured, as a result of the September Agreements. In analyzing this increase in

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[6518] JPMorgan, Exposure, Collateral and Setoff Summary (Oct. 27, 2009) [LBEX-JPMC 000199].

[6519] *See* ISDA Master Agreement between JPMCB and LBCC (Nov. 15, 1993), at p. 25 [JPM-2004 0000368] (providing a guaranty by LBHI); ISDA Master Agreement between JPMM and LBIE (Aug. 26, 1997), at p. 14 [JPM-2004 0086169] (providing a guaranty by LBHI); ISDA Master Agreement between JPMCB and LBFSA (Nov. 15, 1993), at p. 24 [JPM-2004 000850] (providing a guaranty by LBHI); Amendment to the ISDA Master Agreement between JPMM and LBFSA (July 11, 2008), at p. 35 [JPM-2004 0086103] (providing guaranty by LBHI); ISDA Master Agreement between JPMCB and LBSF (Dec. 20, 1995), at p. 22 [JPM-2004 0000345] (providing guaranty by LBHI); ISDA Master Agreement between JPMBD and LBIE (Feb. 23, 1998), at p. 21 [JPM-2004 0086072]; Guarantee of LBHI for ISDA Master Agreement between WMB and LBSF (May 28, 1998) [LBEX-JPM 0000210]; Guarantee of LBHI for ISDA Master Agreement between JPMM and LBSF (June 7, 2002) [LBEX-JPM 0000212].

[6520] *Id.* The asset management claims are discussed in detail in Section III.B.3.g.5.a.vi of this Report.

exposure, it is important to note that the September Guaranty was for payment, not collection, such that JPMorgan could look first to LBHI for payment without being required to exhaust its collection efforts against the subsidiaries.[6521] As such, the $4.2 billion estimate of the exposure would find support in the September Agreements themselves. This measure of exposure, however, does not account for collateral owned by LBHI's subsidiaries. Although it is theoretically possible that JPMorgan could look to LBHI alone to satisfy the obligations, this would be unlikely. The subsidiaries themselves had assets to pay JPMorgan and collateral pledged to support their direct obligations to JPMorgan.[6522] Thus, JPMorgan would have no reason to look solely to LBHI, but would likely collect from all sources at once (which is what it in fact did to the extent it was able to apply its collateral to reduce its claims post-petition relying upon the safe-harbor provisions of Section 362).[6523] Further, even if JPMorgan were to collect only from LBHI, LBHI would have a subrogation claim against its subsidiaries, reducing the September Guaranty's impact on LBHI and its creditors.[6524] For this reason, the increased exposure should not be measured by the full difference in gross exposure, but should be discounted by two factors: (1) the probability that the

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[6521] *See* Guaranty (Sept. 9, 2008) at p. 1 ("The Guarantor unconditionally and irrevocably guarantees to the Bank the punctual payment of all obligations and liabilities of the Borrowers to the Bank.") [JPM-2004 0005813].

[6522] JPMorgan, Exposure, Collateral and Setoff Summary (Oct. 27, 2009) [LBEX-JMPC 000199].

[6523] *Id*.

[6524] Under Section 5 of the September Guaranty, LBHI's right of subrogation could not be exercised until JPMorgan was paid in full, all Lehman accounts were closed and all of Lehman's obligations under any agreements with JPMorgan were fulfilled. *See* Guaranty (Sept. 9, 2008), at p. 2-3 [JPM-2004 0005813].

September Guaranty would be called at all; and (2) the value of the collateral that secured the obligations at the subsidiary level and the ability of each subsidiary to contribute to a JPMorgan deficiency claim arising under the September Guaranty.

Because of the potential overcollateralization of JPMorgan,[6525] the net exposure to LBHI, after accounting for the collateral pledged by the subsidiaries and assuming that the subsidiaries would not pay anything on account of any general unsecured deficiency claim held by JPMorgan after application of that collateral, was theoretically zero under the September Guaranty.

Conflicting evidence exists as to whether a zero value net exposure under the September Guaranty is reasonable. Some documents indicate that JPMorgan believed it was fully collateralized against Lehman, but those documents do not address all non-clearing obligations.[6526] In addition, interviews with JPMorgan personnel indicate that JPMorgan was concerned over the adequacy of Lehman's collateral, suggesting that JPMorgan believed the guaranties were necessary to protect itself.[6527] Other evidence suggests that JPMorgan was unsure how much collateral it needed at any given time to cover its exposure.[6528] Determining the amount of appropriate collateral was "art, not

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[6525] See III.A.5.b. for a discussion of the issue of overcollateralization.

[6526] *See* JPMorgan, Tri-Party Repo Margin Gap Analysis – Lehman – 9/10/2008 (Sept. 10, 2008) [JPM-2004 0029886-89]; see also Section III.A.5.b of this Report.

[6527] Examiner's Interview of Donna Dellosso, Feb. 27, 2009, at pp. 4-5; *see also* Section III.A.5.b of this Report for a more detailed discussion of the basis of JPMorgan's collateral demands.

[6528] Examiner's Interview of Gail Inaba, Apr. 28, 2009, at pp. 11-12.

science,"[6529] and was dependent upon estimates.[6530] Even if LBHI's net exposure under the September Guaranty could reasonably be valued at zero, the September Guaranty still imposed a cost upon LBHI: namely, the risk that the actual sale of collateral would generate proceeds less than the gross exposure to JPMorgan, triggering LBHI's liability as a guarantor.

Post-bankruptcy events suggest that: (1) these values were incorrect, or (2) the value of the collateral significantly declined following the execution of the September Guaranty. After September 15, 2008, JPMorgan liquidated approximately $1.95 billion of the $8.6 billion in cash collateral LBHI posted on or after September 9, 2008.[6531] JPMorgan claims a right to an additional $943 million of collateral in connection with the September Guaranty.[6532] As of October 27, 2009, JPMorgan asserted $7.6 billion in remaining claims and had $7.14 billion remaining in cash, money market funds, and other collateral. Thus, if all the remaining collateral were liquidated to pay the remaining obligations that JPMorgan asserts are still due, JPMorgan would have approximately $459 million in remaining claims on account of obligations guaranteed by the September Guaranty. Given that approximately $1.95 billion of the $8.6 billion LBHI collateral has been used to pay JPMorgan already and additional LBHI collateral may be used to reduce the claim to zero, the net exposure on September 10, 2008 was

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[6529] Examiner's Interview with Steven D. Black, Sept. 23, 2009, at p. 6.
[6530] Examiner's Interview of Mark G. Doctoroff, Apr. 29, 2009, at p. 3.
[6531] JPMorgan, Exposure, Collateral and Setoff Summary (Oct. 27, 2009) [LBEX-JPMC 000199].
[6532] *Id.*

either greater than zero (assuming that JPMorgan's claims and valuations of collateral are correct) or JPMorgan was overcollateralized pre-bankruptcy and the value of collateral posted by the subsidiaries fell after September 10, 2008 by these amounts. Thus, the Examiner concludes that there is evidence to support a finding that LBHI did in fact increase its exposure to JPMorgan by entering into the September Guaranty.

The next step of the "less than reasonably equivalent value" inquiry is to determine what LBHI received in exchange for increasing its exposure to JPMorgan and whether what it received was approximate in value to what it gave up. In analyzing the likely direct benefits, the starting point for determining whether the September Guaranty increased the value of the subsidiaries is to determine whether the subsidiaries had *any* value at the time of the September Guaranty. Section III.B.3.c discusses the findings of the Examiner with regard to the solvency of the subsidiaries of LBHI. To summarize, the Examiner has concluded that there is evidence to support a finding of insolvency for the following subsidiaries as of May 31, 2008: LCPI, CES Aviation IX and CES Aviation V. Two of these entities, CES Aviation IX and CES Aviation V, remained insolvent through filing for bankruptcy. LCPI was insolvent through much of 2008, but received a $900 million capital infusion on August 29, 2008, which allowed it to become borderline solvent and to apparently maintain this status until its bankruptcy filing.[6533] Three LBHI Affiliates – LBSF, LBCS and CES Aviation –

[6533] See Section III.B.3.c of this Report for a discussion of the solvency of LCPI.

were borderline solvent as of May 31, 2008, meaning that their balance sheets showed assets just slightly in excess of liabilities and that a minimal write down of asset values or a small unaccounted-for liability would render these entities insolvent. The small margin by which these entities were solvent creates a factual issue to be resolved by the court on a case-by-case basis.[6534] Nine LBHI Affiliates – LOTC, LB 745, LBDP, LBCC, BNC Mortgage LLC, LBFP, East Dover Limited, LSF and LRP – were solvent as of as May 31, 2008, and there is insufficient evidence to support a claim that any of these LBHI Affiliates became insolvent during the period ending upon the commencement of the applicable Chapter 11 case.[6535] There is insufficient evidence to reach a determination as to the solvency of Debtor entity PAMI Statler Arms.[6536] PAMI Statler Arms is a subsidiary of Property Asset Management, Inc. ("PAMI"), and its sole asset is

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[6534] The Examiner did not conduct an asset-by-asset valuation of each asset owned by LBHI Affiliates because of the time and cost required for such an exercise. Rather, positions across a number of different asset classes were reviewed for several Debtors. An entity's equity-to-total-assets ratio, as well as the relative likelihood of a misstatement of the value of an entity's assets, is considered in determining whether an entity that posted positive equity might nonetheless be borderline solvent. As the term is used here, a low equity-to-total-assets ratio would make an entity borderline solvent unless the composition of its assets was such that misstatement of their value was very unlikely. In light of the cost and time necessary to evaluate the valuation of all of the assets of each of the borderline solvent entities, the Examiner determined that it would not be beneficial to perform such an exercise. For purposes of analyzing whether these LBHI Affiliates have colorable avoidance claims, the Examiner assumed that the borderline entities were insolvent.

[6535] LRP was established in May 2008 and did not post a balance sheet until June 2008. LRP was solvent as of August 31, 2008 and there is insufficient evidence to support a claim that it became insolvent at any time between its incorporation and the commencement of its Chapter 11 case.

[6536] A motion to dismiss PAMI Statler Arms LLC's bankruptcy petition was filed on May 26, 2009. *See* Motion of Debtors Seeking Entry of an Order Pursuant to Section 1112(b) of the Bankruptcy Code Dismissing Chapter 11 Case of PAMI Statler Arms LLC, Docket No. 3650, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. May 26, 2009). The hearing on the motion has been adjourned without a date. *See* Notice of Adjournment of Motion of Debtors Seeking Entry of an Order Pursuant to Section 1112(b) of the Bankruptcy Code Dismissing Chapter 11 Case of PAMI Statler Arms LLC, Docket No. 4060, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. June 20, 2009).

an apartment complex in Cleveland, Ohio. Lehman did not maintain separate financial statements for PAMI Statler Arms in its general ledger software program.

The Examiner did not make a finding as to the solvency of LBI in as much as this issue is likely being examined by the SIPA Trustee. The Examiner, for the purposes of this analysis, assumes that LBI was insolvent on September 10, 2008. As set forth in Section III.C, this assumption is supported by the sale of LBI to Barclays five days later that did not result in LBHI receiving any value for LBI.

Because there is evidence that supports a finding that some of LBHI's subsidiaries including LBI were insolvent and not likely to generate any value for LBHI, there is a colorable basis to claim that LBHI did not receive any direct quantifiable benefits from entering into the September Guaranty.

Apart from whether the September Guaranty may have increased the value of LBHI's subsidiaries, the September Guaranty may have benefited LBHI by allowing LBHI the ability to sell itself to Barclays or otherwise gain time to execute a rescue. This purported benefit is subject to an indirect benefit analysis. The burden is upon the plaintiff to prove the value – or lack of value – of any indirect benefits.[6537] A plaintiff could value this indirect benefit by quantifying the "option" value of having additional time before the petition date to attempt to enter into a more favorable transaction.

[6537] *Metro Commc'ns*, 945 F.2d at 650; *but see Tousa*, 2009 WL 3261963 at *77-78 (holding if trustee meets burden that debtor did not receive indirect benefits, burden shifts to defendant to produce evidence that debtor received an indirect benefit that was tangible and concrete).

Quantifying this indirect benefit is difficult because it is unclear whether LBHI (as opposed to its subsidiaries) benefited from the opportunity to devise another solution to its problems. KDB relayed its decision not to continue talks with Lehman on September 2, 2008.[6538] In addition to KDB, Lehman pursued alternative transactions with Bank of America, Barclays, and MetLife.[6539] Only the Barclays transaction reached the point of fixing consideration for a sale, but this deal was expressly contingent upon approval by the Financial Services Authority and, thus, a definitive sales agreement had not been executed.[6540] Under the proposed transaction, Barclays would have purchased the operating subsidiaries of LBHI for $3 billion and guaranteed the debt of LBHI and its former subsidiaries.[6541] LBHI's remaining assets would equal the assets for the proposed SpinCo plus $3 billion from the Barclays sale.[6542] Post-sale, LBHI planned to seek $40 billion in new debt financing from a consortium of financial institutions.[6543] Given the speculative nature of the proposed Barclays transaction,[6544] a colorable

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[6538] See Section III.A.3 of this Report for a discussion of the KDB deal.

[6539] See Section III.A.3 of this Report for a discussion of other deals pursued by Lehman.

[6540] Examiner's Interview of Shari D. Leventhal, Apr. 30, 2009, at p. 4; Examiner's Interview of Thomas C. Baxter, Jr., May 20, 2009, at p. 10; e-mail from John Varley, Barclays, to Frits Seegers, Barclays (Sept. 13, 2008) [BCI-EX-(S)-00053344]; Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at pp. 9-10.

[6541] Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 8.

[6542] *Id.*

[6543] *Id.*

[6544] Notably, Lowitt stated that even if JPMorgan had agreed to return some collateral to Lehman, the larger issue for Lehman was that Lehman had lost enormous amounts of secured funding and the confidence of the market, suggesting, albeit with the benefit of hindsight, that additional time may not have benefitted LBHI. Examiner's Interview of Ian T. Lowitt, Oct. 28, 2009, at pp. 22-23.

argument exists that LBHI received no quantifiable indirect benefit from the additional time afforded by the September Guaranty.

Any "value of time" argument must also be discounted if the September Guaranty accelerated Lehman's demise. Evidence exists that the September Guaranty caused LBHI's liquidity problems to become more acute. By providing cash and money market funds to JPMorgan (in the form of collateral in connection with the September Guaranty), LBHI drained its rapidly depleting liquidity pool in the critical days prior to the bankruptcy filing.[6545] If LBHI had declined to execute the September Guaranty, the additional liquidity may have extended LBHI's lifeline. This additional time might have provided an opportunity for the parties to structure an out-of-court reorganization or at least a more orderly liquidation, as opposed to the "free-fall" bankruptcy that occurred.[6546] Thus, there is evidence to support a finding that LBHI did not receive reasonably equivalent value by entering into the September Guaranty.

3. Insolvency as of September 10, 2008

The Examiner has concluded that there is evidence to support a finding that LBHI was insolvent on September 10, the date the September Guaranty was executed.[6547]

[6545] Lehman, Minutes of Meeting of Board of Directors (Sept. 14, 2008) [LBEX-AM 003933].

[6546] Of course, if JPMorgan had pulled its credit, LBHI might have been forced to file bankruptcy before September 15.

[6547] See Section III.B.3.b of this Report for a more detailed discussion of the solvency analysis of LBHI.

4. Undercapitalization as of September 10, 2008

The Examiner also has concluded that there is evidence to support a finding that LBHI was undercapitalized as of September 10, 2008. [6548] Undercapitalization is relevant only to claims made to avoid the September Guaranty under Section 548(a).[6549]

b. Defenses to Avoidability of the September Guaranty

1. Applicability of the Good Faith Defense of Section 548(c) of the Bankruptcy Code and Section 279 of the N.Y. Debtor Creditor Law to the September Guaranty

The Examiner has concluded that JPMorgan will have substantial contrary facts to overcome if it raises the defense of good faith under Section 548(c) or Section 279 of the N.Y. Debtor Creditor Law. Under both Section 548(c) and New York law, a transferee who acts in good faith may enforce an obligation to the extent that it gave value to the debtor in exchange for the obligation.[6550] The burden of proof for each element of a Section 548(c) defense is on JPMorgan.[6551]

Courts apply an objective test when assessing good faith.[6552] JPMorgan would not be found to have taken the obligation in good faith if the circumstances would place a reasonable person on inquiry of LBHI's fraudulent purpose, and a diligent inquiry

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[6548] See Section III.B.d of this Report for a more detailed discussion of the undercapitalization analysis of LBHI.

[6549] *Compare* 11 U.S.C. § 548(a), *with* McKinney's Debtor and Creditor Law, § 274 (2010).

[6550] 11 U.S.C. § 548(c).

[6551] *See Nisselson v. Empyrean Inv. Fund, L.P.* (*In re MarketXT Holdings Corp.*), 376 B.R. 390, 403 (Bankr. S.D.N.Y. 2007); *McColley v. Rosenberg* (*In re Candor Diamond Corp.*), 76 B.R. 342, 351 (Bankr. S.D.N.Y. 1987).

[6552] *In re Bayou Group, LLC*, 396 B.R. 810, 844 (Bankr. S.D.N.Y. 2008) (citations omitted).

would have discovered the fraudulent purpose.[6553] Good faith requires either that: (1) JPMorgan was not on "inquiry notice," or (2) if on notice, JPMorgan was "diligent in its investigation" of LBHI.[6554] Whether JPMorgan was on "inquiry notice" may also be informed by its experience or sophistication.[6555]

Courts have found that a transferee was put on "inquiry notice" in a variety of contexts, including (1) fraudulent purpose of the transfer; (2) underlying fraud; (3) unfavorable financial condition of the transferor; (4) insolvency of the transferor; (5) improper nature of the transaction; and (6) voidability of the transfer.[6556] The enumerated examples, however, "are not exhaustive and thus 'good faith' must be evaluated on a case-by-case basis."[6557]

Some interviews with JPMorgan personnel indicate that JPMorgan did not suspect that Lehman's bankruptcy was imminent.[6558] JPMorgan stated that it did not believe its collateral requests would cause a crisis within Lehman and JPMorgan expressed concern with becoming known as the firm that caused Lehman's demise.[6559]

[6553] *See id.* (citing *Jobin v. McKay* (*In re M&L Bus. Machine Co., Inc.*), 84 F.3d 1330, 1338 (10th Cir. 1996)).

[6554] *See id.* (quoting *In re Manhattan Inv. Fund Ltd.*, 397 B.R. 1 (S.D.N.Y. 2007)).

[6555] *See id.* (citing *Jobin*, 84 F.3d at 1338).

[6556] *Id.* at 845-46 (citations omitted).

[6557] *Id.* at 846 (citations omitted).

[6558] Examiner's Interview of Mark G. Doctoroff, Apr. 29, 2009, at p. 15; Examiner's Interview of James L. Dimon, Sept. 29, 2009, at p. 10 (the first time he thought Lehman may not survive was Saturday, September 13); Examiner's Interview of John J. Hogan, Sept. 17, 2009, at p. 8 (the first time he thought Lehman may not survive was Sunday, September 14).

[6559] Examiner's Interview of Donna Dellosso, Feb. 27, 2009, at pp. 2, 5; Examiner's Interview of James L. Dimon, Sept. 29, 2009, at p. 10; Jane Buyers-Russo, JPMorgan, Unpublished Notes (Sept. 9, 2008), at p. 2 [JPM-EXAMINER00006052]; *see also* e-mail from Jane Buyers-Russo, JPMorgan, to Kelly A. Mathieson,

On the other hand, some JPMorgan personnel stated that JPMorgan was concerned about the status of Lehman and worried by a company [Lehman] that was hanging on to the edge.[6560] JPMorgan personnel stated that the rumor mill was rampant concerning firms no longer doing business with Lehman and Lehman's stock was "getting killed."[6561] In addition, JPMorgan executives had analyzed and expressed serious concerns about Lehman's survival plans,[6562] including the viability of Lehman's SpinCo proposal.[6563] JPMorgan similarly had expressed concerns about presentations that Lehman prepared for the rating agencies;[6564] in particular, JPMorgan was concerned about the treatment of Lehman's survival strategies in the presentations.[6565] In short, evidence exists to support a finding that, given JPMorgan's experience and sophistication,[6566] JPMorgan was on inquiry notice of Lehman's "unfavorable financial condition."[6567]

JPMorgan, *et al.* (Sept. 12, 2008) [JPM-2004 0050097] ("The goal was to protect jpm without pushing [Lehman] over the edge.").

[6560] Interview of James L. Dimon, Sept. 29, 2009, at p. 5.

[6561] Examiner's Interview with Steven D. Black, Sept. 23, 2009, at p. 6

[6562] See Section III.A.5.b of this Report.

[6563] *Id.*

[6564] E-mail from Paolo R. Tonucci, Lehman, to Mark G. Doctoroff, JPMorgan, *et al.* (Sept. 4, 2008) [JPM-2004 0006302]. Lehman highlighted the sensitive nature of these documents multiple times. *See id.* ("There is a lot of confidential info . . . ."); e-mail from Ian T. Lowitt, Lehman, to Barry L. Zubrow, JPMorgan (Sept. 5, 2008) [JPM-2004 0006314] ("The materials we sent you are obviously very sensitive . . . "); e-mail from Ian T. Lowitt, Lehman, to Barry L. Zubrow, JPMorgan (Sept. 7, 2008) [JPM-2004 0006317]. JPMorgan limited the circulation of the materials. *See* e-mail from Barry L. Zubrow, JPMorgan, to Ian T. Lowitt, Lehman, *et al.* (Sept. 8, 2008) [JPM-2004 006317].

[6565] Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at p. 7; *see* e-mail from Barry L. Zubrow, JPMorgan, to Mark G. Doctoroff, JPMorgan, *et al.* (Sept. 5, 2008) [JPM-2004 0006286].

[6566] *In re Bayou Group, LLC*, 396 B.R. 810, 844 (Bankr. S.D.N.Y. 2008) (citing *Jobin*, 84 F.3d at 1338).

[6567] *Id.* at 845-46 (citations omitted).

Once on inquiry notice, if JPMorgan "fail[ed] to conduct a 'diligent investigation'" it will lack a good-faith defense.[6568] To prove "good faith," JPMorgan's "diligent investigation" must "ameliorate the issues that placed the transferee [or obligee] on inquiry notice in the first place."[6569] There is evidence that JPMorgan made inquiries of Lehman regarding its financial condition. James Dimon, JPMorgan's CEO, stated that, in every conversation he had with Fuld, he reiterated that JPMorgan wanted to help and that if anything JPMorgan was doing was hurting Lehman, Fuld should let Dimon know.[6570] In addition, Donna Dellosso, a risk manager in JPMorgan's investment bank, was receiving daily liquidity pool updates from Lehman.[6571]

The Examiner has observed no evidence, however, that JPMorgan's investigation ameliorated the issues that put JPMorgan on inquiry notice in the first place. The evidence suggests the opposite.[6572] After meeting with Lehman on September 4, 2008 to discuss Lehman's third quarter earnings and the status of its SpinCo plans,[6573] JPMorgan left concerned about the viability of its plans.[6574] In addition, after reviewing a draft copy of a presentation Lehman intended to give the rating agencies, executives at

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[6568] *Id.* at 859.

[6569] *Id.* (citing *Jobin*, 84 F.3d at 1335-56).

[6570] Examiner's Interview of James L. Dimon, Sept. 29, 2009, at p. 2.

[6571] Examiner's Interview of Donna Dellosso, Oct. 6, 2009, at p. 11; e-mail from Edward A. Deleon, JPMorgan, to Donna Dellosso, JPMorgan (Sept. 4, 2008) [JPM-2004 0001065]; e-mail from Mark G. Doctoroff, JPMorgan, to Donna Dellosso, JPMorgan, *et al.* (Sept. 11, 2008) [JPM-2004 0002262]. See also Section III.A.5.b of this Report for a discussion of the daily liquidity reporting.

[6572] See Section III.A.5.b of this Report for a detailed discussion of the attempts of JPMorgan to investigate Lehman's financial condition and JPMorgan's increasing concerns.

[6573] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at pp. 10-11.

[6574] *Id.* at p. 11.

JPMorgan found the presentation to be too vague and were concerned about the strategies Lehman outlined.[6575] Thus, there is evidence to support a finding that JPMorgan lacks a good-faith defense because JPMorgan was on inquiry notice and subsequent investigation did not ameliorate the issues that put JPMorgan on inquiry notice in the first place.

With respect to the question of value, this element of the good-faith defense raises the same inquiry as the reasonably equivalent value analysis. If JPMorgan were to prove that it acted in good faith, JPMorgan would retain its rights under the Guaranty to the extent of the value it provided. As described in Section III.B.3.g.5.a.ii.a.2 above, however, the Examiner has determined that there is sufficient evidence to conclude that JPMorgan did not transfer a quantifiable benefit to LBHI in connection with the September Guaranty.

2. Applicability of the Safe Harbor Provisions of the Bankruptcy Code to the September Guaranty

The Examiner concludes that there is sufficient legal basis to support a determination that the September Guaranty is not protected under Sections 546(e), (f), (g) or (j), which provide that "the trustee may not avoid a *transfer*" made to a Protected Party in connection with Protected Contracts, except in the case of actual fraud.[6576] In

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[6575] Examiner's Interview of Barry L. Zubrow, Sept. 16, 2009, at p. 7; *see* e-mail from Mark G. Doctoroff, JPMorgan, to Barry L. Zubrow, JPMorgan, *et al*. (Sept. 5, 2008) [JPM-2004 0006286].
[6576] *See* 11 U.S.C. §§ 546(e), (f), (g) and (j) (emphasis added).

contrast, Section 548 provides that "[t]he trustee may avoid any transfer . . . of an interest of the debtor in property, *or any obligation* . . . incurred by the debtor."[6577] The decision to include "obligations" within a trustee's avoidance powers under Section 548 but to exclude that same language from Section 546 suggests that the safe harbors do not protect the incurrence of obligations from avoidance.[6578] Whether the safe harbors protect the September Guaranty turns on whether a debtor makes a transfer or incurs an obligation when a debtor executes a guaranty.

Courts have uniformly determined that when a debtor incurs an obligation under a guaranty, this incurrence of debt is not a transfer under the Bankruptcy Code or New York state law, both of which define a transfer to include disposing or parting with an interest in property.[6579] These cases generally follow the rationale set forth in

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[6577] 11 U.S.C. § 548(a)(1) (emphasis added).

[6578] The Examiner has not located any reported decisions directly addressing this issue. However, this reading of Section 546 finds strong support in the case law. *See BFP v. Resolution Trust Corp.*, 511 U.S. 531, 537 (1994) (interpreting differently the phrases "fair market value" in Section 522 and "reasonably equivalent value" in Section 548 of the Bankruptcy Code because "it is generally presumed that Congress acts intentionally and purposely when it includes particular language in one section of a statute but omits it in another.") (quoting *Chicago v. Envtl. Def. Fund*, 511 U.S. 328 (1994)); *In re Joelson*, 427 F.3d 700, 705 (10th Cir. 2005) ("Because the phrase 'respecting the debtor's . . . financial condition' is used in both § 523(a)(2)(A) and § 523(a)(2)(B) and both provisions were enacted as part of the same statute, this is 'a classic case for application of the normal rule of statutory construction that identical words used in different parts of the same act are intended to have the same meaning.'") (internal citations omitted); *In re Merchants Grain, Inc.*, 93 F.3d 1347, 1356 (7th Cir. 1996) (applying same meaning to the phrase "fixing of liens" in Sections 522 and 545 of the Bankruptcy Code because "[t]here is a natural presumption that identical words used in different parts of the same act are intended to have the same meaning.") (internal citations omitted); *In re Revco D.S., Inc.*, No. 588-1308, 1990 Bankr. LEXIS 2966 (Bankr. N.D. Ohio Dec. 17, 1990) (comparing Section 544, which references attacking as fraudulent either the transfer of property or the incurrence of an obligation, with Section 502(d), which limits its application to fraudulent transfers and omits any reference to incurrence of an obligation).

[6579] 11 U.S.C. § 101(54); N.Y. DEBT & CRED. LAW § 270 (McKinney 2009); *see, e.g., Covey v. Commercial Nat'l Bank of Peoria*, 960 F.2d 657, 661 (7th Cir. 1992) ("Although a note or guarantee is not a "transfer" for

the Supreme Court's decision in *Barnhill v. Johnson*.[6580] In that case, the Court considered whether, for purposes of Section 547, a preferential transfer occurs on the date a check is written or on the date the drawee bank honors the check. The Court first noted that "'[w]hat constitutes a transfer and when it is complete' is a matter of federal law."[6581] Nevertheless, because the Bankruptcy Code's definition of transfer includes references to undefined terms such as "property" and an "interest in property," the Court had to look to state law to determine when a transfer of property occurred.[6582] After reviewing applicable state law, the Court concluded that the issuance of a check merely creates a promise to pay – *i.e.*, an obligation – for the maker and that the maker's property did not transfer until the drawee bank honored the check.[6583] The Court rejected the argument that issuing the check created a "conditional transfer," determining that the payee had no control over any of the maker's property until the check was honored:

> Until the moment of honor the debtor retains full control over disposition of the account and the account remains subject to a variety of actions by third parties. To treat petitioner's nebulous right to bring suit as a "conditional transfer" of the property would accomplish a near-limitless expansion of the term "conditional." In the absence of any right against

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purposes of 11 U.S.C. § 101(54) . . . both note and guarantee are obligations"); *In re Nirvana Restaurant Inc.*, 337 B.R. 495, 508 (citing *Covey* and holding that guaranty could not be avoided under N.Y.D.C.L § 274 because that statute did not apply to fraudulent obligations); *In re Asia Global Crossing, Ltd.*, 333 B.R. 199, 204 (Bankr. S.D.N.Y. 2005) (a guaranty is an "obligation" rather than a "transfer" within the meaning of 11 U.S.C. 101(54)); *see also Rubin v. Mfrs. Hanover Trust*, 661 F.2d 979, 990-91 (2d Cir. 1981) (granting of a guaranty is an "obligation incurred"); *accord In re Lawrence Paperboard Corp.*, 76 B.R. 866, 872 (Bankr. D. Mass. 1987).

[6580] 503 U.S. 393 (1992).

[6581] *Id*. at 397-98 (quoting *McKenzie v. Irving Trust Corp.*, 323 U.S. 365, 369-70 (1945)).

[6582] *Id*. at 398.

[6583] *Id*. at 400.

> the bank or the account, we think the fairer description is that petitioner had received no interest in debtor's property, not that his interest was "conditional."[6584]

Relying upon *Barnhill*, the Bankruptcy Court in the Southern District of New York concluded that when a debtor executes a guaranty, it incurs an obligation. The court reasoned:

> Like the check in *Barnhill*, the Guaranty gave 360networks a chose in action against Asia Global, conditioned on the default by GC Bandwidth. It did not grant 360networks any interest in or right to Asia Global's property. As such, it was an "obligation" rather than a "transfer" within the meaning of § 101(54). *See Covey v. Commercial Nat'l Bank*, 960 F.2d 657, 661 (7th Cir. 1992) ("Although a note or guarantee is not a 'transfer' for purposes of 11 U.S.C. § 101(54) . . . both note and guaranty are obligations."); *cf. Barnhill*, 503 U.S. at 400 n. 8 (even if the delivery of a check gave rise to a cause of action against the debtor, it would still not be a "transfer" under the Bankruptcy Code).[6585]

Thus, a court may find that LBHI's incurrence of obligations under the September Guaranty is not protected by the safe harbors.

A contrary argument may be constructed based upon recent Congressional amendments to expand the protections of the safe harbors. Pursuant to the 2005 amendments to the Bankruptcy Code, the definition of Protected Contracts was

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[6584] *Id*. at 401.

[6585] *Asia Global Crossing*, 333 B.R. at 204. In *In re Adler*, *Coleman Clearing Corp.*, 263 B.R. 406 (S.D.N.Y. 2001), the issue of whether a guaranty was outside of the reach of the safe harbors because it was the incurrence of an obligation and a not a transfer was raised, but not decided. *Id.* at 472-73. The trustee argued that because 546(e) shelters only "transfers" and because the Trustee was attempting to avoid "obligations," those "obligations" were not protected by the safe harbor. The court held that it did not need to reach this issue because, "[r]egardless of how broadly or narrowly the term [transfer] is defined, this Court is persuaded that the transfers which [defendants] seek to enforce against Adler either did not constitute qualifying 'payments' or did not contemplate consummation of a bona fide securities 'settlement' in the relevant sense of these words." *Id.* at 480.

expanded to include "any security agreement or arrangement or other credit enhancement related to any agreements or transactions referred to [ ], including any guarantee or reimbursement obligation…."[6586] An argument may also be made based upon the legislative history of the enactment of the safe-harbor provisions and the amendments thereto which evidence that Congress sought to reduce the systemic risk in the financial marketplace and prevent a "ripple effect" in which the insolvency of one financial firm triggers failures elsewhere in the market.[6587]

The Examiner observes that no decisions have been reported that apply the distinction between the avoidability of a transfer and an obligation in a case involving the safe harbor provisions of the Bankruptcy Code. Consequently, this issue will ultimately have to be resolved by the Court. If the September Guaranty is avoided, LBHI would not be liable for any unsecured deficiency claims that JPMorgan might assert based on the September Guaranty.

[6586] See §§ 11 U.S.C. 101(25) (forward contracts); 101(38)(A) (master netting agreements); 101(47) (repurchase agreements); 101(53)(B) (swap agreements) 761(4) (commodity contracts); and 741(7) (securities contracts).

[6587] See Section III.C.5.b.1 for a discussion of the application of the safe harbor provisions in light of recent Congressional amendments. The issue addressed in that Section of the Report deals with an actual transfer of securities as opposed to the creation of an obligation, which is the issue the Examiner is addressing here. An argument based upon legislative history and the discernment of perceived Congressional policy contravenes the instruction of various appellate court decisions requiring application of the plain meaning of the statute in the absence of ambiguity. *See QSI Holdings, Inc., v Alford* (*In re QSI Holdings, Inc.*), 571 F.3d 545, 549 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 984-85 (8th Cir. 2009); *Lowenschuss v. Resorts Int'l, Inc.* (*In re Resorts Int'l, Inc.*), 181 F.3d 505, 515 (3rd Cir. 1999); *Kaiser Steel Corp. v. Charles Schwab & Co., Inc.*, 952 F.2d 1230, 1237 (10th Cir. 1991).

c. Avoidability of Transfers of Collateral in Connection with the September Guaranty

While avoidance of the September Guaranty would eliminate any general unsecured deficiency claim filed by JPMorgan against LBHI for amounts owed to it in excess of its collateral, it would not automatically result in the return of the $8.6 billion pledged to secure the September Guaranty or an unwinding of the post-petition application of $1.95 billion of this pledge. The more difficult issue is whether (1) the transfers made between September 9 and September 12 of additional collateral to JPMorgan in connection with the September Agreements can be avoided either as fraudulent transfers or preferences or based upon a common law claim belonging to the LBHI estate under Section 541, or (2) the approximately $1.95 billion in setoffs that JPMorgan took post-petition may be avoided as improper post-petition transfers.

1. LBHI's Collateral Transfers and Post-Petition Setoffs

Between September 9 and the bankruptcy filing on September 15, 2008, LBHI transferred approximately $8.6 billion in cash collateral in connection with the September Agreements.[6588] Specifically, the following collateral transfers occurred during this period:[6589]

[6588] See Section III.A.5.b of this Report for a more detailed discussion of the transfers of collateral.

[6589] Appendix 18, Lehman Collateral at JPMorgan summarizes collateral posted by Lehman at JPMorgan from June 2008 through September 2008 in response to JPMorgan's margin requirements and collateral requests, which are discussed in detail at Section III.A.5.b of this Report. The chart neither lists every collateral movement nor tracks every individual security, but summarizes significant collateral posts, transfers and returns.

September 9, 2008	Cash	Lehman posted $1 billion cash in response to JPMorgan's September 9 collateral request for $5 billion (of which Lehman agreed to post $3 billion immediately).
September 9, 2008	Money Market Funds	Lehman posted approximately $1.7 billion in money market funds in response to JPMorgan's September 9 collateral request.
September 10, 2008	Cash	Lehman posted $300 million cash in response to JPMorgan's September 9 collateral request for $5 billion (of which Lehman agreed to post $3 billion immediately).
September 10, 2008	Corporate bonds	Lehman provided JPMorgan corporate bonds with a value of approximately $1.5 billion to value and possibly to substitute for some of the cash collateral Lehman posted in response to JPMorgan's September 9 collateral request.
September 11, 2008	Cash	Lehman posted $600 million cash related to JPMorgan's September 9 collateral request.
September 11, 2008	Corporate bonds	JPMorgan returned approximately $500 million of corporate bonds posted by Lehman.
September 12, 2008	Cash	Lehman posted $5 billion cash in response to JPMorgan's September 11 collateral request for $5 billion cash.
September 12, 2008	Corporate bonds	JPMorgan returned the remaining corporate bonds (approximately $1 billion) to Lehman.
September 12, 2008	Pine	JPMorgan released $1 billion (Lehman's valuation) of the Pine CLO to Lehman.

Of these transfers, the two that occurred on September 9 were made before the September Agreements were executed. Although it may be claimed that these transfers fall under the August Agreements, the evidence suggests that they were made in connection with JPMorgan's requests of LBHI to enter into the September Agreements.[6590]

Following LBHI's bankruptcy, JPMorgan applied $10.6 million of the $8.6 billion in cash collateral that LBHI pledged to repay obligations that were not owed by LBHI prior to the execution of the September Guaranty and applied $1.94 billion of the $8.6 billion in cash collateral to repay obligations that LBHI had guaranteed prior to September 9 on an unsecured basis. JPMorgan is holding the balance of the $8.6 billion in collateral (approximately $6.9 billion[6591]) and is asserting a right of offset in its Proofs of Claim. The specific setoffs that JPMorgan has already taken to date, asserting that these repayments were allowed under the safe-harbor provisions, are listed as follows:

- JPMorgan liquidated $10.1 million of LBHI collateral to pay an LBI obligation to JPMSI arising from securities lending activity.[6592]
- JPMorgan liquidated $545,000 of LBHI collateral to pay an LBI obligation to JPMorgan Clearing arising from securities lending activity.[6593]

[6590] See Section III.A.5.b of this Report.

[6591] This amount includes subsequent interest earned.

[6592] *See* JPMorgan, Exposure, Collateral and Setoff Summary (Oct. 27, 2009), at p. 5 [LBEX-JMPC 000199]. This collateral liquidation repays an obligation that was not owed by LBHI before the execution of the September Guaranty.

[6593] *See id.* This collateral liquidation repays an obligation that was not owed by LBHI before the execution of the September Guaranty.

- JPMorgan liquidated $1.57 billion of collateral against a JPMCB derivative claim on LBSF.[6594]
- JPMorgan liquidated $80.3 million of collateral against a WMB derivative claim on LBSF.[6595]
- JPMorgan liquidated $138.5 million of collateral against a JPMCB derivative claim on LBCC.[6596]
- JPMorgan liquidated $3.4 million of collateral against a JPMM derivative claim on LBIE.[6597]
- JPMorgan liquidated $2.1 million of collateral against a JPMBD derivative claim on LBIE.[6598]
- JPMorgan liquidated $91.0 million of collateral against a JPMCB derivative claim on LBFSA.[6599]
- JPMorgan liquidated $10.2 million of collateral against a JPMM derivative claim on LBFSA.[6600]
- JPMorgan liquidated $3.9 million of collateral against a JPMCFI claim on LBIE for repo transaction exposure.[6601]
- JPMorgan liquidated $1.9 million of collateral against a JPMM claim on LBIE for repo transaction exposure.[6602]

[6594] *See id.* at p. 3. This collateral liquidation repays an obligation that was guaranteed by LBHI on an unsecured basis before the execution of the September Agreements.

[6595] *See id.* This collateral liquidation repays an obligation that was guaranteed by LBHI on an unsecured basis before the execution of the September Agreements.

[6596] *See id.* This collateral liquidation repays an obligation that was guaranteed by LBHI on an unsecured basis before the execution of the September Agreements.

[6597] *See id.* This collateral liquidation repays an obligation that was guaranteed by LBHI on an unsecured basis before the execution of the September Agreements.

[6598] *See id.* This collateral liquidation repays an obligation that was guaranteed by LBHI on an unsecured basis before the execution of the September Agreements.

[6599] *See id.* This collateral liquidation repays an obligation that was guaranteed by LBHI on an unsecured basis before the execution of the September Agreements.

[6600] *See id.* This collateral liquidation repays an obligation that was guaranteed by LBHI on an unsecured basis before the execution of the September Agreements.

[6601] *See id.* at p. 5. This collateral liquidation repays an obligation that was guaranteed by LBHI under the August Guaranty.

- JPMorgan liquidated $17.6 million of collateral against a JPMM derivative claim on LBSF.[6603]
- JPMorgan liquidated $18.9 million of collateral against a JPMM claim on LBREM II BS Financing Mezz Holdings LLC for repo transaction exposure.[6604]

In summary, JPMorgan has liquidated approximately $1.95 billion of the $8.6 billion in cash collateral; it is still holding approximately $6.9 billion of this collateral and it is asserting a right of setoff against the following obligations: (1) approximately $6.56 billion in exposures related to clearance advances; (2) approximately $75.6 million related to derivative contract claims; (3) approximately $228.8 million related to other investment bank and treasury and security services claims;[6605] and (4) $733.5 million related to asset management exposure.[6606]

Absent application of the safe harbors, the Examiner concludes that there is a colorable claim to avoid, at least in part, the collateral transfers LBHI made in connection with the September Guaranty. If the September Guaranty is avoided as a fraudulent obligation, it cannot serve as the underlying claim supporting the collateral

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[6602] *See id.* This collateral liquidation repays an obligation that was guaranteed by LBHI under the August Guaranty.

[6603] *See id.* at p. 3. This collateral liquidation repays an obligation that was guaranteed by LBHI on an unsecured basis before the execution of the September Agreements.

[6604] *See id.* at p. 5. This collateral liquidation repays an obligation that was guaranteed by LBHI under the August Guaranty.

[6605] *See* Section III.B.3.g.5.a.ii.c.4, of this Report for a description of the investment bank and treasury and security services claims.

[6606] *See* Section III.B.3.g.5.a.vi of this Report for a description of asset management exposure claims.

pledges.[6607] Because there would be no underlying debt owed by LBHI there would be no basis for JPMorgan to retain collateral posted by LBHI. Thus, to the extent that JPMorgan declined to return the collateral voluntarily, the transfers of cash made solely in reliance upon the September Guaranty would be subject to claims for a return of the collateral under Article 9 of the UCC and New York common law,[6608] fraudulent transfer law[6609] and state law claims for unjust enrichment, money had and received and conversion.[6610] Alternatively, as set forth in Section III.B.3.g.5.a.ii.b.2, absent application of the safe harbors, there is a colorable claim to avoid certain of the transfers made following the execution of the September Guaranty as preferences.

There are two important caveats to this analysis. First, with respect to any collateral that is found to be posted in favor of JPMorgan to secure derivatives contracts, LBHI had previously guaranteed these obligations on an unsecured basis for certain of its subsidiaries and the September Agreements simply made LBHI's prior guaranty

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[6607] *See Silverman v. Paul's Landmark, Inc. (In re Nirvana Restaurant Inc.),* 337 B.R. 495, 502 (Bankr. S.D.N.Y. 2006) ("if the Guaranty is avoided as a fraudulent obligation, it cannot serve as 'fair consideration' for the subsequent Transfers") (citing *Dempster v. Overview Equities, Inc.,* 4 A.D.3d 495 (N.Y. App. Div. 2004) (unenforceable obligation cannot constitute "fair consideration")).

[6608] For collateral where a secured party exerts control (deposit accounts, electronic chattel paper, investment property, letter of credit right, electronic document), Section 9-208 of the New York UCC requires the secured party to turn over the property if no further obligations are owed to the secured party "within 10 days after receiving an authenticated demand by the debtor." McKinney's Uniform Commercial Code Law § 9-208 (2010). New York law further provides that when the underlying obligation is satisfied, the debtor is entitled to the property back. *Keshishian Bros. v. Deverian*, 279 A.D. 324 (N.Y. App. Div. 1952), *order amended by* 280 A.D. 910 (N.Y. App. Div. 1952); *Kirsch v. Provident Loan Soc. of N.Y.*, 71 N.Y.S.2d 241 (N.Y. App.. Term 1947). If the property is not returned the creditor is liable for conversion. *Rutherford Nat. Bank v. Manniello*, 271 N.Y.S. 69 (N.Y. App. Div. 1934), *aff'd*, 195 N.E. 203 (N.Y. 1935).

[6609] *Nirvana Rest.,* 337 B.R. at 502

[6610] See III.B.3.g.5.a.v of this Report.

secured.[6611] Thus, even if the September Guaranty is avoided, there remains in place a contract that creates liability for LBHI on account of the derivatives contracts. Because transfers in favor of guaranties of derivatives contracts are safe-harbored,[6612] unless the underlying unsecured derivatives guaranty can be avoided, this analysis does not apply. Although the Examiner has not undertaken to analyze whether any claims exist to avoid LBHI's guaranties of its subsidiaries' obligations under various ISDA agreements, he notes that these guaranties were all executed well outside of the time period during which the Examiner has found evidence to support a finding of insolvency or undercapitalization, and thus the Examiner does not believe that there would be colorable claims to avoid these guaranties.

Second, on June 9, 2005, the Executive Committee of LBHI's Board of Directors approved a Unanimous Written Consent pursuant to which LBHI "hereby fully guarantees the payment of all liabilities, obligations and commitments of the

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[6611] *See* ISDA Master Agreement between JPMCB and LBCC (Nov. 15, 1993), at p. 25 [JPM-2004 0000368] (providing a guaranty by LBHI); ISDA Master Agreement between JPMM and LBIE (Aug. 26, 1997), at p. 14 [JPM-2004 0086169] (providing a guaranty by LBHI); ISDA Master Agreement between JPMCB and LBFSA (Nov. 15, 1993), at p. 24 [JPM-2004 000850] (providing a guaranty by LBHI); Amendment to the ISDA Master Agreement between JPMM and LBFSA (July 11, 2008), at p. 35 [JPM-2004 0086103] (providing guaranty by LBHI); ISDA Master Agreement between JPMCB and LBSF (Dec. 20, 1995), at p. 22 [JPM-2004 0000345] (providing guaranty by LBHI); ISDA Master Agreement between JPMBD and LBIE (Feb. 23, 1998), at p. 21 [JPM-2004 0086072]; Guarantee of LBHI for ISDA Master Agreement between WMB and LBSF (May 28, 1998) [LBEX-JPM 0000210]; Guarantee of LBHI for ISDA Master Agreement between JPMM and LBSF (June 7, 2002) [LBEX-JPM 0000212].

[6612] 11 U.S.C. § 546 (e), (f), (g), and (j).

subsidiaries set forth on Schedule A."[6613] The Schedule A guaranteed subsidiaries include LBJ, LBIE, LBCB, and Lehman Brothers Bankhaus AG.[6614] Later Unanimous Written Consents of LBHI's Board of Directors provide for a guaranty of Lehman Brothers Treasury Co., LBCS, LBB, Lehman Brothers PTE, Ltd, and Lehman Brothers Finance Asia Pte. Ltd.[6615] In addition, in at least one instance, LBHI revoked the guaranteed status of its subsidiary, Lehman Re Ltd.[6616] The Examiner cannot conclude with certainty whether or to what extent other LBHI guaranties of subsidiaries were added or revoked. There is evidence to support a conclusion, however, that LBI was not a guaranteed subsidiary of LBHI.[6617] The Amended and Restated Code of Authorities for LBHI authorized LBHI upon resolution of the Executive Committee of

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[6613] Unanimous Written Consent of the Executive Committee of the Board of Directors of Lehman Brothers Holding Inc. (June 9, 2005) [LBEX-AM 003415].

[6614] *Id.*

[6615] Unanimous Written Consent of the Executive Committee of the Board of Directors of LBHI (Feb. 24, 2005) [LBEX-WGM 1102366] (resolution to make Lehman Brothers Treasury Co. a guaranteed subsidiary of LBHI); Unanimous Written Consent of the Executive Committee of the Board of Directors of LBHI (Nov. 7, 2005) [LBEX-WGM 1104149] (resolution to make LBCS a guaranteed subsidiary of LBHI); Unanimous Written Consent of the Executive Committee of the Board of Directors of LBHI (May 14, 2007) [LBEX-WGM 965000] (resolution to make LBB a guaranteed subsidiary of LBHI); Unanimous Written Consent of the Executive Committee of the Board of Directors of LBHI (Apr. 9, 2008) [LBEX-AM 003644] (resolution to make Lehman Brothers Finance Asia Pte. Ltd a guaranteed subsidiary of LBHI); Lehman Brothers Holdings Inc. Minutes of the Board of Directors (Nov. 8, 2007) [LBHI_SEC07940_026649] (reflecting consent to make Lehman Brothers PTE Ltd. a guaranteed subsidiary of LBHI].

[6616] Lehman Brothers Holdings Inc. Minutes of the Board of Directors (Nov. 8, 2007) [LBHI_SEC07940_026649] (reflecting consent to revoke the guaranteed subsidiary status of Lehman Re Ltd.).

[6617] Alvarez & Marsal, Responses to Questions for Alvarez & Marsal/Weil, Gotshal & Manges (Dec. 7, 2009), at p. 1 (confirming that LBI was not a guaranteed subsidiary of LBHI).

its Board of Directors to provide a full guaranty of all of the obligations of its subsidiaries.[6618]

The Examiner has located no decision involving the enforceability of a guaranty contained only in a corporate resolution. This resolution, however, may be viewed as a unilateral contract for a general guaranty that may be enforced by "anyone to whom it is presented who acts upon it."[6619] The guaranty resolution appears to satisfy the basic general guarantee requirements of knowledge,[6620] acceptance (which can be implied) and consideration and therefore may be held to create an enforceable general guaranty obligation.[6621] To the extent this guaranty is upheld, it would serve as a pre-existing debt that would support the application of LBHI's collateral to the claim of entities covered by the guaranty resolution. As set forth in Section III.B.3.g.5.a.ii.c.4, some of the non-Protected obligations asserted in JPMorgan's proof of claim are obligations owed by subsidiaries covered by the guaranty resolution. As analyzed in Section III.B.3.g.5.a.v, this fact may make the transfers of collateral to secure obligations

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[6618] The Amended and Restated Code of Authorities for LBHI As Amended Through July 1, 2004 [LBEX-AM 043802].

[6619] *FinanceAmerica Private Brands, Inc. v. Harvey E. Hall, Inc.*, 380 A.2d 1377, 1379 (Del. Super. Ct. 1977).

[6620] The LBHI 2006 10-K (Feb. 13, 2007) and 2007 10-K (Jan. 29, 2008) refer to the fact that LBHI "guarantee[s] all of the obligations of certain subsidiaries…."

[6621] *See APL, Inc. v. Ohio Valley Aluminum, Inc.*, 839 S.W. 2d 571, 573 (Ky. Ct. App. 1992) ("When the circumstances surrounding the issuance of an absolute guaranty and the terms of the writing itself evidence no indication that the guarantor anticipates notification of acceptance from the creditor, the guarantor will be held liable on the instrument from the time the creditor acts in reliance on it.").

covered by the guaranty resolution avoidable as preferences and not as fraudulent transfers or under state law.[6622]

2. Application of the Safe Harbors to the $8.6 Billion Cash Collateral Transfers

Whether the September Guaranty is protected by the safe harbors is, as noted above, a question of first impression that must be resolved by the Court. If the Court determines that a guaranty is an obligation not protected by the safe harbors and thus avoidable, the transfers of collateral pursuant to the September Agreements nevertheless may still be protected by the safe harbors. The safe-harbor provisions of Sections 546(e), (f), (g), and (j) protect transfers made to Protected Parties *in connection with* the Protected Contracts from avoidance.[6623] Protected Contracts include "any security agreement or arrangement or other credit enhancement related to any agreements or transactions referred to [ ], including any guarantee or reimbursement obligation. . . ."[6624] Thus a transfer made pursuant to a guaranty of a Protected Contract is also itself protected under the safe harbors. This would seem to insulate the transfers of collateral to JPMorgan to the extent that the transfers were made to secure obligations owed by LBHI or its affiliates on account of Protected Contracts. This results in the

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[6622] Given the manner in which LBHI's liability under the August Guaranty is calculated, as explained in Section III.B.3.g.5.a.iii, LBHI's liability under the August Guaranty may have been minimal or zero as of September 15, 2008.

[6623] *See* §§ 11 U.S.C. 546(e), (f), (g) and (j).

[6624] *See* §§ 11 U.S.C. 101(25) (forward contracts); 101(38)(A) (master netting agreements); 101(47) (repurchase agreements); 101(53)(B) (swap agreements) 761(4) (commodity contracts); and 741(7) (securities contracts).

anomaly of the September Guaranty being subject to avoidance while the pre-petition transfers of collateral made pursuant to the September Guaranty not being subject to avoidance.

Nonetheless, the Examiner concludes that there are three different colorable bases to assert that the safe-harbor provisions of the Bankruptcy Code do not apply. First, the safe-harbor provisions do not create rights for JPMorgan that do not otherwise exist in the parties' agreements. If the September Guaranty is avoided, there is no underlying debt owed by LBHI to JPMorgan (subject to the caveats noted above) and no basis for JPMorgan to apply the $8.6 billion in LBHI collateral to repay the debts owed in the first instance by LBHI's subsidiaries. Put another way, the safe-harbor provisions do not grant a financial participant rights to collateral it does not enjoy under its agreements. Moreover, the safe-harbor provisions do not apply to Section 553 except in certain circumstances or to Section 549 of the Code.[6625] Thus, if JPMorgan seeks permission to apply the collateral to its claims under Section 553, the Bankruptcy Court is not constrained by the safe-harbor provisions in denying the request (except in the circumstances set forth in Sections 362(b)(6), (7), (17), (27) and 561). Because Section 553(a)(1) expressly provides that a right of setoff is not preserved if the "claim of such

[6625] 11 U.S.C. §§ 546(e), (f), (g), and (j).

creditor against the debtor is disallowed,"[6626] the Court would likely deny a request for leave to setoff LBHI's cash against the obligations owed by other Lehman entities.

Alternatively, if JPMorgan applies the LBHI collateral without first seeking Bankruptcy Court permission, the Bankruptcy Court will be entitled to examine that setoff under Section 549, again without being constrained by the safe-harbor provisions of the Code, except to the extent that the setoffs are covered by Sections 362(b) (6), (7), (17), (27) and 561. Because the exceptions to the automatic stay only allow for collateral to be liquidated to pay claims in accordance with the parties' agreements and do not expand the rights of the financial participant, if the September Guaranty is avoided, there would be no authority in the Code to authorize the setoff and it would be recoverable under Section 549(a).

Second, the Enron bankruptcy produced several decisions involving the safe harbors of Section 546(e), including decisions that held that transfers made by Enron to acquire its own shares at a time when it was allegedly already insolvent or rendered insolvent by virtue of the transactions were not protected from avoidance by Section 546(e) because the transactions at issue were illegal and unenforceable, and therefore void from inception, pursuant to an Oregon statute that prohibits distributions by an

[6626] 11 U.S.C. § 553(a)(1).

insolvent corporation on account of its stock.[6627] Thus, the argument here would be that transfers made pursuant to a void guaranty are not protected.

Third, the transfers of collateral in connection with the September Guaranty could be avoided under state law claims that belong to LBHI pursuant to Section 541. Although the safe-harbor provisions explicitly prohibit a trustee from avoiding transfers under Sections 544, 545, 547, 548(a)(1)(B) and 548(b), they apparently do not prohibit a trustee from asserting causes of actions that become property of a debtor's estate under Section 541, such as state law claims arising under the UCC, for conversion, unjust enrichment or money had and received, nor do they prohibit a trustee from bringing claims under Sections 549 or 553 (subject to Sections 362(b)(6), (7), (17), (27) and 561) to unwind improper post-petition setoffs.[6628] Therefore, because the safe harbors omit Section 541, the safe harbors may not protect against actions brought pursuant to Section 541 to avoid the transfers made pursuant to the September Agreements.[6629]

[6627] *See Enron Corp. v. UBS AG (In re Enron),* No. 01 B 16034 (AJG), 2005 WL 3873897 (Bankr. S.D.N.Y. Aug. 10, 2005); *Enron Corp. v. Credit Suisse First Boston Int'l (In re Enron Corp.),* 328 B.R. 58 (Bankr. S.D.N.Y. 2005); *Enron v. Bear, Stearns Int'l Ltd. (In re Enron Corp.),* 323 B.R. 857 (Bankr. S.D.N.Y. 2005).

[6628] A general canon of statutory construction is that "the enumeration of specific statutory sections subject to a rule implies that the omitted sections are excluded from that rule's application." *DiCello v. U.S.A. (In re Railway Reorganization Estate, Inc.),* 133 B.R. 578, 581 (Bankr. D. Del. 1991) (citations omitted). The Bankruptcy Code specifically provides that the terms "includes" and "including" are not limiting. 11 U.S.C. § 102(3). Because the list of sections subject to the safe harbors is not set off by terms such as "includes" or "including," "it may be assumed Congress meant the list to be exhaustive." *DiCello,* 133 B.R. at 581-82 (interpreting list of enumerated Sections subject to 546(a)).

[6629] In other contexts, courts have read Section 546 narrowly and limited its application expressly as written. *See Hartvig v. Tri-City Baptist Temple of Milwaukee, Inc. (In re Gomes),* 219 B.R. 286, 296 (Bankr. D.

However, as set forth more fully in Appendix 1, Legal Issues, Section IV.F., any court addressing this issue will likely be faced with the argument that Section 546 preempts all state law claims, including those arising under Section 541, notwithstanding the lack of an express reference to Section 541 within Section 548.[6630] The case law on preemption is unsettled and the two leading decisions, neither of which would be controlling in this case, are distinguishable in that in one of these cases the state law claims asserted were not state law claims belonging to the estate under Section

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Or. 1998) (bankruptcy court "is in no position to recognize an exception to avoidance powers where Congress did not create one."); *see also In re Nat'l Forge Co.,* 343 B.R. 340, 370 (W.D. Pa. 2006) (refusing to read into Section 546(e) "terms that are presently absent" where to do so "would result 'not [in] a construction of [the] statute, but, in effect, an enlargement of it by the court, so that what was omitted, presumably by inadvertence, may be included within its scope.'") (quoting *Lamie v. U.S. Trustee,* 540 U.S. 526, 538 (2004); *see also El Paso City of Texas v. Am. W. Airlines, Inc. (In re Am. W. Airlines, Inc.),* 217 F.3d 1161, 1167-68 (9th Cir. 2000) (objections to claims pursuant to Section 502(d) were not subject to Section 546(a) limitations even though trustee was precluded from filing Section 547 actions by Section 546(a) limitations); *In re Stoecker,* 143 B.R. 118, 131-38 (Bankr. N.D. Ill. 1992) (same), *order aff'd in part, rev'd in part on other grounds,* 143 B.R. 879 (N.D. Ill. 1992), *judgment aff'd in part, vacated in part on other grounds,* 5 F.3d 1022 (7th Cir. 1993); *Schwartz v. Pierucci,* 60 B.R. 397, 399 (E.D. Penn. 1986) (trustee's claims pursuant to Uniform Fiduciary Act were not brought pursuant to trustee's avoiding powers and therefore were not subject to Section 546(a) limitations); *Smith v. Morris R Greenhaw Oil and Gas, Inc. (In re Greenhaw Energy, Inc.),* 359 B.R. 636, 640-42 (Bankr. S.D. Tex. 2007) (although trustee was barred by Section 546(a) limitations period from asserting wrongful foreclosure under Section 544, trustee had authority to pursue such claim under Section 541 which was not so time barred); *Miller v. Spitz, M.D. (In re CS Assoc.),* 156 B.R. 755 (Bankr. E.D. Penn. 1993) (holding that trustee's proceeding under Section 723 was not subject to Section 546(a) limitations and rejecting argument that Section 723 actions were within the scope of Section 544 actions); *Mann v. Commonwealth Savings & Loan Assoc. (In re Ollada),* 114 B.R. 654 (Bankr. E.D. Mo. 1990) (trustee's action for turnover pursuant to Sections 542 and 543 was not subject to Section 546(a) limitations); *Britton v. Fessler & Bowman, Inc. (In re Britton),* 66 B.R. 572, 575 (Bankr. E.D. Mich. 1986) (debtor's claims categorized by the court as an "equitable action for restitution" were not subject to Section 546(a) limitations because the action was not brought by a trustee and because it did not arise under Section 544, 545, 547, 558 or 553).

[6630] *See Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 988 (8th Cir. 2009) (state law claims for unjust enrichment and illegal and/or excessive shareholder distributions preempted by § 546(e)); *Official Comm. of Unsecured Creditors of Hechinger Inv. Co. v. Fleet Retail Fin. Group (In re Hechinger Inv. Co.)*, 274 B.R. 71, 96 (D. Del. 2002) (unjust enrichment claim preempted by § 546(e)).

541.[6631] Further, one of the cases relies upon the conclusion that the claim at issue was effectively the same as an action to avoid a transfer under Sections 544 or 548, and therefore, the court determined that the claim could not be brought.[6632] Apart from the fact that the preemption decisions are both distinguishable and not controlling, a valid argument can be made, as set forth in Appendix 1, Legal Issues, Section IV.F, that preemption does not apply to Section 546 because by its own terms Section 546 does not apply to actions brought under Sections 541, 548(a)(1)(A), 549 and 553 (subject to certain exceptions), suggesting that Congress did not intend to fully cover all types of claims against financial participants when it enacted the safe-harbor provisions.[6633] Thus, the Examiner concludes that notwithstanding the existence of the preemption case law, there is a colorable basis to conclude that state law claims belonging to LBHI under Section 541 are not barred.

3. There Is Evidence to Support Potential State Law Claims Available to LBHI Pursuant to Section 541 to Avoid the Transfers In Connection with the September Guaranty

If the September Guaranty is avoided, and the Court finds that state law claims that belong to LBHI under Section 541 are not preempted by the safe-harbor provisions

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[6631] *Contemporary Indus.*, 564 F.3d at 984 (state law claims asserted pursuant to section 544).

[6632] *Hechinger*, 274 B.R. at 96.

[6633] See Appendix 1, Legal Issues, at Section IV.F. for a discussion of the issue of preemption of such state law claims.

of Section 546, then LBHI has three colorable state law claims to recover the transfers of collateral.

First, under Section 9-208 of the UCC, a secured creditor is under a duty to relinquish control over deposit accounts if the underlying obligation is satisfied.[6634] The Official Comments to Section 9-208 provide that a secured party also is required to relinquish possession of collateral when the underlying obligation is satisfied and the failure to do so would constitute conversion.[6635]

Conversion is "any unauthorized exercise of dominion or control over property by one who is not the owner of the property that interferes with and is in defiance of a superior possessory right of another in the property."[6636] To maintain a claim for conversion, a plaintiff must show: "(1) legal ownership or an immediate superior right of possession to a specific identifiable thing and (2) that the defendant exercised an unauthorized dominion over the thing in question, to the alteration of its condition or to the exclusion of the plaintiff's rights."[6637] A conversion claim "may only succeed if the party alleges a wrong that is distinct from any contractual obligations."[6638] Rather, a

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[6634] McKinney's Uniform Commercial Code Law § 9-208 (2010).

[6635] *Id*. at cmt. 4; *Rutherford Nat. Bank v. Manniello*, 240 A.D. 506, 508, 271 N.Y.S. 69, 72 (1934).

[6636] *Command Cinema Corp. v. VCA Labs, Inc.*, 464 F. Supp. 2d 191, 199 (S.D.N.Y. 2006).

[6637] *Id.*

[6638] *Id.* (quoting *Phensalker v. Anderson Weinroth & Co., L.P.*, 175 F. Supp. 2d 635, 639 (S.D.N.Y. 2001), *vacated on other grounds*, 344 F.3d 184 (2d Cir. 2003) (internal quotations omitted)).

"plaintiff must show acts that were unlawful or wrongful as opposed to violations of contractual rights."[6639]

Evidence exists to support this claim because (1) LBHI had legal ownership or an immediate superior right of possession to the $8.6 billion in cash transfers made to JPMorgan in connection with the September Guaranty; and (2) if the September Guaranty is avoided and JPMorgan is not entitled to recover from LBHI, JPMorgan will have exercised unauthorized dominion over the funds, to the alteration of their condition and to the exclusion of LBHI's rights. Although JPMorgan might argue that LBHI authorized JPMorgan's possession and control over the transfers, LBHI could not have consented to an agreement that violates the law.[6640] Therefore, if the September Guaranty is found to be a fraudulent obligation, there is a colorable claim against JPMorgan for conversion to recover the $8.6 billion in collateral less an amount equal to any unpaid obligations covered under any other guaranties, such as the August Guaranty,[6641] the derivatives guaranties[6642] or the guaranty resolution.[6643]

[6639] *Id.*

[6640] *Smith v. Brown*, 778 N.E.2d 490, 496 (Ct. App. Ind. 2002) (finding that the defendant exerted unauthorized control, despite consent to an agreement, because a party cannot consent to an agreement that violates state law).

[6641] As set forth in Section III.B.3.g.5.a.iii, there are likely no claims covered by the August Guaranty.

[6642] The claims covered by the derivatives guaranties remaining after the application of subsidiaries' collateral total approximately $1.94 billion. *See* JPMorgan, Exposure, Collateral and Setoff Summary (Oct. 27, 2009) [LBEX-JPMC 000199].

[6643] The guaranty resolution would appear to apply to a $95 million claim asserted by LBJ and contingent claims asserted by Lehman Brothers Bankhaus AG and Woodlands Commercial Bank (f/k/a/ Lehman Brothers Commercial Bank). Unanimous Written Consent of the Executive Committee of the Board of

Second, LBHI may have a cause of action for unjust enrichment to remedy the transfers made to JPMorgan in connection with the September Guaranty because: (1) JPMorgan was enriched, (2) at Lehman's expense and (3) it would be against equity and good conscience to permit JPMorgan to retain what is sought to be recovered.[6644] Here, if the September Guaranty is avoided, LBHI may have a colorable claim for unjust enrichment because JPMorgan received a benefit on a contract later found to be void or unenforceable.[6645] The remedy for unjust enrichment is restitution.[6646] Where a party has a claim for unjust enrichment, the value of the claim will depend on the conduct of the parties, but will not be less than the value of the property at the time it was transferred unless the transferee is without fault.[6647]

If LBHI were to prevail on a claim for unjust enrichment, LBHI would likely recover at least the value of the assets at the time of the transfer. As the assets may have

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Directors of Lehman Brothers Holding Inc. (June 9, 2005) [LBEX-AM 003415]. It also would cover the LBIE line of credit but no amounts are claimed as due under that line of credit. *Id*.

[6644] *See AHA Sales, Inc. v. Creative Bath Prods., Inc.,* 867 N.Y.S. 2d 169, 180 (N.Y. App. Div. 2008) (citations omitted).

[6645] *See U.S. E. Telecomm., Inc. v. US W. Comm. Servs.,* 38 F.3d 1289, 1299 (2d. Cir. 1994) (holding that a subcontractor could recover against a general contractor under unjust enrichment theory where the contract between the parties was found to be unenforceable); *see also Taylor & Jennings, Inc. v. Bellino Bros. Constr. Co. Inc.,* 483 N.Y.S. 2d 813 (N.Y. App. Div. 1984) (finding that where a subcontract was voided as induced by fraud, recovery by the subcontractor against the contractor under the equitable doctrine of quantum meruit was proper); *Aluminum Fare, Inc. v. Abdella,* 456 N.Y.S. 2d 184 (N.Y. App. 1982) (where no valid agreement existed because written proposal was never signed and parties subsequently orally altered proposal, contractor could still recover from owner on theory of quantum meruit for services rendered).

[6646] *State of New York v. SCA Servs. Inc.,* 761 F. Supp. 14, 15 (S.D.N.Y. 1991) ("a plaintiff who establishes a prima facie case of unjust enrichment is entitled to the equitable remedy of restitution.").

[6647] *See Vanleigh Carpet Corp. v. Gene Schoor's Iron Forge*, 318 N.Y.S.2d 402 (N.Y. Civ. Ct. 1971); *see also* 22A N.Y. Jur. 2d Contracts § 587 (2009).

declined in value since the transfer, a court would have to determine their value as of the time of transfer. However, the amount of that value available to LBHI for recovery will depend on the Court's determination of LBHI and JPMorgan's behavior. If the court determines that JPMorgan was conscious that its demands that LBHI execute additional and expanded guaranties or that its subsequent demands for collateral under those guaranties were wrongful, then LBHI would be able to recover the full value of the assets plus any of JPMorgan's profits from them. If the court determines that JPMorgan's demands were not consciously wrongful, LBHI would be able to recover the value of the property up to the amount of its loss. If the court determines that LBHI is entitled to restitution for the assets but that JPMorgan acquired them innocently and with no more fault than LBHI, LBHI's recovery would be limited to the benefit JPMorgan received from the assets or the return of the transferred assets.

Finally, the Examiner has concluded that LBHI has a colorable claim against JPMorgan for money had and received. Such cause may lie to remedy the transfers made to JPMorgan in connection with the September Guaranty because (1) JPMorgan received money belonging to the claimant, (2) JPMorgan benefited from receipt of the money, and (3) under principles of equity and good conscience, the defendant should not be permitted to keep the money.[6648] An action for money had and received is based upon unjust enrichment and therefore the analysis is similar. JPMorgan will likely

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[6648] *Brewer v. State of New York*, 672 N.Y.S.2d 650, 656 (N.Y. Ct. Cl. 1998).

argue that there was a contract, and therefore unjust enrichment or money had and received cannot apply. If the September Guaranty is avoided, however, there is no contract.[6649] As in the case of *Friar,* there is evidence to support a finding that LBHI had no realistic alternative but to accept to JPMorgan's demands.[6650] Therefore, the transfers at issue may be subject to a claim for money had and received.

The remedy for a cause of action for money had and received is restitution.[6651] Therefore, LBHI's recovery for claims for money paid and received will be governed by the principles of unjust enrichment and restitution set forth above.[6652]

[6649] Underlying contracts would exist with respect to the derivatives contracts and any obligations also falling within the scope of the August Guaranty or the LBHI guaranty resolution. For this reason, avoiding the August Guaranty may also be necessary.

[6650] *Friar v. Vanguard Holding Corp.*, 434 N.Y.S.2d 698, 701-02 & n.2 (N.Y. App. Div. 1980) (holding that an action for money had and received was adequately pled where the seller of home alleged he was compelled to pay mortgage tax to lender or else sale would be aborted, and seller had no realistic alternative to surrender to lender's demands).

[6651] *Citipostal, Inc. v. Unistar Leasing*, 724 N.Y.S.2d 555, 559 (N.Y. App. Div. 2001).

[6652] Whether preemption applies may depend on whether the state law causes of action are in the nature of *avoidance* actions. *See In re Fin. Mgmt. Servs., Inc.*, 261 B.R. 150, 156 (Bankr. W.D. Pa. 2001). The remedy for an unjust enrichment or money had and received is restitution. A person obtains restitution when he is restored to the position he formerly occupied either by the return of something that he formerly had or by the receipt of its equivalent in money. *Restatement (First) of Restitution* (2009), Chap. 1, Topic 1, § 1. Even if JPMorgan acted tortiously, the most LBHI would be able to recover through restitution is the value of the property up to the full amount of LBHI's loss and the profits JPMorgan obtained. Therefore, restitution is basically an avoidance of the benefit received by the wrongdoer, or a legal doctrine "designed to avoid unjust enrichment." *In re Rezulin Prods. Liability Litig.*, 390 F. Supp. 2d 319, 340 (S.D.N.Y. 2005). Because restitution can be equated to an avoidance action, the causes of action of unjust enrichment and money had and received could be deemed preempted by the safe harbors if a court applies the doctrine. A state law cause of action for conversion, however, cannot be equated to an avoidance action. The remedy for conversion is a damage remedy. The property itself is not returned to the party who was wronged; rather, the party receives damages in the amount of the value of the property at the time of conversion. *See Bank Brussels Lambert v. Credit Lyonnais (Suisse)*, 192 B.R. 73, 76 n.3 (S.D.N.Y. 1996) ("recovery on a conversion claim will be an amount equal to the full value of the converted property, rather than return of the specific property"). Therefore, a state law cause of action for conversion cannot be equated to an avoidance action, and thus is arguably not preempted by the safe harbors.

In summary, if the safe harbors set forth in Section 546 do not protect the transfers of collateral in connection with a voided guaranty, or if, in the alternative, state law claims are not preempted, then there are colorable claims that transfers of collateral made in connection with the September Agreements totaling as much as $6.9 billion[6653] (the $8.6 billion in transfers less the $1.95 billion in setoffs JPMorgan has already taken on account of obligations that are both Protected Contracts and/or subject to the derivatives guaranties) would be avoidable as fraudulent transfers or preferences.

4. To the Extent the September Guaranty Provided for a Guaranty of Non-Protected Contract Obligations, or to the Extent JPMorgan Liquidated Collateral Pursuant to Non-Protected Contract Exposure, a Colorable Basis Exists That the Safe Harbor Provisions Are Not Applicable

The Examiner concludes that LBHI has a colorable basis to claim that even if the safe harbors are generally applicable, not all of the collateral transfers made pursuant to the September Agreements are protected. The safe-harbor provisions of Sections 546(e), (f), (g), and (j) protect transfers made to the Protected Parties *in connection with* the Protected Contracts from avoidance.[6654] Whether or not guaranties that secure both Protected Contracts and non-Protected Contracts fall within the safe-harbor provisions depends on a court's interpretation of the "in connection with" language.

[6653] *See* Appendix 23, Duff & Phelps, Analysis of APB, Journal Entry, Cash Disbursement and JPMorgan Collateral for a detailed listing of the amount, and timing, of the collateral transferred from LBHI to JPMorgan in connection with the September 9 Guaranty.

[6654] *See* 11 U.S.C. §§ 546(e), (f), (g) and (j).

The court in *American Home Mortgage* provides some guidance on this issue.[6655] There, the debtors entered into a repurchase agreement that governed the rights and obligations related to the sale and repurchase of mortgage loans or interests in mortgage loans from the debtors to counterparty Calyon. The agreement also provided for the servicing of mortgage loans subject to the repurchase agreement.[6656] Applying the plain meaning of the statute, the court held that the sale and repurchase of mortgage loans under the contract constituted a repurchase agreement under the criteria of Section 101(47). Therefore, Section 559 applied and Calyon could enforce its rights under the contract triggered by a condition of the kind specified in Section 365(e)(1).[6657] The court also held that the contract was a securities contract and that Calyon was a financial institution and therefore Section 555 was also applicable.[6658] Although it found portions of the contract subject to the safe harbors, the court held that the debtor's obligations relating to the servicing of mortgage loans under the contract were severable.[6659] Because the servicing contract was neither a repurchase agreement nor a securities contract, it was not subject to Sections 555 or 559, and therefore the court held that this part of the contract was not subject to the safe harbors, and Calyon could not

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[6655] *Calyon N.Y. Branch v. American Home Mortgage Corp. (In re American Home Mortgage, Inc.),* 379 B.R. 503 (D. Del. 2008).
[6656] *Id.* at 509.
[6657] *Id.* at 517-18.
[6658] *Id.* at 518-19.
[6659] *Id.* at 521.

enforce its rights relating to the servicing of the mortgage loans triggered by a condition of the kind specified in Section 365(e)(1).[6660]

A plausible reading of *American Home Mortgage* would be that if a contract is not severable and involves transactions or agreements that do not qualify for safe-harbor protection, then the entire agreement falls outside of the safe-harbor provisions. *American Home Mortgage*, however, first determined the subject contract was a repurchase agreement entitled to safe-harbor protection and then determined whether it could sever the protected portions of the contract from the part of the contract that was not safe-harbored.

Applying *American Home Mortgage's* rationale to this case, a court may first determine whether the September Guaranty overall qualifies for safe-harbor protection and *then* determine whether any portions of the September Guaranty could be severed and excluded from safe-harbor protection. Alternatively, a court may interpret Section 546's "in connection with" language more broadly, departing from *American Home Mortgage,* and hold that severable portions of a contract are still "in connection with" the Protected Contracts and entitled to protection. Still another possibility exists: a court may determine that, to the extent the September Guaranty is entitled to safe-harbor protection, it is entitled to protection only to the extent it guarantees Protected

[6660] *Id.* at 523.

Contract obligations, or to the extent JPMorgan liquidated collateral pursuant to Protected Contract exposure.

In any event, there is evidence to support a finding that JPMorgan liquidated collateral only pursuant to clearance and settlement obligations, derivative obligations, and repurchase transactions – all Protected Contracts.[6661] Thus, even if a court were to limit the scope of the "in connection with" language, it appears that JPMorgan's post-petition collateral liquidations were all entitled to safe-harbor protection absent a conclusion that because September Guaranty is avoided, all of the collateral transfers may be avoided as well.

The Examiner has identified four categories of obligations incurred by LBHI pursuant to the September Guaranty that are not subject to the protection of the safe-harbor provisions of the Bankruptcy Code.

First, there is a $95.6 million loan to LBJ that was originally made on an unsecured basis.[6662] In March 2008, JPMorgan requested that LBHI pledge $60 million as security for this loan.[6663] Under the September Agreements, LBHI guaranteed this debt. As a result, this loan, which was originally partially unsecured, became fully secured on account of the September Agreements. The Examiner has not found any basis to assert that this loan would be protected from avoidance by any of the safe-harbor exemptions.

[6661] JPMorgan, Exposure, Collateral and Setoff Summary (Oct. 27, 2009) [LBEX-JPMC 000199].
[6662] *Id.*
[6663] JPMorgan, Lehman Brothers Exposure Overview (Sept. 2008), at p. 3 [JPM-EXAMINER00005966].

There also is no evidence indicating that JPMorgan has liquidated LBHI's prior $60 million pledge, or applied any of the $8.6 billion in cash collateral to repay this loan. Based upon *American Home Mortgage*, a colorable claim exists that the transfer of collateral totaling at least $35.6 million to secure the LBJ loan should be returned to the LBHI estate.[6664]

Second, there is a $2 billion line of credit that JPMorgan extended to LBIE that was unsecured prior to the September Agreements, but became secured thereafter.[6665] The Examiner has uncovered no evidence of any outstanding obligations on this $2 billion line of credit owed as of the Petition Date,[6666] nor has JPMorgan asserted any claims in its Proofs of Claim against this line. In addition, there is no evidence that JPMorgan applied any of the $8.6 billion of collateral to repay obligations owing under this line between September 9 and 15. Thus, there are no collateral transfers made pursuant to the September Agreements that apply to this line of credit.

Third, JPMorgan has asserted a secured claim totaling $295,885,149 as to certain fees and expenses.[6667] There is no clear basis on which JPMorgan can assert that the safe-harbor provisions would apply to these fees and expenses. For example, one such

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[6664] If the guaranty resolution is upheld, then the transfer of additional collateral to JPMorgan to secure the LBJ loan would be a transfer made on account of an antecedent debt (the guaranty resolution) and avoidable as preferential under 11 U.S.C. § 547(b).

[6665] *Id.* at p. 6 [JPM-EXAMINER 00005971].

[6666] *See* E-mail from Kelly Mathieson, JPMorgan, to Jeff Hack, JPMorgan, *et al.* (Sept. 15, 2008) [JPM-2004 0069403] ("there is $0 credit in use with LBIE").

[6667] JPMorgan, Exposure, Collateral and Setoff Summary (Oct. 27, 2009), at p. 1 [LBEX-JPMC 000199].

fee, an operational overdraft fee of $23,500,000 in connection with a payment to a law firm, does not appear to be connected to any Protected Contract pursuant to the safe-harbor provisions of the Bankruptcy Code.[6668] Other listed expenses, however, may be subject to safe-harbor provisions. One is a claim of $54,041,439 for "Repo Agreement/Securities Lending Closeout Amounts."[6669] This amount may arguably be protected by the safe-harbor provisions as being in connection with the Protected Contracts of repurchase contracts and/or securities contracts. Thus, while some of these fees and expenses may be subject to the safe-harbor provisions, and therefore unavoidable, it appears that others may not be protected and therefore colorable claims exist to avoid the collateral transfers made to secure these fees and expenses.

Finally, JPMorgan has asserted contingent claims relating to (1) LCPI participation obligations in the amount of $687.8 million; (2) Aurora Bank FSB letters of credit in the amount of $587.3 million; (3) Lehman Brothers Bankhaus AG in the amount of $209.3 million;[6670] and (4) Woodlands Commercial Bank (f/k/a/ Lehman Brothers Commercial Bank) in the amount of $261.3 million.[6671] The Examiner has not attempted to estimate the value of these claims. To the extent that the claims are estimated as

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[6668] *Id.*

[6669] *Id.*

[6670] *Id*. This entity is a subsidiary covered by the guaranty resolution. Unanimous Written Consent of the Executive Committee of the Board of Directors of Lehman Brothers Holding Inc. (June 9, 2005) [LBEX-AM 003415].

[6671] *Id.* at p. 10. This entity is a subsidiary covered by the guaranty resolution. Unanimous Written Consent of the Executive Committee of the Board of Directors of Lehman Brothers Holding Inc. (June 9, 2005) [LBEX-AM 003415].

having a positive value, the Examiner is not aware of facts to support a finding that these claims are subject to Section 546's safe-harbor provisions and any collateral pledged on account of these claims may be subject to avoidance.

To the extent that the collateral remaining in JPMorgan's hands is not sufficient to allow for the full return of the transfers made to secure non-Protected Contracts, a colorable basis exists to find that JPMorgan should not be permitted to "cherry pick" obligations in which to liquidate collateral to ensure safe-harbor protection. *American Home Mortgage* supports the conclusion that a court should assume that collateral transfers to JPMorgan were first posted to secure non-Protected Contracts and avoid those dollars first for the benefit of the estate.[6672] In other contexts, courts assume, for example, that a payment to a creditor with a partially secured claim is first applied to the unsecured obligation to allow the trustee to avoid the transfer as a preference.[6673] While this analogy is not perfect, it supports a finding that, based, upon *American Home Mortgage,* of the $6.9 billion in cash still held by JPMorgan, JPMorgan must first return cash equal to the amounts owed on account of non-Protected Contracts before applying any of the funds to reduce obligations owed on account of Protected Contracts.

[6672] *See id*.

[6673] *Covey v. Comm'l Nat'l Bank of Peoria*, 960 F.2d 657, 662-63 (7th Cir. 1992) (interests of creditors dominate in determining whether a creditor may apply payments to avoid liability under Section 548); *see also Drabkin v. A.I. Credit Corp.,* 800 F.2d 1153, 1157 (D.C. Cir. 1986) (recognizing conclusive presumption that an undersecured creditor first applies any transfer it receives from the debtor to the unsecured portion of the debt); *Deutsche Bank Securities, Inc. v. Kendall (In re Consilient, Inc.),* No. C 05-2430 CW, 02-40383 NK, 2006 WL 335415, *3 (N.D. Cal. 2006) (same); *Armstrong v. John Deere Co. (In re Gilbertson),* 90 B.R. 1006, 1010 (Bankr. N.D. 1988) (same).

(iii) Avoidability of the August Agreements and Transfers in Connection With the August Agreements

The August Agreements consisted of (1) the August Amendment to the Clearance Agreement, which expanded the reach of the Clearance Agreement by adding LBHI, LBIE, LOTC and LBJ as parties and adding language that the liability of the Lehman entities under the Clearance Agreement was several, not joint;[6674] (2) the August Guaranty, under which LBHI guaranteed the Lehman parties' obligations under the Clearance Agreement;[6675] and (3) the August Security Agreement, which secured LBHI's Guaranty, granting JPMorgan a security interest in a Cash Account, Securities Account and certain related accounts.[6676]

a. Avoidability of the August Guaranty as a Constructive Fraudulent Obligation

1. LBHI Incurred an Obligation Within the Applicable Look-Back Periods When it Executed the August Guaranty

As described above, in Section III.B.3.g.5.a.ii.a.1, execution of a guaranty is not itself the incurrence of an obligation; rather, the obligation is incurred when the loan is made to the primary obligor, thereby creating a contingent liability for the guarantor.[6677] Here, the August Guaranty required LBHI to guarantee "all obligations and liabilities (including without limitation the "Obligations" as defined in the Clearance Agreement)

[6674] *See* Amendment to Clearance Agreement (Aug. 26, 2008), at p. 1 [JPM-2004 0005856].
[6675] Guaranty (Aug. 26, 2008), at p. 1 [JPM-2004 0005879].
[6676] Security Agreement (Aug. 26, 2008), at p. 2 [JPM-2004 0005867]. See Section III.A.5.b of this Report for a comprehensive account of the August Agreements.
[6677] *See Rubin*, 661 F.2d at 990-91.

of [the Lehman parties] to [JPMorgan] . . . pursuant to the Clearance Agreement."[6678] As of August 29, 2008, the Lehman parties (LBI, LCPI, LBIE, LOTC and LBJ) owed obligations to JPMorgan. Thus, upon execution of the August Guaranty on August 29, 2008, LBHI had a contingent liability to repay JPMorgan if one of the Lehman parties to the August Amendment to the Clearance Agreement could not repay JPMorgan.

2. There Is Evidence That LBHI Received Less Than Reasonably Equivalent Value or Did Not Receive Fair Consideration in Exchange for Granting JPMorgan the August Guaranty

The Examiner has concluded that there is evidence to support a finding that LBHI did not receive reasonably equivalent value or fair consideration in exchange for incurring the additional obligations imposed upon it by the August Guaranty. Prior to August 29, 2008, LBHI had not guaranteed the obligations of LBI to JPMorgan under the Clearance Agreement.[6679] Under the August Agreements, LBHI guaranteed all of the obligations that the Lehman parties owed to JPMorgan under the Clearance Agreement.[6680] LBHI's liability was capped at the amount of cash and securities held by JPMorgan in two pledged accounts.[6681] As LBHI had not guaranteed these obligations previously, its gross exposure was adjusted "each day" "and for each such day shall be equal to the dollar amount of cash and securities (based on the market value of such

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[6678] Guaranty (Aug. 26, 2008), at p. 1 [JPM-2004 0005879].

[6679] *Compare* Amendment to Clearance Agreement (Aug. 26, 2008) [JPM-2004 0005856] *with* Clearance Agreement (June 15, 2000) [JPM-2004 0031786].

[6680] Guaranty (Aug. 26, 2008) at p.1-2 [JPM-2004 0005879].

[6681] *Id.*

securities as determined by the Bank in its reasonable discretion)" held in two accounts that were subject to the Clearance Agreement and the related Security Agreement.

For the same reasons as set forth in Section III.B.3.g.5.a.ii.a.2 with respect to the September Guaranty, the net increase in exposure to LBHI was theoretically zero under the August Guaranty because of the potential overcollaterization of JPMorgan. This preliminary conclusion is made taking into account the collateral pledged by the subsidiaries, and assumes that the subsidiaries would not pay anything on account of general unsecured deficiency claims held by JPMorgan after application of the collateral.[6682] This preliminary conclusion is also subject to the caveats and further analysis discussed in Section III.B.3.g.5.a.ii.a.2 above regarding the net exposure under the September Agreements.

After assessing LBHI's net exposure under the August Agreements, it is necessary to determine what benefit LBHI received in exchange. This analysis mirrors that set forth in Section III.B.3.g.5.a.ii.a.2, above with respect to the September Guaranty. Because the Examiner has determined that there is evidence to support a finding of insolvency for some of LBHI's subsidiaries, any benefit provided to those subsidiaries would not have resulted in a quantifiable increase in the subsidiary's value to LBHI. Whether or not reasonably equivalent value was exchanged will depend on whether the time between August 29, 2008 and September 15, 2008 had, as of August

[6682] See Section III.A.5.b of this Report for a discussion of the issue of overcollateralization

29, 2008, any quantifiable value to LBHI. Moreover, as explained in Section III.B.3.g.5.a.ii.a.2 above, any benefit to LBHI could be discounted or eliminated entirely if entry into the August Guaranty in any way accelerated Lehman's demise.

3. Insolvency as of August 29, 2008

The Examiner concludes that there is insufficient evidence to support a finding of insolvency on August 29, the date on which the August Guaranty was executed. [6683]

4. Undercapitalization and Inability to Pay Debts as They Come Due as of August 29, 2008

The Examiner concludes that there is sufficient evidence to support a finding of undercapitalization of LBHI as of August 29, 2008, the date of the execution of the August Guaranty.[6684] Undercapitalization is relevant only to claims made to avoid the August Guaranty under Section 548(a).[6685]

b. Defenses to Avoidability of the August Guaranty

As discussed in Section III.B.3.g.5.a.ii.b, which addresses the defenses to avoidability of the September Guaranty, the two primary defenses at issue are good faith pursuant to Section 548(c) and the safe-harbor provisions of Section 546 of the Bankruptcy Code. The Examiner concludes that a colorable basis exists to avoid the August Guaranty notwithstanding these defenses, although with respect to the good-faith defense, because LBHI's troubled financial condition was less apparent on August

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[6683] See Section III.B.3.b of this Report for a more detailed discussion of the solvency analysis of LBHI.
[6684] *See* Section III.B.3.d for a more detailed discussion of the undercapitalization analysis of LBHI.
[6685] *Compare* 11 U.S.C. § 548(a), *with* McKinney's Debtor and Creditor Law section 274 (2010)

29 than it was on September 10, JPMorgan's claim of good faith is stronger. See Section III.B.3.g.5.a.ii.b.1 above for a full discussion of this defense.

As discussed in Section III.B.3.g.5.a.ii.b.2, the Examiner has concluded that there is a colorable basis to find that the August Guaranty is not protected by the safe-harbor provisions.

c. Avoidability of Transfers of Collateral in Connection With the August Guaranty

Because the August Guaranty is limited to the value of the pledged collateral and this cap changed to match the value of the pledged collateral held in two accounts, avoidance of the August Guaranty would not benefit the LBHI estate by eliminating a potential unsecured claim.[6686] Further, LBHI did not pledge any additional collateral in connection with the August Agreements.[6687] However, because the September Agreements did not replace the August Agreements, JPMorgan may claim that the August Security Agreement and Guaranty also serve as a basis to retain the $8.6 billion in collateral transferred between September 9 and September 12, 2008.

[6686] Guaranty (Aug. 26, 2008) at p.2 [JPM-2004 0005879]. The Guaranty provided that: "The Guarantor's maximum liability under this Guaranty shall adjust each day and for each such day shall be equal to the dollar amount of cash and securities (based on the market value of such securities as determined by the Bank in its reasonable discretion) (i) held on such day in the accounts of the guarantor subject to the Clearance Agreement and the Security Agreement and (ii) that the Bank has notified the Guarantor to be delivered to the Bank on such day in support of the Guaranty." *Id.* at p. 2.

[6687] *See* Appendix 18, Lehman's Collateral at JPMorgan. But see Section III.A.5.b. noting that LBHI transferred cash collateral to JPMorgan on September 9, 2008 before the execution of the September Security Agreement.

The August Security Agreement only granted JPMorgan a lien upon a Securities Account, a Cash Account and certain related accounts.[6688] Of the $8.6 billion in collateral transferred to JPMorgan from LBHI, cash totaling $6.9 billion was transferred to the Cash Account in which JPMorgan would have had a lien pursuant to the August Security Agreement and Guaranty.[6689] Following the receipt of this $6.9 billion in cash, the cash was moved to other accounts and as of the Petition Date, there was a zero balance in the Cash Account.[6690] If the $6.9 billion was moved from the Cash Account by JPMorgan and not at LBHI's direction, then under the definition of "Accounts" found in the August Security Agreement, JPMorgan may have lost its lien on the $6.9 billion. Some evidence exists that JPMorgan controlled the movement of cash from the Cash Account.[6691] In addition, JPMorgan witnesses stated that the September 9 collateral requests were based primarily on its investment bank exposure, not in connection with

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[6688] Security Agreement, (Aug. 26, 2009), at p.1-2 [JPM-2004 00058567]. The "Accounts" against which JPMorgan had a lien under the August Security Agreement are defined as:

> (i) the securities account of [LBHI] at [JPMorgan] known as LCE or any subaccount or replacement accounts thereto (the "Securities Account"), (ii) DDA# 066-141-605 (the "Cash Account") and (iii) any other account at [JPMorgan] to which [LBHI] transfers (A) cash from the Cash Account, (B) any interest, dividends, cash, instruments and other property from time to time received, receivable (including without limitation sales proceeds) or otherwise distributed in respect of or in exchange for any or all of the cash or securities in the Securities Account or the Cash Account or (C) any cash or securities from the Securities Account or the Cash Account during such time as [LBHI] or an Other Obligor has an outstanding obligation or liability to [JPMorgan] under the Guaranty or the Clearance Agreement.

Id. at p. 1.

[6689] *See* LBHI Account Statement (Sept. 30, 2008) JPM-EXAMINER00006270-72]; *see also* Security Agreement (August 26, 2008) [JPM-2004 0005867].

[6690] JPMorgan, Account Statement for Acct. No. XXX-605 (Aug. 30, 2008-Sept. 30, 2008), at pp. 2-4 [JPM-Examiner00006269].

[6691] Memorandum of Teleconference between Harold Novikoff, Wachtell, Lipton, Rosen & Katz, *et al.* and Jerome Epstein, Jenner & Block, *et al.*(Nov. 19, 2009) at p. 4.

the Clearance Agreement.[6692] Because the stated basis for requesting a significant portion of the $6.9 billion was not to secure obligations arising under the Clearance Agreement and also because the definition of "Accounts" would appear to exclude these funds once they were moved by JPMorgan out of the Cash Account, the August Security Agreement would not appear to create a basis to retain these funds as they were not in accounts covered by the August Security Agreement on LBHI's petition date. In addition, there is evidence that the remaining $1.7 billion, consisting of money market funds, was transferred to accounts in which JPMorgan would not have a lien pursuant to the August Security Agreement.[6693] Thus, even if the September Guaranty is avoided and the August Guaranty is not, there is a colorable basis to assert that the August Security Agreement does not cover the $8.6 billion in cash transfers. There also is a colorable basis to claim that based upon the language limiting LBHI's liability under the August Guaranty to the collateral held in the Securities Account and Cash Account as adjusted on a daily basis that there is no claim arising under the August Guaranty to collect from the $8.6 billion because this money was not held in the Cash Account or Securities Account as of LBHI's September 15 bankruptcy filing.[6694]

[6692] See Section III.A.5.b.(1).(h) of this Report, which discusses the basis for the Sept. 9 collateral call.

[6693] *See* JPMorgan, Accounts Holding LBHC Collateral Pledged to JPM [JPM-2004 0083539]; *see also* Security Agreement (August 26, 2008) [JPM-2004 0005867].

[6694] The same analysis for avoiding the September collateral transfers applies to those transfers if they are considered as having been made under the August Security Agreement. *See* Section III.B.3.g.5.a.ii.c.

(iv) Avoidability of the August and the September Security Agreements And Collateral Transfers Pursuant to Section 548(a)(1)(A)

There is evidence to support a finding that some of the badges of fraud necessary to prove the requisite intent to state a claim under Section 548(a)(1) exist. Therefore, the Examiner concludes that there is a colorable claim to avoid the August and September Guaranties and the $8.6 billion of collateral transfers made pursuant to the September Guaranty as actual fraudulent obligations and transfers.[6695] The Examiner, however, also notes that when these badges of fraud are viewed against the backdrop of events overtaking LBHI and in connection with its conduct in dealing with its creditors during this time-period, it is likely that the trier of fact may also conclude that LBHI did not have the requisite intent to hinder, delay or defraud its other creditors when it agreed to grant JPMorgan a guaranty under either the August or September Guaranties or when it transferred $8.6 billion of cash collateral to JPMorgan.

Under Section 548(a)(1)(A), any transfer of an interest of the debtor in property or the incurrence of an obligation that occurs within two years of the debtor's bankruptcy filing is subject to avoidance if the debtor made the transfer with an "actual

[6695] If successful, a claim made under Section 548(a)(1)(A) is not protected by the safe-harbor provisions of Section 546(e), (f), (g) or (j). There is no comparable exclusion for actual fraudulent transfer claims made under 11 U.S.C. § 544 and state law and thus the Examiner's Report focuses only upon a claim based upon Section 548(a)(1).

intent to hinder, delay or defraud any entity to which the debtor was or became indebted, on or after such transfer was made or such obligation was incurred."[6696]

As set forth in connection with the Examiner's analysis of the constructive fraudulent transfer claims, LBHI incurred obligations and made transfers within the applicable look-back period. The only issue is whether LBHI did so with the requisite intent. Courts consider whether a debtor incurred an obligation or made a transfer with an actual intent to hinder, delay or defraud its creditors generally by looking to whether certain "badges of fraud" are present.[6697] The intent that matters here is the intent of LBHI.[6698] Because intent is rarely susceptible to direct proof, the courts have developed what are known as the "badges of fraud" to assess whether a debtor has the requisite intent. The badges of fraud include, but are not limited to: (1) the transfer of property by a debtor during the pendency of a suit; (2) a transfer of property that renders the debtor insolvent or greatly reduces its estate; (3) a series of contemporaneous transactions that strip the debtor of all property available for execution; (4) secret or hurried transactions not in the usual mode of doing business; (5) any transaction conducted in a manner differing from customary methods; (6) a transaction whereby the debtor retains benefits over the transferred property; (7) little or no consideration in

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[6696] 11 U.S.C. § 548(a)(1)(A).

[6697] See Appendix 1, Legal Issues, at Section IV.A.1, which discusses of the legal elements of an actual fraudulent transfer claim in greater detail.

[6698] *See Rubin Bros. Footwear, Inc. v. Chem. Bank* (*In re Rubin Bros. Footwear, Inc.),* 119 B.R. 416, 423 (S.D.N.Y. 1990) ("For purposes of 11 U.S.C. § 548(a)(1), plaintiff must show fraudulent intent on the part of the transferor, rather than on the part of the transferee.") (citations omitted).

return for the transfer; or (8) a transfer of property between family members or related entities.[6699] A plaintiff is not required to prove all of the badges of fraud, but once the plaintiff establishes a confluence of several badges of fraud, the trustee is entitled to a presumption of fraudulent intent, shifting the burden to the obligee or transferee to prove some "legitimate supervening purpose" for the transfers and incurrences of obligations at issue.[6700]

The intent that is relevant is that of the debtor, not the recipient of the fraudulent transfer.[6701] JPMorgan's intent is irrelevant unless it can be shown that JPMorgan so dominated or controlled LBHI so as to make its intent, LBHI's intent.[6702] The doctrine of imputed intent is generally reserved for circumstances where: (1) the person or entity exercising control over the disposition of the debtor's property stands in a position to do so by reason of a relationship of ownership, executive office or other insider role; (2) the controlling person, standing in the position of either principal or agent on either side of the transaction, may be presumed to act with actual or apparent authority to effectuate the disposition of the relevant property from the debtor on behalf of and for the benefit of the transferee; (3) the controlling person is considered to stand in a

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[6699] *Salomon v. Kaiser (In re Kaiser)*, 722 F.2d 1574, 1582-83 (2d Cir. 1983) (identifying badges of fraud under 11 U.S.C. S 548) (citing *In re May*, 12 B.R. 618, 627 (N.D. Fla. 1980)); *Wall St. Assocs. v. Brodsky*, 684 N.Y.S.2d 244, 248 (N.Y. App. Div. 1999) (identifying badges of fraud under N.Y. D.C.L. § 276).

[6700] *Acequia, Inc. v. Clinton (In re Acequia, Inc.)*, 34 F.3d 800, 806 (9th Cir. 1994); *accord Tavenner v. Smoot*, 257 F.3d 401, 408 (4th Cir. 2001); *Kelly v. Armstrong*, 141 F.3d 799, 802 (8th Cir. 1998).

[6701] *Rubin Bros. Footwear*, 119 B.R. at 423.

[6702] *In re Roco Corp.*, 701 F.2d 978, 984 (1st Cir. 1983); *In re James River Coal Co.*, 360 B.R. 139, 161 (Bankr. E.D. Va. Feb. 8, 2007) (collecting cases); *Armstrong v. United Bank of Bismark (In re Bob's Sea Ray Boats, Inc.)*, 144 B.R. 451, 459 (Bankr. D.N.D. 1992).

fiduciary capacity or hold a position of trust in the transferor entity; (4) imputation is necessary in order to recognize and discourage the misuse of the corporate form by means of transferring property between affiliated entities.[6703] While JPMorgan may have been in a superior bargaining position, cases indicate that such control is not sufficient to impute intent.[6704] Thus, there does not appear to be evidence to support a colorable basis for its application in this case. Therefore, only LBHI's intent should be considered in assessing whether a colorable claim exists to avoid the August and September Guaranties and the collateral transfers as actual fraudulent transfers and obligations exists.

As for LBHI's intent, the following badges of fraud are present: (1) LBHI did not incur the obligation or make the transfers during the pendency of one lawsuit, but it did so during the pendency of a market free-fall that was directly impacting LBHI's value. This free-fall was more pronounced at the time of the execution of the September Guaranty and the transfers of collateral in connection with the September Guaranty. (2) There is evidence to support a finding of insolvency of LBHI at the time of the execution of the September Guaranty. (3) There is evidence to support a finding that little or no value was given to LBHI in exchange for incurring the guaranty obligations or making the collateral transfers (this analysis mirrors the question of what value LBHI received

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[6703] *Jackson*, 263 B.R. at 447-48.

[6704] *Andrew Velez Constr., Inc. v. Consol. Edison Co. of N.Y. (In re Andrew Velez Constr., Inc.)*, 373 B.R. 262, 269 (Bankr. S.D.N.Y. 2007).

in exchange for guaranteeing its subsidiaries' debts, see Section III.B.3.g.5.a.ii.a.2, above). (4) The negotiations that resulted in the incurrence of the obligations and the requests for collateral on September 9, 2008 were hurried transactions, executed overnight on a very rushed basis without key Lehman officers reviewing the September Agreements or understanding their scope before they were signed.[6705] By way of contrast, the August Guaranty was negotiated over a period of more than a week, between August 18, 2008, when Doctoroff e-mailed a draft,[6706] and August 29, 2008 when the August Agreements were executed.[6707] Thus, this badge of fraud is likely not present with respect to the August Guaranty. (5) The transfers of $8.6 billion of cash collateral were significant to Lehman's overall liquidity and were done in a manner designed to create the public impression that the cash pledged still counted as part of Lehman's liquidity pool.[6708] Although it is an issue for the trier of fact to determine whether these badges of fraud are sufficient to shift the burden to JPMorgan to justify the transfers and the incurrence of the obligation, a colorable basis exists to find that they could shift the burden to JPMorgan. The analysis of the common law claims set

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[6705] See Section III.A.5.b. for a discussion of the hurried nature of the transactions.

[6706] E-mail from Mark G. Doctoroff, JPMorgan, to Daniel J. Fleming, Lehman (Aug. 18, 2008) [LBEX-DOCID 451527].

[6707] *See, e.g., id.*; e-mail from Daniel J. Fleming, Lehman, to Mark G. Doctoroff, JPMorgan (Aug. 21, 2008) [LBEX-DOCID 310528]; e-mail from Jeffrey Aronson, JPMorgan, to Paul W. Hespel, Goodwin Procter, *et al.* (Aug. 25, 2008) [JPM-2004 0003466]; e-mail from Nikki G. Appel, to Paul W. Hespel, Goodwin Procter, *et al.* (Aug. 28, 2008) [JPM-2004 0004408]. See Section III.A.5.b of this Report, which discusses the August Agreement negotiations in greater detail.

[6708] E-mail from Mark G. Doctoroff, JPMorgan, to Jane Buyers-Russo, JPMorgan, *et al.* (Sept. 9, 2008) [JPM-2004 0032520].

forth in Section III.A.5.b includes arguments that JPMorgan may employ to justify the transfers.

The Examiner notes that these badges of fraud must be viewed in the context of what was happening in the market and in light of the fact that LBHI granted similar guaranties and made similar collateral pledges in favor of other creditors of its subsidiaries as LBHI and the other Lehman entities slipped into bankruptcy. A reasonable inference could be drawn from this conduct that LBHI did not agree to all of these additional obligations or collateral pledges to hinder, delay or defraud its other creditors, *i.e.*, it was not making a transfer to one friendly creditor to avoid paying others or to protect its assets for later use, but rather was attempting to quell creditor concerns by granting parent guaranties and pledging collateral where necessary based upon its perception that failing to do so might cause the credit flowing to Lehman to dry up and its business to fail. Nonetheless, because the question of intent is fact intensive, and there exists evidence to support some of the badges of fraud, the Examiner concludes that a colorable claim exists, although that claim is subject to substantial contrary evidence and inferences drawn from the evidence.

(v) Avoidability of the Transfers of Collateral in Connection with the September Guaranty Pursuant to Section 547(b) of the Bankruptcy Code

The Examiner concludes that there is not sufficient evidence to support a colorable claim to avoid the transfers of collateral from LBHI to JPMorgan on or after

September 9 that secured obligations that LBHI had previously guaranteed on an unsecured basis as avoidable preferences. Specifically, prior to the execution of the September Guaranty, LBHI had guaranteed, on an unsecured basis, JPMorgan derivatives claims totaling approximately $3.08 billion as of September 9.[6709] Thus, the pledge of collateral under the September Agreements was: (1) a transfer to or for the benefit of JPMorgan; (2) for or on account of an antecedent debt owed by LBHI before such transfer was made; (3) made while LBHI was insolvent;[6710] (4) made on or within 90 days of the date of the filing of LBHI's bankruptcy petition; and (5) enabled JPMorgan to receive more than it would have received if the case were under Chapter 7 of this title, the transfers had not been made and JPMorgan received payment of such debt to the extent provided by the provisions of this title.[6711] Transfers generally made in connection with derivatives contracts, however, are Protected Contracts, and thus

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[6709] *See* ISDA Master Agreement between JPMCB and LBCC (Nov. 15, 1993), at p. 25 [JPM-2004 0000368] (providing a guaranty by LBHI); ISDA Master Agreement between JPMM and LBIE (Aug. 26, 1997), at p. 14 [JPM-2004 0086169] (providing a guaranty by LBHI); ISDA Master Agreement between JPMCB and LBFSA (Nov. 15, 1993), at p. 24 [JPM-2004 000850] (providing a guaranty by LBHI); Amendment to the ISDA Master Agreement between JPMM and LBFSA (July 11, 2008), at p. 35 [JPM-2004 0086103] (providing guaranty by LBHI); ISDA Master Agreement between JPMCB and LBSF (Dec. 20, 1995), at p. 22 [JPM-2004 0000345] (providing guaranty by LBHI); ISDA Master Agreement between JPMBD and LBIE (Feb. 23, 1998), at p. 21 [JPM-2004 0086072]; Guarantee of LBHI for ISDA Master Agreement between WMB and LBSF (May 28, 1998) [LBEX-JPM 0000210]; Guarantee of LBHI for ISDA Master Agreement between JPMM and LBSF (June 7, 2002) [LBEX-JPM 0000212]; *see also* JPMorgan, Exposure, Collateral and Setoff Summary (Oct. 27, 2009) [LBEX-JPMC 000199].

[6710] The Examiner has concluded that there is evidence to support a finding that LBHI was insolvent as of September 2, 2009. For the complete analysis of LBHI's solvency, see Section III.B.3.b of this Report. For purposes of a Section 547(b) claim insolvency is presumed. 11 U.S.C. § 547(f).

[6711] *See* 11 U.S.C. § 547(b). See Appendix 1, Legal Issues, at Section IV.D of this Report, which discusses Section 547(b) in greater detail.

there is not a colorable claim to avoid the transfer of collateral to secure these previously unsecured obligations of LBHI.[6712]

To the extent that LBHI's June 9, 2005 guaranty of certain subsidiaries' debts through its corporate resolution is enforceable by JPMorgan against LBHI, then that portion of the transfer of the $8.6 billion that secured obligations owed to subsidiaries covered by the resolution guaranty would be: (1) a transfer to or for the benefit of JPMorgan; (2) for or on account of an antecedent debt owed by LBHI before such transfer was made; (3) made while LBHI was insolvent; (4) made on or within 90 days of the date of the filing of LBHI's bankruptcy petition; and (5) enabled JPMorgan to receive more than it would have received if the case were under Chapter 7 of this title, the transfers had not been made and JPMorgan received payment of such debt to the extent provided by the provisions of this title. Based upon JPMorgan's Proofs of Claim, there appear to be at least three claims implicated by this analysis: (1) the LBJ of $95.6 million;[6713] (2) the Lehman Brothers Bankhaus AG contingent claim of $209.3 million; and (3) the Woodlands Commercial Bank (f/k/a Lehman Brothers Commercial Bank) contingent claim in the amount of $261.3 million. In addition, some of the $391,490,210 in fees and expenses may be implicated as well; however, the JPMorgan Proofs of Claim

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[6712] *See* 11 U.S.C. § 546(e).

[6713] The transfer subject to avoidance would be limited to $35 million as LBHI had posted approximately $60 million to secure this debt outside of the preference period and thus, LBHI's transfer of additional collateral in September, 2008 only secured $35.6 million of this debt. *See* JPMorgan, Lehman Brothers Exposure Overview (Sept. 2008), at p. 3 [JPM-EXAMINER00005966].

are not clear in all respects as to which subsidiary owes these fees. Because there is no evidence to suggest that any of these obligations fall under the safe harbors, they are not barred from avoidance and there is evidence to support a colorable preference claim.

In addition, the Examiner concludes that there are colorable claims to avoid as preferential the collateral transfers made on account of Non-Protected Contracts. Much of the $8.6 billion in cash transfers took place following the execution of the September Agreements, and thus, there is a colorable basis to claim that the post-execution collateral transfers secured an antecedent debt owed by LBHI arising under the September Guaranty. JPMorgan's counsel has asserted that the cap on liability contained in the September Guaranty defeats a preference claim because any transfer of collateral would not be on account of an antecedent debt. The September Guaranty, however, provided that LBHI's "maximum liability under this Guaranty shall be THREE BILLION DOLLARS ($3,000,000,000) or such greater amount that [JPMorgan] has requested from time to time as further security in support of this Guaranty."[6714] Thus, LBHI's liability under the September Guaranty was always capped at the amount of additional collateral that JPMorgan had requested. JPMorgan's counsel has asserted that this language means there is no antecedent debt as there is no LBHI liability under the September Guaranty until such time as additional collateral is actually posted.

[6714] Guaranty (Sept. 9, 2008), at p. 2 [JPM-2004 0005813].

On September 9, however, JPMorgan requested $5 billion of collateral in connection with the agreements that it anticipated executing with LBHI.[6715] The language of the September Guaranty does not tie the capping of liability to collateral in the hands of JPMorgan but only to "such greater amount that [JPMorgan] has requested from time to time as further security in support of this Guaranty."[6716] Thus, as of the execution of the September Guaranty, LBHI's liability under the Guaranty was $5 billion. As of the execution of the September Guaranty, LBHI had posted only $3 billion. Thus, $2 billion of the cash collateral posted following the execution of the September Guaranty was on account of an antecedent debt. Similarly, JPMorgan requested an additional $5 billion of collateral on September 11, increasing LBHI's liability under the September Guaranty to $10 billion. The additional collateral was not pledged until the next day, making that pledge on account of an antecedent debt.

To the extent that the collateral transferred was on account of Protected Contracts, JPMorgan would have a defense under the safe-harbor provisions. As set forth in Section III.B.3.g.5.a.ii.b, however, based upon *American Home Mortgage*, LBHI has a colorable basis for asserting that collateral transferred to secure the non-Protected Contracts discussed in Section III.B.3.g.5.a.ii.c.4 may be avoided as preferential transfers.

[6715] See Appendix 18, of this Report, which discusses Lehman's collateral at JPMorgan in greater detail.
[6716] Guaranty (Sept. 9, 2008), at p. 2 [JPM-2004 0005813].

With respect to those transfers of collateral not protected by the safe-harbor provisions outlined in Section III.B.3.g.5.a.ii.c.4, even if all of the elements set forth in Section 547(b) are satisfied, liability will not lie if JPMorgan can establish a defense under Section 547(c).[6717] The three applicable defenses are found in Section 547(c)(1), (2), and (4). [6718]

In order to succeed with a contemporaneous exchange defense under Section 547(c)(1), JPMorgan must show (1) that the transfers of collateral were for new value given to LBHI; (2) that the transfers were intended to be a contemporaneous exchange; and (3) that the transfers were in fact substantially contemporaneous exchanges.[6719] Although the transfers were made within days of the execution of the September Guaranty and thus, JPMorgan may be able to show that the transfers were intended to be and were in fact contemporaneous, there is no evidence that JPMorgan extended new value in the form of "money or money's worth in . . . new credit" to LBHI in exchange for the transfers. There is no evidence that JPMorgan lent additional amounts to LBHI as a result of the September Guaranty. Instead, JPMorgan continued its extension of discretionary credit to LBHI's affiliates. This same discretionary extension

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[6717] 11 U.S.C. § 547(c).

[6718] *Id.* § 547(c)(1).

[6719] *The Official Comm. of Unsecured Creditors of 360networks (USA) Inc. v. U.S. Relocation Servs., Inc. (In re 360networks (USA), Inc.)*, 338 B.R. 194, 204 (Bankr. S.D.N.Y. 2005) (citing *In re Mid Atlantic Fund, Inc.*, 60 B.R. 604, 609 (Bankr. S.D.N.Y. 1986); *In re McLean Indus. Inc.*, 132 B.R. 247, 263-64 (Bankr. S.D.N.Y. 1991), *rev'd on other grounds*, 30 F.3d 385 (2d Cir. 1994); *Official Comm. of Unsecured Creditors of 360networks (USA), Inc. v. AAF-McQuay, Inc. (In re 360networks (USA), Inc.)*, 327 B.R. 187, 191 (Bankr. S.D.N.Y. 2005)).

of credit existed prior to the execution of the September Guaranty and thus, even if the value JPMorgan provided to the other Lehman entities could be considered "new value given to LBHI," it could be construed as nothing more than its forbearance from withdrawing such credit. Because "[f]orbearance alone does not constitute new value," there is a colorable basis to conclude that there are claims to avoid the transfers as preferential notwithstanding a Section 547(c)(1) defense.[6720]

For similar reasons, it is questionable whether JPMorgan has a defense pursuant to Section 547(c)(4), which provides a defense to the extent of new value transferred to or for the benefit of the debtor following the transfer deemed preferential.[6721] Although Section 547(c)(4), unlike Section 547(c)(1), contemplates that the new value may be to or for the debtor's benefit, forbearance also is not new value within the meaning of Section 547(c)(4).[6722] Thus, since there is no evidence that JPMorgan increased its total exposure to all Lehman entities following the execution of the September Agreements, JPMorgan likely does not have a defense under Section 547(c)(4).

Finally, given the questionable timing of the transfers, the extraordinary nature and size of the transfers and other unique facts surrounding JPMorgan's request for additional collateral as set forth in Section III.A.5.b, JPMorgan likely does not have a

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[6720] *Id.* at 205 (citations omitted).
[6721] 11 U.S.C. § 547(c)(4).
[6722] *In re ABC-NACO, Inc.*, 483 F.3d 470, 473-74 (7th Cir. 2007).

defense that the transfers of collateral were in the ordinary course of business pursuant to Section 547(c)(2).[6723]

(vi) Avoidability of Obligations of LBHI to Funds Managed by JPMorgan

Relying upon the September Guaranty, JPMorgan, in its Proof of Claims, has asserted claims arising from obligations of Lehman to various funds managed by JPMorgan. JPMorgan asserts that these obligations are covered by the scope of the September Agreements because such funds are "affiliates" of JPMorgan. The September Agreements cover exposure to JPMorgan "*and its affiliates*, subsidiaries, successors and assigns."[6724]

The term "affiliate" is not defined in the applicable September Agreements. Per their terms, the September Agreements are governed by the laws of the state of New York. Further, the Security Agreement provides that "all terms used herein which are defined in the Uniform Commercial Code shall have the meanings therein stated."[6725] The Guaranties between the parties contain no similar provision. Further, the Uniform Commercial Code ("UCC"), which is referenced in the Security Agreements to provide meaning to undefined terms, does not provide a definition of the term "affiliate."

[6723] 11 U.S.C. § 547(c)(2); *see* Appendix 1, Legal Issues, at Section IV.D.

[6724] *See* Amendment to Clearance Agreement (Sept. 9, 2008), at p. 1 [JPM-2004 0005861]; Security Agreement (Sept. 9, 2008), at p. 1 [JPM-2004 0005873] (emphasis added).

[6725] Security Agreement (Sept. 9, 2008), at p. 1 [JPM-2004 0005873].

New York law, as the governing law of the September Agreements, provides several definitions of the term "affiliate."[6726] However, there is no indication which definition, if any, represents the intent of the parties.

Likewise, several federal statutes define the term "affiliate."[6727] Again, there is no indication that any such definition should be applied to the September Agreements in question. Without more, the term "affiliate" has no plain meaning.

New York case law provides guidance on how to deal with instances of contract ambiguity. First and foremost, "[w]hether a contract is ambiguous or, on the contrary, clear and unequivocal in its terms, is a question of law to be decided by the court in the first instance."[6728] Furthermore, "[t]he objective in any question of the interpretation of a written contract…is to determine what is the intention of the parties as derived from the language employed."[6729]

Without further inquiry, it cannot be said that LBHI intended its September Agreements to extend to all obligations to the various funds managed by JPMorgan. Similarly, it is not evident that JPMorgan sought to extend the September Agreements

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[6726] *See, e.g.*, N.Y. Bus. Corp. Law § 912(a)(1); N.Y. Banking Law §6-l(1)(a); N.Y. Banking Law § 606(6)(b)(i).

[6727] *See, e.g.*, Bank Holding Company Act of 1956, 12 U.S.C. § 1841(k); Investment Company Act of 1940, 15 U.S.C. § 80a-2; Securities Exchange Act of 1934, 17 C.F.R. § 240.13e-3(a)(1); Securities Act of 1933, 17 C.F.R. § 230.405.

[6728] *Rice v. Miller*, 864 N.Y.S.2d 255, 258 (N.Y. Sup. Ct. 2008) (citing *In re Wallace v. 600 Partners Co.*, 658 N.E.2d 715, 717 (N.Y. 1995)).

[6729] *Id.* (citing *Hartford Accident & Indemnity Co. v. Wesolowski*, 305 N.E.2d 907, 909-10 (N.Y. 1973)); *see also Sutton v. E. River Sav. Bank*, 435 N.E.2d 1075, 1078 (N.Y. 1982) (quoting *Brown Bros. Elec. Contrs. v. Bean Constr. Corp.*, 361 N.E.2d 999, 1001 (N.Y. 1977)) ("[p]ut another way, 'the aim is a practical interpretation of the expressions of the parties to the end that there be a realization of [their] reasonable expectations'").

to such a degree at the time of contracting. Possible arguments based on (1) definition of the term "Accounts" in the September Security Agreement or (2) JPMorgan's subsidiaries' role as promoter of and advisor to the funds are available, though neither provides a definitive answer.

The only specific mention of funds contained within any of the September Agreements is in the definition of the term "Accounts" as it describes what would serve as security under the September Security Agreement.[6730] The Security Agreement provides that the term "Accounts" is to mean: "all accounts of the Guarantor at [JPMorgan] (including but not limited to . . . any nominee in any money market fund issued, managed, advised or subadvised by [the Bank])."[6731]

While this reference serves as a demonstration that money market funds were contemplated by the parties – at least in the sense that they would serve as security under the September Security Agreement – it also raises the argument that such a clause would not be necessary where obligations to these funds, as affiliates to JPMorgan, would be protected under the September Agreements. Given this, it is difficult to glean the intent of the parties from this provision alone.

Based on the claims on file with the Court, subsidiaries of JPMorgan act as investment advisors to the funds in question. In this capacity, JPMorgan's subsidiaries

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[6730] Security Agreement (Sept. 9, 2008), at p. 1 [JPM-2004 0005873].
[6731] *Id.*

have the power in certain instances to take actions such as directing investment decisions of the funds, monitoring performance and compliance of the funds, and negotiating terms of agreements to be entered into on behalf of the funds.

Further, for certain funds, it appears a Form D – Notice of Sale of Securities filing is on file with the Securities and Exchange Commission. In some instances, a JPMorgan subsidiary is listed as a "Promoter" within these filings. Under the Investment Company Act of 1940, a "Promoter" is defined as "a person who, acting alone or in concert with other persons, is initiating or directing, or has within one year initiated or directed, the organization of such company."[6732] While some degree of control is evidenced by this relationship, that degree of control does not resolve whether this would qualify as an "affiliate" within the intended meaning of the parties in the applicable Agreements.

Given the lack of a plain meaning of the term "affiliate" and the ambiguity which results, extrinsic evidence of the reasonable intent of the contract parties would be necessary to determine whether various funds managed by subsidiaries of JPMorgan should be considered affiliates.

To summarize, the intent of the parties cannot be determined within the four corners of the applicable agreements. No provision contained in the September Agreements provides clarification as to whether a fund managed by a subsidiary of

[6732] 15 U.S.C. § 80a-2(a)(30).

JPMorgan qualifies as an affiliate. As noted above, the UCC, which the September Agreements reference in order to define terms used but not defined, also lacks a definition of "affiliate." The issue of whether various funds managed by subsidiaries of JPMorgan are affiliates of JPMorgan presents material issues of fact and law that cannot be resolved without further evidence regarding the reasonable intent of the parties and the precise relationship of JPMorgan to the money market funds in question.

Based on the above analysis, there is a colorable claim that these obligations are unsecured due to the ambiguity of the September Agreements. On behalf of JPMorgan's various funds which it alleges are "affiliates," JPMorgan claims $746 million for which roughly $12.5 million has been paid through collateral held. That leaves a net amount of $734 million.[6733] Thus, assuming the scope of the September Guaranty does not cover the various funds alleged to be "affiliates," then these obligations will become unsecured, and the $12.5 million that has been paid will be subject to avoidance.

(b) Citi Avoidance Analysis

(i) Background

Citi was Lehman's designated settlement member on the Continuous Linked Settlement ("CLS") system.[6734] In addition, Citi provided other financial services such as

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[6733] JPMorgan, Exposure, Collateral and Setoff Summary (Oct. 27, 2009), at p. 1 [LBEX-JPMC 000199].

[6734] Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, Ex. A, Docket No. 109, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008). The LBI-Citibank CLS relationship was established by a "CLS Settlement

"the establishment and maintenance of cash deposit and custodial accounts, the provision of credit facilities, trade clearing and settlement services, agency and trust services, foreign exchange-related services, and securities lending."[6735] The CLS system is a trading platform, operated by a consortium of banks, for the clearance and settlement of foreign exchange trades.[6736] After the market's negative reaction to Lehman's second quarter earnings announcement and Lehman's personnel changes, Citi sought to reduce its intra-day risk exposure to Lehman.[6737] Consequently, on June 12, 2008, Citi obtained a $2 billion cash deposit from LBHI, to be deposited with Citi in an overnight call account.[6738] On June 12, 2008, LBHI was a party to a Guaranty dated June 7, 2004 (the "2004 Guaranty") under which LBHI agreed to "unconditionally guarantee[] the punctual payment when due, whether upon maturity, by acceleration or otherwise, of all obligations (now or hereafter existing) of each Borrower to Citigroup, Inc."[6739] Citigroup, Inc. is defined to include each of its subsidiaries or affiliates,

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Services Agreement for CLS User-Members" dated December 19, 2003. *Id*. at p. 1. This CLS clearance agreement was amended and restated in a "Citibank CLS Settlement Services Amended and Restated Agreement for CLS User Members" dated October 28, 2004. *Id*. References to the "CLS Clearance Agreement" refer to the Agreement as amended and restated.

[6735] Motion of Debtors for Order, Pursuant to Section 105 of the Bankruptcy Code, Confirming Status of Citibank Clearing Advances, at p. 2, Docket No. 109, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008).

[6736] *See* CLS, About CLS, http://www.cls-group.com/About /Pages/default.aspx (last visited Dec. 23, 2009).

[6737] E-mail from Brian R. Leach, Citigroup, to Vikram S. Pandit, Citigroup, *et al.* (June 12, 2008) [CITI-LBHI-EXAM 00114115] (stating that Citi initially asked for $3 billion segregated but Lehman sent $2 billion in a call account).

[6738] E-mail from Daniel J. Fleming, Lehman, to Ian T. Lowitt, Lehman (June 12, 2008) [LBEX-AM 008608].

[6739] Guaranty (Jan. 7, 2004) [LBEX-DOCID 1090071], attached to email from Michael Mauerstein, Citi, to Emil Cornejo, Lehman (Sept. 9, 2008) [LBEX-DOCID 1079084].

including Citi.[6740] The Borrowers are defined to include only Lehman Brothers Holdings PLC, LB Securities Asia Ltd., LBSF, LBJ, LBIE, LBCC Asia Ltd., and Lehman Brothers Bankhaus AG.[6741] LBI was not a Borrower under the 2004 Guaranty.

For two months, beginning in July 2008, the parties negotiated – without success – a formal pledge agreement with the understanding that LBHI would pledge securities to collateralize Citi's clearing and settlement credit lines in lieu of the cash deposit.[6742] Those pledge agreement negotiations ceased when, instead, between September 9 and 12, LBHI and Citi amended the 2004 Guaranty to expand its scope by adding ten more LBHI subsidiaries to it, including LBI (the "Amended Guaranty").[6743] LBI amended its Direct Custodial Services Agreement ("DCSA," together with the Amended Guaranty, the "September Agreements"),[6744] which provided Citi with a broad and explicit right of

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[6740] *Id.*

[6741] *Id.*

[6742] *See* E-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup (Sept. 10, 2008) [CITI-LBHI-EXAM 00075863] (discussing how Citi spent two months negotiating the collateral arrangement and should have had it completed long ago instead of the "fire drill" of getting the Guaranty Amendment on September 9).

[6743] *See* Amendment 1 To Guaranty (Sept. 9, 2008) [LBEX-DOCID 090568] (executed version signed by Ian Lowitt and adding LBCC on September 11, 2008) attached to Rosa Garcia, Lehman to Emil Cornejo, Lehman *et al.* (Sept. 12, 2008) [LBEX-DOCID 065565]. In addition to LBI, the Amended Guaranty added LB Australia Securities Pty Ltd., LB Taiwan, LB Securities Private Ltd., Neuberger Berman, LBCS, LB Finance Japan, LB GCS, LB Securities Taiwan and LBCC.

[6744] The DCSA is alternatively titled the Direct Custody Agreement ("DCA") in the document signed on March 26, 1992, and referred to as the DCSA in the September 12, 2008 amendment. However, the DCA and DCSA are the same document, amended by the Deed addendum on September 12, 2008. For consistency, the Examiner refers to the 1992 version as the "DCSA," or "original DCSA," and the 2008 version as the "DCSA Amendment." *See* Direct Custodial Services Agreement Deed (Sept. 12, 2008) [CITI-LBHI-EXAM 00005903] (referring to the DCSA entered into by LBI, then known as Shearson Lehman Brothers Inc., and Citibank on March 26, 1992), *and* Direct Custody Agreement for Citibank,

setoff and granted Citi a first fixed security interest in Lehman's cash and securities in its Citi accounts, except for cash and securities in Lehman's customer accounts.[6745] The Amended Guaranty also provided Citi with cross-affiliate setoff rights.[6746] Citi continued thereafter to provide clearing and trade settlement services for Lehman, albeit under reduced clearing limits, until LBHI filed for bankruptcy on September 15.

Early on September 15 or late on September 14,[6747] Citi transferred $500 million from LBHI's account at Citi to LBI's account at Citi to fund Lehman's CLS obligations after Fleming made the request on the afternoon of September 14.[6748] See Section III.A.5.c for a complete discussion of Lehman's dealings with Citi.

N.A., Subsidiaries and Affiliates and Shearson Lehman Brothers Inc. (Mar. 26, 1992) [CITI-LBHI-EXAM 00031437].

[6745] Direct Custodial Services Agreement Deed (Sept. 12, 2008), at p. 2 [CITI-LBHI-EXAM 00005903].

[6746]Guaranty (Jan. 7, 2004) [LBEX-DOCID 1090071], attached to Michael Mauerstein, Citi, to Emil Cornejo, Lehman (Sept. 9, 2008) [LBEX-DOCID 1079084].

[6747] Lehman Brothers, Inc. Account Report (Oct. 1, 2008), at p. 1033 [CITI-LBI 00024142]; e-mail from Julius Silbiger, Citigroup, to Thomas Obermaier, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00104189] (stating that the $500 million had moved by 9:42 p.m. that evening); e-mail from Roger Barnes, Citigroup, to Naresh N. Kumar, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00104189] (explaining that Citichecking opened at 9 p.m. that evening so the transfer could be made then); e-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00101129] (approving the transfer); Lehman Brothers Inc. Account Report (Oct. 1, 2008), at p. 1033 [CITI-LBI 00024142 (Confidential For Settlement Purposes Only)] (account statement confirming that the transaction transferred $500 million from Lehman Brothers Holdings Main Open Account 4061-5202 to Lehman Brothers Inc. account 3054-4658 for value on September 15, 2008).

[6748] E-mail from Daniel J. Fleming, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Sept. 14, 2008) [LBEX-DOCID 457630].

(ii) Avoidability of the $2 Billion Deposit

Because the transfer of the $2 billion deposit from LBHI to Citi occurred on June 12, 2008, it is outside of the ninety-day preference period.[6749] In addition because it was made on account of an antecedent obligation arising under the 2004 Guaranty, it would not be a fraudulent transfer, as value is received by a debtor if property is transferred to secure an antecedent obligation.[6750] Thus, the Examiner concludes that the evidence does not support the existence of a colorable claim to avoid the transfer of the $2 billion deposit from LBHI to Citi as a preference or as a fraudulent transfer.

(iii) Avoidability of the Amended Guaranty

The Examiner concludes that a colorable claim exists to avoid the Amended Guaranty as constructively fraudulent, although the benefit to the estate from this avoidance action may not be significant. The legal analysis of this claim and some aspects of the factual analysis underlying this conclusion mirror those contained in the Examiner's discussion of the potential claim to avoid the JPMorgan September Guaranty as a fraudulent obligation and thus, to streamline this discussion, the Examiner incorporates that analysis where appropriate.

[6749] See Appendix 1, Legal Issues, at Section IV.D. for a discussion of preference law pursuant to Section 547 of the Bankruptcy Code.

[6750] 11 U.S.C. § 548(d)(2)(A).

LBHI executed the Amended Guaranty on September 9, 2008 and added an additional party on September 11, 2008.[6751] At that time, obligations were owed to Citi and thus, LBHI incurred obligations on those dates,[6752] which fall within the applicable look-back periods under Sections 548 and 544 and New York law.[6753] In addition, there is evidence to support a finding that LBHI had unreasonably small capital and was insolvent on September 9, 2008.[6754]

As with the JPMorgan analysis, the likely key factual dispute in connection with this claim will be whether LBHI received reasonably equivalent value for the Amended Guaranty. LBHI's subsidiaries cleared trades through Citi. Thus, LBHI would directly benefit from the Amended Guaranty only if, by providing this credit support, the value of LBHI's interests in its subsidiaries increased by at least an amount reasonably approximate to the additional obligations that LBHI incurred.

As with the JPMorgan analysis, the starting point is what did LBHI give up by agreeing to guarantee the debts of the additional subsidiaries. The *ex post* increased exposure to LBHI that resulted from LBHI entering into the Amended Guaranty was approximately $337 million, largely consisting of (1) claims against LBCC for $13.7

[6751] *See* Amendment 1 To Guaranty (Sept. 9, 2008) [LBEX-DOCID 090568] (executed version signed by Ian Lowitt and adding LBCC on September 11, 2008) attached to email from Rosa Garcia, Lehman, to Emil Cornejo, Lehman, *et al.* (Sept. 12, 2008) [LBEX-DOCID 065565]..

[6752] *See Rubin*, 661 F.2d at 990-91.

[6753] 11 U.S.C. § 548(a); McKinney's Civil Practice Law and Rules § 213 (2010); *Island Holding LLC v. O'Brien*, 775 N.Y.S.2d 72, 74 (App. Div. 2004).

[6754] See Section III.B.3.b of this Report for the solvency analysis of LBHI. *See* Section III.B.3.d of this Report for the unreasonably small capital analysis of LBHI.

million, of which a majority related to derivative termination payments; and (2) claims against LBI for $336 million, of which $260 million is pursuant to a CLS agreement.[6755]

As with the JPMorgan analysis, this theoretical increase in exposure of $337 million must be measured against any direct or indirect benefits LBHI received as a result of providing this credit support. As detailed in the JPMorgan analysis there is evidence to support a finding that certain LBHI subsidiaries were insolvent. The Examiner did not make a finding as to the solvency of LBI inasmuch as this issue is likely being examined by the SIPA Trustee. The Examiner's conclusions, therefore, assume without independent investigation that LBI was insolvent on September 9-11, 2008. The Examiner has not, however, found evidence to support a finding that LBCC was insolvent, but the increase in liabilities related to LBCC were a relatively small component of the increase in liability.[6756] In light of the insolvency of the LBHI subsidiaries, the Examiner concludes that there is a colorable basis to find that LBHI did not receive quantifiable direct benefits as a result of signing the Amended Guaranty.

The analysis as to whether LBHI received any indirect benefits mirrors that of the JPMorgan analysis.[6757] As with that analysis, the Examiner concludes that there is

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[6755] Duff & Phelps Memorandum Regarding Review of Citibank Claims on Lehman Entities (Jan. 22, 2010).

[6756] LBCC is an entity covered by the resolution guaranty and thus, if it is valid, then LBHI was already liable for its obligations to Citi and the Amended Guaranty did not create this additional exposure.

[6757] See III.B.3.g.5.a.ii.a.2. for an analysis of the "buying of time" benefit as it relates to the agreements entered into with JPMorgan.

evidence to support a conclusion that the indirect benefit of additional time was not reasonably equivalent to the additional liabilities LBHI incurred.

With respect to the issues of both direct and indirect benefit to LBHI from the execution of the Amended Guaranty, Citi can be expected to present evidence to the contrary, including the fact that the Debtors filed the Motion of Debtors For Order Pursuant To Section 105 Of The Bankruptcy Code, Confirming Status Of Citibank Clearing Advances, seeking authority to continue clearing for certain Lehman entities and confirming that any claims arising from such clearing activities would be allowed as claims under the Amended Guaranty.[6758] These issues will have to be resolved by a trier of fact.

Because LBHI incurred an obligation when it entered into the Amended Guaranty, as discussed in Section III.B.3.g.5.a.ii.b.2, it did not engage in a safe-harbored transaction, and the Amended Guaranty may be avoided. Thus, the Examiner has determined that, if the Court adopts a narrow application of the safe harbors described above,[6759] then there is a basis for a colorable claim to avoid the Guaranty Agreement. If the Guaranty Agreement is avoided, the 2004 Guaranty governs.[6760] As such, if avoided,

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[6758] Motion of Debtors For Order Pursuant To Section 105 Of The Bankruptcy Code, Confirming Status Of Citibank Clearing Advances, Docket No. 109, *In re Lehman Bros. Holding, Inc.* No. 08-13555 (Bankr. S.D.N.Y. Sept. 18, 2008). The Motion, however, states that '[t]his Motion does not seek an order of this Court validating the Guaranty…." *Id*. at ¶ 15.

[6759] See III.B.3.g.5.a.ii.b.2. for the description of the legal question regarding the scope of the safe harbor amendments.

[6760] Guaranty (Jan. 7, 2004) [LBEX-DOCID 1090071], attached to e-mail from Michael Mauerstein, Citi, to Emil Cornejo, Lehman (Sept. 9, 2008) [LBEX-DOCID 1079084].

LBHI would no longer be obligated to cover the obligations of the ten Lehman subsidiaries added by the Amended Guaranty and any excess collateral would be returned to the LBHI estate.

Citi has asserted the following claims against LBHI on account of obligations of LBHI subsidiaries that were added to the list of borrowers pursuant to the Amended Guaranty:

- LBCS overdraft of account no. xxx-769 in the amount of $85,296.[6761]
- Amount owed by LBI under CLS Agreement in the amount of $260,326,894.[6762]
- Amount owed by LBI under securities lending transactions in the amount of $1,199,775.[6763]
- Custody fees owed by LBI under Direct Custody Agreement in the amount of $82,345.[6764]
- Pre-petition interest charged owed by LBI for the late settlement of securities lending and repurchase transactions in the amount of $207,624.[6765]
- LBI overdrafts in the amount of $12,199,628.[6766]
- Account service fees owed by LBI in the amount of $42,627.[6767]
- Amounts owed by LBI for misdirected wire claims in the amount of $12,795,775.[6768]

[6761] Summary of Citi Proofs of Claim Against Lehman Filed Before September 22, 2009 Bar Date, at p. 2 [LBEX-CITI 000001].
[6762] *Id.* at p. 4.
[6763] *Id.*
[6764] *Id.*
[6765] *Id.*
[6766] *Id.*
[6767] *Id.*

- LBI check mistakenly credited to JPMorgan in the amount of $35,389.[6769]
- Aggregate net amount owed by Lehman CLS parties (LBI, LBSF, LBCC and LBIE) under CLS agreement, after taking into consideration $1 billion setoff in the amount of $47,424,651.[6770]
- Amount owed by Neuberger Berman under December 6, 2004 securities lending agreement in the amount of $13,044.[6771]
- Face value of LBI note due 2026 in the amount of $8,132,177.[6772]
- Amount owed by LBI pursuant to FX transaction in the amount of $1,156,390.[6773]
- Amount owed by LBI for account service fees in the amount of $111,278.[6774]
- Amount owed by LBI under FX transactions in the amount of $2,676,721.[6775]
- Amount owed by LBI under Custody Agreements in the amount of $57,278.[6776]

In total, Citi claims an additional $346.5 million against LBHI based upon obligations owed by subsidiaries that were added under the Amended Guaranty. If the Amended Guaranty is avoided, the $2 billion deposit would not be subject to setoff on account of these claims, nor would Citi have an unsecured claim against the LBHI estate on account of these amounts. But because the total claims of Citi against LBHI are

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[6768] *Id.*
[6769] *Id.*
[6770] *Id.* at p. 5. This claim is relevant to this analysis only to the extent of LBI and LBCCs portion of the claim.
[6771] *Id.* at p. 8.
[6772] *Id.*
[6773] *Id.* at p. 10.
[6774] *Id.*
[6775] *Id.* at p. 11.
[6776] *Id.* at p. 11.

approximately $2.8 billion,[6777] assuming the validity of these claims, avoidance of the Amended Guaranty will not result in a return of any part of these funds and may serve only to avoid a general unsecured claim against the LBHI estate of up to $346.5 million.[6778]

Because the DCSA was between LBI and Citi, the Examiner defers to the SIPA Trustee to determine whether any claims arise as a result of the DCSA.

(iv) Avoidability of the $500 Million Transfer From an LBHI Account to an LBI Account

Either late on September 14 or on September 15, 2008, after the filing of LBHI's bankruptcy petition, Citi transferred $500 million from LBHI's account at Citi to LBI's account at Citi[6779] to fund Lehman's CLS obligations.[6780] An account statement dates the transfer as of September 15;[6781] however, contemporaneous e-mails evidence that the

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[6777] This amount excludes contingent claims. As such, the $2.8 billion total in claims against LBHI may be subject to increase on account of such claims.

[6778] If the LBHI resolution guaranty is valid, then claims attributable to LBIE, LBJ, LBCS and LBCC would be excluded from this analysis, *See* Unanimous Written Consent of the Executive Committee of the Board of Directors of Lehman Brothers Holding Inc. (June 9, 2005) [LBEX-AM 003415]; Unanimous Written Consent of the Executive Committee of the Board of Directors of LBHI (Nov. 7, 2005) [LBEX-WGM 1104149] (resolution to make LBCS a guaranteed subsidiary of LBHI);

[6779] Lehman Brothers Inc. Account Report (Oct. 1, 2008), at p. 1033 [CITI-LBI 00024142] (account statement confirming that the transaction transferred $500 million from Lehman Brothers Holdings Main Open Account 4061-5202 to Lehman Brothers Inc. account 3054-4658).

[6780] E-mail from Daniel J. Fleming, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Sept. 14, 2008) [LBEX-DOCID 457630].

[6781] Lehman Brothers Inc. Account Report (Oct. 1, 2008), at p. 1033 [CITI-LBI 00024142] (account statement confirming that the transaction transferred $500 million from Lehman Brothers Holdings Main Open Account 4061-5202 to Lehman Brothers Inc. account 3054-4658).

transfer actually occurred on the evening of September 14.[6782] Because transfers executed after 9 p.m. on Sunday night are batched with the Monday trades, Citi's counsel advised the Examiner that the account statement dated September 15 reflected that transfer.[6783] Whether the transfer is found to have occurred on September 14, the day before LBHI filed its petition, or on September 15, following the filing, determines whether the transfer may be avoided. If it occurred on September 14, the transfer would fall under the safe harbors.[6784] If the transfer occurred after the filing of LBHI's bankruptcy, it is a post-petition transfer avoidable pursuant to Section 549.[6785] This transfer was not authorized under either the Bankruptcy Code or by the Court,[6786] nor does it appear to have a defense provided by Section 549.[6787] Moreover, the safe-harbor provisions of Section 546 do not protect transfers avoidable by Section 549.[6788]

[6782] E-mail from Julius Silbiger, Citigroup, to Thomas Obermaier, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00104189] (stating that the $500 million had moved by 9:42 p.m. that evening); e-mail from Roger Barnes, Citigroup, to Naresh N. Kumar, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00104189] (explaining that Citichecking opened at 9 p.m. that evening so the transfer could be made then); e-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00101129] (approving the transfer).

[6783] E-mail from Claudia Hammerman, Paul Weiss, to Angela Allen, Jenner & Block, *et al*. (Jan. 26, 2010).

[6784] 11 U.S.C. § 546(e).

[6785] See Appendix 1, Legal Issues, at Section IV.G. for a more detailed discussion of Section 549.

[6786] *See* 11 U.S.C. § 549.

[6787] *See id.*

[6788] 11 U.S.C. § 546(e), (f), (g), (j).

(c) FRBNY Avoidance Analysis

The Examiner has found no evidence that any transfers made to the FRBNY were made by or originated from any Lehman Chapter 11 entity. Instead, the Examiner has found that all collateral Lehman transferred to the FRBNY originated from LBI.

To determine whether FRBNY, with LBI as a conduit, may have received collateral from the Lehman Chapter 11 entities, the Examiner analyzed the trading activity of 177 different CUSIPs in which FRBNY had trading activity with Lehman during the period of August 1, 2008 to September 19, 2008. Of the 177 CUSIPs with direct trading activity between LBI and the FRBNY, a sample of 30 were analyzed to determine if any Lehman Chapter 11 entity was the source of these CUSIPs from LBI (*i.e.*, did LBI enter into any financing trades, such as reverse repo trades,[6789] whereby LBI loaned cash in return for a security) during the time period of June 1, 2008 to September 19, 2008.

The Examiner determined that LBI engaged in reverse repos with LBF, LBIE, and LBSF during the time period established above. While 21 of the CUSIPs were included in reverse repos between LBI and the Lehman Chapter 11 entities, the FRBNY did not engage in any corresponding reverse repo activity with LBI for these same securities

[6789] A reverse repurchase agreement ("reverse repo") is a repo from the standpoint of the buyer/lender. In a reverse repo, Party A (the buyer/lender) purchases a security from Party B (the seller/borrower) in exchange for cash for a predetermined period of time, after which Party A returns the security to Party B at a predetermined price (cash plus interest). Reverse repos are a way for Party A to lend funds and hold the traded security as collateral. In a repurchase agreement ("repo") Party A transfers a security to Party B in exchange for cash for a predetermined period of time, after which Party B returns it to Party A at a predetermined price (cash plus interest).

(*i.e.*, the FRBNY did not reverse in the corresponding securities from LBI). Therefore, it does not appear that FRBNY provided financing to LBI using collateral sourced from Lehman Chapter 11 entities.

To further this analysis, the Examiner reviewed the trading activity for all non-treasury related CUSIPs traded between FRBNY and LBI during the relevant time period of interest.[6790] After examining the trade data for these CUSIPs, the Examiner determined that there were no instances where LBI entered into any reverse repo trades for these CUSIPs with any non-LBI Lehman Chapter 11 entity as counterparty. Thereby, coupled with the sample analysis, the evidence shows that the FRBNY did not provide financing to LBI using collateral from any Lehman Chapter 11 entity.

Because the Examiner has identified no instances of a transaction between LBI and the FRBNY where LBI provided collateral to the FRBNY that originated from a Chapter 11 Lehman entity, the Examiner defers to the SIPA Trustee with regard to potentially avoidable transactions between FRBNY and LBI.

(d) HSBC Avoidance Analysis

(i) Background

HSBC was a clearing bank, source of intra-day credit for settling trades, and counterparty to LBHI and related entities in transactions involving a variety of treasury

[6790] Approximately 50 of the 177 CUSIPs involved non-treasury which were deemed to have a higher likelihood of being repoed by LBI to the FRBNY.

products.[6791] On January 4, 2008, LBHI guaranteed all of LBIE's payments, liabilities, and obligations to HSBC.[6792] Approximately one month prior to the petition date, HSBC informed Lehman that HSBC would be completely, albeit gradually, exiting their relationship.[6793]

During the last week of August and the first week of September, HSBC demanded the equivalent of $945 million[6794] and received from various Lehman entities (described below) approximately GBP 435 million and approximately HKD 1.4 billion (for a total of the equivalent of approximately $947 million to $992 million[6795]) cash collateral in order to continue providing clearing and settlement services to Lehman.[6796] HSBC also demanded that Lehman execute the U.K. and Hong Kong Cash Deeds to secure the collateral (collectively, including the deposits, the "Cash Deed Transactions"

[6791] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 3.

[6792] *See* Annex A to Proof of Claim of HSBC Private Bank (Suisse) SA, at p. 2, Claim No. 15603, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 17, 2009).

[6793] Nicholas J. Taylor, HSBC, Briefing Note — Project Milan (Aug. 18, 2008), at pp. 1-2 [HBUS 90]; Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at p. 6; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 4.

[6794] This amount and some of the other monetary amounts discussed in this Section are of foreign currency. To the extent there are conversions to USD, all such conversions are approximate.

[6795] The evidence is not conclusive as to the amount of such collateral. For an explanation of this discrepancy, see Section III.A.5.d of this Report.

[6796] E-mail from Guy Bridge, HSBC, to Carlo Pellerani, Lehman, *et al.* (Aug. 27, 2008) [HBUS 3] (demanding combined deposits of $945 million in London and Hong Kong); e-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Aug. 28, 2008) [HBUS 9250] (reporting initial receipt of GBP 435 million); e-mail from Carlo Pellerani, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Aug. 28, 2008) [LBEX-AM 008853] (reporting return of GBP 435 million to Lehman); e-mail from Martina C. W. Kung, HSBC, to Patricia Gomes, HSBC, *et al.* (Sept. 1, 2008) [HBUS 397] (reporting pending deposit of HKD 1.4 billion); e-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Sept. 1, 2008) [HBUS 401] (reporting receipt of GBP 435 million).

and separately, including the deposits, the "U.K. Cash Deed Transactions" and the "Hong Kong Cash Deed Transactions," respectively).[6797]

(ii) The U.K. Cash Deed Transactions

The GBP 435 million deposit was made on September 1, 2008.[6798] The Examiner's financial advisors have identified a GBP 435 million (the equivalent of approximately $800 million) transfer on September 1, 2008 from LBHI's London branch, LBHI(U.K.), to LBIE, after which LBIE and LBHI(U.K.) transferred GBP 435 million back and forth each day.[6799] Meanwhile, as described in more detail in Section III.A.5.d of this Report, Lehman successfully negotiated with HSBC to narrow the proposed right of setoff and expand its own access to the cash secured by the cash deeds.[6800] On September 9, 2008, both LBHI(U.K.) and LBIE executed a cash deed with HSBC plc (together, the "U.K. Cash Deeds")[6801] to secure whatever portions of the $435 GBP deposit HSBC determined were necessary to cover certain exposures to Lehman as specified by the deeds.[6802] HSBC returned EUR 200 million (the equivalent of approximately $282 million) of the

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[6797] E-mail from Guy Bridge, HSBC, to Carlo Pellerani, Lehman, *et al.* (Aug. 27, 2008) [HBUS 3]; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at pp. 5-6; Examiner's Interview of Nicholas J. Taylor, Oct. 15, 2009, at pp. 6-7 (discussing plan to require collateral).

[6798] E-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Sept. 1, 2008) [HBUS 401] (reporting receipt of GBP 435 million).

[6799] Duff & Phelps, Timeline of HSBC Cash Transfers (Nov. 13, 2009), at p. 1.

[6800] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 6; *see* e-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al.* (Sept. 3, 2008) [HBUS 570] (discussing Lehman's refusal to sign the Cash Deeds without changes to the terms).

[6801] Cash Deed between HSBC and LBIE (Sept. 9, 2008) [HBUS 1180]; Cash Deed between HSBC and LBHI(U.K.) (Sept. 9, 2008) [HBUS 1190].

[6802] E-mail from Guy Bridge, HSBC, to Nicholas J. Taylor, HSBC, *et al*. (Sept. 9, 2008) [HBUS 1179]; Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 6.

deposit to a Lehman entity on September 11,[6803] but the Examiner's financial advisers have been unable to identify which Lehman entity received the funds because of the multiplicity of EUR 200 million transfers on that same day.[6804] Given the September 9, 2009 Stipulation between HSBC and the Debtors, described below, the Examiner did not continue to pursue additional avenues to determine which Lehman entity received the EUR 200 million.

(iii) The Hong Kong Cash Deposit Transactions

On September 1, HSBC personnel reported a pending deposit from Lehman of approximately HKD 1.4 billion, or the equivalent of approximately $180 million[6805] and Lehman executed the Hong Kong Cash Deed on September 12.[6806] The Examiner's financial advisors have identified potentially related transfers: an intercompany transfer of HKD 1,432,547,668.60 (approximately $183,400,000) on August 29, 2008 ordered by LBIE, and a transfer of HKD 1,515,153,863.02 (approximately $194,131,922) out of the Lehman Brothers Asia Holdings ("LBAH") Money Market Placement general ledger cash account (account no. XXXXXXX600) on September 1, 2008.[6807] According to counsel

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[6803] Examiner's Interview of Guy Bridge, Sept. 29, 2009, at p. 7. According to Lehman's Daily Funding Call Update e-mail for September 11: "Trsy have reduced cash deposit with HSBC to GBP200m to release liquidity in the firm." E-mail from Maria Barrio, Lehman, to Neil Ullman, Lehman, *et al*. (Sept. 11, 2008) [LBEX-DOCID 1898196]. The Examiner's financial advisors' analysis of Lehman's transactions during this period shows that this report was erroneous, and that Lehman received EUR 200 million on September 11. Duff & Phelps, Preliminary Findings re: HSBC Deposits (Dec. 2, 2009), at p. 1.

[6804] Duff & Phelps, Preliminary Findings re: HSBC Deposits (Dec. 2, 2009), at p. 1.

[6805] E-mail from Martina C. W. Kung, HSBC, to Patricia Gomes, HSBC, *et al.* (Sept. 1, 2008) [HBUS 397].

[6806] E-mail from Patricia Gomes, HSBC, to Agnes Y. L. Lau, HSBC, *et al.* (Sept. 12, 2008) [HBUS 1760].

[6807] Duff & Phelps, Preliminary Findings re: HSBC Deposits (Dec. 2, 2009), at p. 2.

for HSBC, however, the relevant LBAH deposit account held HKD 1.15 billion until September 16, 2008.[6808]

On September 12, 2008, LBAH executed a cash deed with HSBC Ltd. to secure these funds (the "Hong Kong Cash Deed"); however, because Lehman executed the Hong Kong Cash Deed too late in the day for HSBC Ltd to transfer the cash collateral to a secured account covered by the deed, and because of a September 15 public holiday in Hong Kong, HSBC Ltd. was unable to transfer the funds into such an account until September 16.[6809]

All but approximately $3.7 million of the Hong Kong funds were subsequently returned to an account designated by the provisional liquidators of Lehman's Asia-Pacific subsidiary.[6810]

(iv) September 9, 2009 Stipulation

On September 9, 2009, HSBC and LBHI entered into a stipulation (the "Stipulation") regarding funds held by HSBC pursuant to deposits by LBHI in connection with the U.K. Cash Deed between LBHI(U.K.) and HSBC plc.[6811] HSBC and Lehman agreed that HSBC was permitted to setoff (1) an overdraft in the amount of

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[6808] Memorandum from Ken Coleman, HSBC counsel, to Examiner, re: Transfers in Connection With the Hong Kong Cash Deed (Oct. 23, 2009), at p. 1.

[6809] E-mail from Patricia Gomes, HSBC, to Agnes Y. L. Lau, HSBC, *et al.* (Sept. 12, 2008) [HBUS 1760].

[6810] Memorandum from Ken Coleman, HSBC counsel, to Examiner, re: Transfers in Connection With the Hong Kong Cash Deed (Oct. 23, 2009), at p. 1.

[6811] Stipulation, Agreement and Order, Pursuant to Sections 362 and 553 of the Bankruptcy Code, Modifying the Automatic Stay for the Limited Purpose of Permitting HSBC Bank plc to Effect Setoff and Resolution of Certain Banking Arrangements Between Lehman Brothers Holdings Inc. and HSBC Bank plc, at p. 2, Docket No. 5089, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 9, 2009).

GBP 99,992,714.37 (the equivalent of approximately $164 million) plus accrued interest in the amount of GBP 69,347.60 (the equivalent of approximately $144,070); and (2) a misdirected payment in the approximate amount of GBP 605,000.00 (the equivalent of approximately $999,516)[6812] (for a total setoff of approximately GBP 100,667,061.97, or approximately $164.6 million).[6813] In addition, HSBC agreed to transfer EUR 70 million (approximately $101 million) to an account designated by LBHI.[6814] As for any and all other and further claims, HSBC and Lehman agreed to "work in a commercially reasonable manner to address issues surrounding HSBC's additional alleged setoff rights against LBHI."[6815]

For a complete discussion of Lehman's dealings with HBSC, see Section III.A.5.d of this Report.

(v) Avoidability of the January 4, 2008 Guaranty

The Examiner cannot conclude that the January 4, 2008 Guaranty is avoidable as a constructively fraudulent incurrence of an obligation, because there is insufficient evidence to support a finding that LBHI had unreasonably small capital or was insolvent on this date.[6816]

[6812] *Id.*

[6813] The amount of setoff was subject to HSBC's final accounting. *See id.*

[6814] *Id.*

[6815] *Id.*

[6816] *See* Section III.B.3.b. for the solvency analysis of LBHI; *see* Section III.B.3.d. for the unreasonably small capital analysis of LBHI.

(vi) Avoidability of the Hong Kong Cash Deed Transactions

It is unnecessary to analyze the avoidability of the Hong Kong Cash Deed Transactions because (1) the funds have been returned to LBAH, except for approximately $3.7 million, exempted with the approval of the LBAH provisional liquidators,[6817] and (2) the Examiner and his financial advisers have not been able to identify a U.S. Debtor as the source of the funds for the Hong Kong Cash Deeds Transactions. The Hong Kong Cash Deed Transactions are included in the discussion below only insofar as they relate to the U.K. Cash Deed Transactions.

(vii) Avoidability of the U.K. Cash Deed

Because of the Stipulation entered into between HSBC and LBHI, the Examiner has determined it is unnecessary to analyze the avoidability of the U.K. Cash Deed, as it appears that the parties have resolved any outstanding issues pursuant to the U.K. Cash Deed.

According to the Stipulation, the balance of accounts in the name of LBHI (Collateral Accounts) was EUR 343,446,459.96 (approximately $495 million) as of April 28, 2009. Pursuant to the Stipulation, HSBC was permitted to offset approximately GBP 100,667,061.97 (approximately $164.6 million).[6818]

[6817] Memorandum from Ken Coleman, HSBC counsel, to Examiner, re: Transfers in Connection With the Hong Kong Cash Deed (Oct. 23, 2009), at p. 1.

[6818] The amount of setoff was subject to HSBC's final accounting. *See* Stipulation, Agreement and Order, Pursuant to Sections 362 and 553 of the Bankruptcy Code, Modifying the Automatic Stay for the Limited Purpose of Permitting HSBC Bank plc to Effect Setoff and Resolution of Certain Banking Arrangements

(viii) Avoidability of the Transfer of the Remaining Collateral

Under the terms of the Stipulation, HSBC and LBHI have agreed to work together to resolve issues regarding the remaining claims of HSBC. For this reason, and the fact that the transfers of any collateral remaining pursuant to the Stipulation appear to be protected transactions under the safe-harbor provisions, the Examiner determined that it was unnecessary to form an opinion as to whether there are colorable claims in connection with the collateral that remains pursuant to the Stipulation.[6819]

(e) Standard Bank Avoidance Analysis

Standard Bank was Lehman's clearing and settlement bank for trades in South Africa.[6820] Standard, like other clearing banks, demanded and received a collateral deposit shortly before Lehman's bankruptcy.[6821] On September 5, 2008, Standard Bank informed Lehman that Lehman must pledge $200 million in collateral, and that Standard Bank would fail Lehman's trades that were not timely funded or supported by adequate collateral.[6822] The next day, Standard Bank set a deadline of September 9 to

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Between Lehman Brothers Holdings Inc. and HSBC Bank plc, at p. 2, Docket No. 5089, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 9, 2009).

[6819] 11 U.S.C. § 546(e).

[6820] E-mail from Jonathan Seeranj, Lehman, to Stirling Fielding, Lehman, *et al.* (Sept. 4, 2008) [LBEX-DOCID 455717].

[6821] E-mail from Joseph Igoe, Lehman, to Steve Durrant, Lehman, *et al.* (Sept. 9, 2008) [LBEX-DOCID 455717].

[6822] E-mail from Steve Durrant, Lehman, to Shaun Lawrence, Lehman, *et al.* (Sept. 8, 2008) [LBEX-DOCID 1058390] (e-mail chain discussing how to respond to Standard Bank).

receive the funds or it would cease settling Lehman's trades.[6823] On September 9, a Lehman entity placed a $200 million deposit with Standard in response to Standard's demand.[6824] On September 11, LBIE executed and delivered a pledge agreement to cover the deposit.[6825] The pledge agreement allowed Standard Bank to setoff debts LBIE or LBI owed Standard in connection with clearing and settlement in the South African market.[6826] On September 16, Standard Bank setoff $10,422,859.72 from LBIE's account to cover advances for trades settling on September 15 and 16.[6827] For a complete discussion of Lehman's dealings with Standard Bank, see Section III.A.5.g.

To date, neither the Examiner nor the Examiner's financial advisors have been able to identify a transfer from a Lehman Chapter 11 Debtor as the source of the September 9 deposit of $200 million. In order to determine whether the source of the transfer of the equivalent of $200 million to Standard Bank[6828] was a U.S. Lehman Debtor, the Examiner's financial advisors executed a search of the GCCM data set for possible transfers from Lehman to Standard Bank, or to an intermediary that ultimately transferred funds to Standard Bank. The Examiner's financial advisors found that, based upon a review of transfers that appeared relevant because of (1) the dates of the

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[6823] E-mail from Joseph Igoe, Lehman, to Steve Durrant, Lehman, *et al.* (Sept. 9, 2008) [LBEX-DOCID 455717].

[6824] *Id.*

[6825] E-mail from Stirling Fielding, Lehman, to Maria Barrio, Lehman, *et al.* (Sept. 11, 2008) [LBEX-DOCID 1777132].

[6826] Letter from Kenny Fihla, Standard Bank, to Huw Rees, Lehman, re: Notice of Enforcement of Pledge and Cession (Sept. 16, 2008), at p. 1 [LBEX-DOCID 1090737].

[6827] *Id.*

[6828] The transfer may have been in USD or it may have been in South African Rand (ZAR).

transfers and (2) the absolute amounts of the transfer (in both USD and ZAR), no transfers were identified in the GCCM data set that appear to match the transfer in question. Based upon this review, the evidence suggests that a non-Chapter 11 Lehman Entity was the source of the funds.

Accordingly, because there did not appear to be evidence to support a conclusion that the transfer involved property of a Lehman Chapter 11 Debtor, the Examiner did not analyze the avoidability of such transfer.

(f) BNYM Avoidance Analysis

The Bank of New York Mellon ("BNYM") provided, among other services, account support to Lehman for Lehman's European commercial paper trading program and account and financing support for medium-term note issuances and redemptions.[6829] As a result, BNYM believed that it bore intra-day credit risk from Lehman, and in August of 2008, BNYM began requesting that Lehman place collateral with BNYM.[6830]

LBHI, through LBHI (U.K), eventually placed $170 million in collateral with BNYM through a series of transfers made between September 10 and 12, 2008 (the

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[6829] E-mail from Graham Kettle, Lehman, to Joseph Igoe, Lehman, *et al*. (Aug. 21, 2008) [LBEX-DOCID 1066642] (explaining sources of BNYM's intra-day exposure to Lehman).
[6830] *Id.*

"BNYM Deposit").[6831] The BNYM Deposit was secured with a collateral deposit agreement that LBHI executed on September 11, 2008.[6832]

On December 3, 2009, the Court approved a stipulation among LBHI, LBSF, and BNYM that provided that BNYM would return the BNYM Deposit to LBHI, plus interest of $1,756,492.41 and minus bank fees of $306,641.36.[6833] Due to this court approved stipulation providing for a full return of LBHI's collateral, the Examiner has determined that any avoidance analysis is rendered unnecessary. For a more detailed discussion of Lehman's dealings with BNYM, see Section III.A.5.f.

(g) BofA Avoidance Analysis

At the time of this writing, Lehman and BofA are before the Court in an adversary proceeding. The pending dispute stems from BofA's November 10, 2008,

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[6831] E-mail from Graham Kettle, Lehman, to Scott Alvey, Lehman, *et al.* (Sept. 10, 2008) [LBEX-DOCID 1065130] (ordering the transfer of $125 million from LBHI to an account held for the benefit of BNYM); e-mail from Steven J. Engel, Lehman, to Graham Kettle, Lehman, *et al.* (Sept. 10, 2008) [LBEX-DOCID 65930] (providing transaction details); e-mail from Craig L. Jones, Lehman, to Stirling Fielding, Lehman, *et al.* (Sept. 10, 2008) [LBEX-DOCID 065919] (confirming outgoing payment); e-mail from Graham Kettle, Lehman, to Steven J. Engel, Lehman, *et al.* (Sept. 11, 2008) [LBEX-DOCID 065879] (reporting BNYM ordering the return of $75 million to Lehman); e-mail from Graham Kettle, Lehman, to Daniel J. Fleming, Lehman, *et al.* (Sept. 12, 2008) [LBEX-DOCID 65923] (reporting deposit of $120 million with BNYM).

[6832] Collateral Deposit Agreement between Lehman Brothers Holdings, Inc. and the Bank of New York Mellon, London Branch (Sept. 11, 2008) [LBEX-DOCID 1031225] (final version for execution).

[6833] Stipulation and Agreed Order Between Lehman Brothers Holdings, Inc., Lehman Brothers Special Financing, Inc. and Bank of New York Mellon Regarding (1) Turnover of Collateral Deposit and (2) Return of Misdirected Wires, at pp. 1-2, Docket No. 6040, *In re Lehman Bros. Holdings, Inc.*, Case No. 08-13555 (Bankr. S.D.N.Y. Dec. 3, 2009). The stipulation also provided for the return of $71,305890.63 in misdirected transfers that BNYM erroneously wired to an LBSF account at JPMorgan on April 16 and 20, 2009. *Id.* at p. 2.

setoff of approximately $509 million from various LBHI accounts.[6834] Specifically, BofA setoff the funds against debts it claims Lehman Brothers Special Financing incurred through derivative and swap agreements with BofA.[6835] Lehman claims that this setoff was improper.[6836] Out of deference to the Court and to avoid interfering with active litigation, the Examiner has limited his direct investigation of this claim and does not reach conclusions about the relative merits of the parties' arguments. For a complete discussion of Lehman's dealings with BofA, see Section III.A.5.e.

(h) CME Avoidance Analysis

(i) Summary

This Section describes the circumstances surrounding the transfers by the CME Group (the "CME") of more than $2.0 billion in LBI collateral (margin) and clearing deposits, including margin pertaining to futures and options contracts cleared by LBI for the benefit of LBHI affiliates, at the CME in connection with the CME's decision to sell and transfer LBI's proprietary positions, including positions maintained for the benefit of LBHI affiliates, to three entities, Barclays [redacted]. This Section also addresses whether any colorable common law or bankruptcy claims arise from the transfers.

[6834] Joint Stipulation of Undisputed Facts, at ¶ 44, Docket No. 74, *Bank of Am., N.A. v. Lehman Bros. Holdings, Inc. (In re Lehman Bros. Holdings, Inc.)*, No. 08-01753 (Bankr. S.D.N.Y. Dec. 7, 2009).
[6835] *Id.* at ¶ 45.
[6836] *Id.* at ¶ 46.

The Examiner concludes that an argument can be made that the transfers at issue were fraudulent transfers avoidable pursuant to Section 548 of the Bankruptcy Code and Sections 273 through 275 of the New York Debtor and Creditor law[6837] because (1) the transfers were made during the applicable look-back period; and (2) Lehman received less than reasonably equivalent value or fair consideration for the transfers (a loss to Lehman exceeding [redacted] Whether LBI had unreasonably small capital or was insolvent at the time of the transfer is an issue unresolved by this Report and the Examiner defers to the findings of the SIPA Trustee.[6838] In any event, the Examiner concludes that the evidence does not support the existence of colorable claims because (i) the CME and its officers likely would be immune because the CME acted within its statutory role as a self-regulator of its exchanges, (ii) the Commodity Exchange Act ("CEA")[6839] likely would preempt most suits against both the CME or the transferees, and (iii) the transfers likely were protected from avoidance by the safe-harbor provisions of the Bankruptcy Code.

[6837] *See* Appendix 1, Legal Issues, at Sections IV.A., IV.C for a discussion of applicable fraudulent transfer law.

[6838] An argument could be made that it is the solvency or unreasonably small capital of LBHI and its affiliates (rather than LBI) that is relevant because LBI cleared for the benefit of LBHI and its affiliates. *See* Section III.B.3.d for the analysis of unreasonably small capital of LBHI and its affiliates. *See* Section III.B.3.b for the solvency analysis of LBHI. *See* Section III.B.3.c for the solvency analysis of the affiliates of LBHI.

[6839] 7 U.S.C. § 1 *et seq.*

(ii) Background

The CME Group is comprised of four designated contract markets: the Chicago Board of Trade ("CBOT"), the Chicago Mercantile Exchange, the New York Mercantile Exchange and COMEX (f/k/a Commodity Exchange, Inc.). The CME's Clearing House Division confirms, clears and settles all derivatives contracts traded at the CME exchanges, acts as the central counterparty and provides a performance guaranty for all futures and options contracts cleared through these exchanges. [6840]

LBI was a long-standing clearing member of all four of the CME exchanges. At the time of LBHI's bankruptcy, LBI maintained substantial proprietary – or "house" – positions in energy, interest rate, and equities (*i.e.*, S&P 500, etc.) futures and options traded on CME exchanges, along with smaller positions in metals, agriculture, and foreign exchange. At the time, LBI's combined margin requirements at the CME totaled roughly $2 billion for LBI's proprietary positions and an additional $2 billion for LBI's public customer positions.[6841]

LBI's proprietary positions included the domestic exchange-traded commodity futures and options positions of most LBI affiliates, such as LBCS and LBSF. Because they were not CME clearing members, affiliates such as LBCS entered into and cleared domestic exchange-traded commodities futures and options contracts through LBI,

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[6840] Examiner's Interview of Timothy Doar, Oct. 16, 2009, at p. 2.
[6841] *Id.*

which was a registered futures commission merchant and clearing member of most major exchanges.[6842]

LBI historically maintained very little excess margin at the CME and instead managed its cash aggressively so that only a few million dollars in excess margin funds would remain on deposit at the CME.[6843] The CME began more actively monitoring LBI's financial condition (and the financial condition of all other investment banks that were clearing members of the CME) following the collapse of Bear Stearns. During this period, the CME was in regular contact with Lehman personnel and Lehman personnel met with the CME on at least one occasion to provide assurances about LBHI and LBI's liquidity.[6844] The CME also regularly consulted with the CFTC (primarily through Ananda Radhakrishnan and Robert Wasserman, director and associate director, respectively, of the CFTC's Division of Clearing and Intermediary Oversight), the SEC (primarily through Mike Macchiaroli) and the Federal Reserve Bank concerning the financial condition of LBI and other investment banks on its watch list.[6845]

Sometime on Friday, September 12, 2008, the federal regulators made CME aware that they expected Lehman either would be sold or in bankruptcy by Monday, September 15. The CME understood that in the event Lehman filed bankruptcy, it was

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[6842] Examiner's Interview of Satu Parikh, Aug. 26, 2009, at pp. 9-10.
[6843] *Id.*
[6844] Examiner's Interview of Timothy Doar, Oct. 16, 2009, at p. 3.
[6845] *Id.*

expected to follow the "Refco model,"[6846] which involved an immediate holding company bankruptcy filing but no immediate bankruptcy filing for regulated subsidiaries.[6847]

On Saturday, September 13, 2008, the CME began preparations for a possible liquidation or transfer of LBI positions. Tim Doar, Managing Director of Risk Management in the CME Clearing House Division, stated in interviews with the Examiner that the CME believed it would not be prudent to conduct an open market liquidation of LBI's positions because of the size and complexity of the positions, as well as the credit and execution risk that would be associated with such a large open market liquidation.[6848] LBI was a major clearing member of the CME; the aggregate margin requirements for all CME clearing members was approximately $95 billion, of which roughly $4 billion was attributable to LBI alone.[6849] As a result, on Saturday, September 13, 2008, Kim Taylor, President of the CME Clearing House Division, contacted Jeff Jennings, Lehman's Global Head of Futures, for permission to disclose LBI's house positions to potential buyers and seek bids from firms that would assume responsibility for the positions.[6850] On Sunday, September 14, 2008, Tom Russo (Lehman's general

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[6846] *Id.*

[6847] In the *Refco* case, its regulated futures commission merchant subsidiary, Refco, LLC, did not commence bankruptcy proceedings until it was ready to be sold and transfer all customer positions to Man Financial, Inc., n/k/a MF Global.

[6848] Examiner's Interview of Timothy Doar, Oct. 16, 2009, at p. 3.

[6849] *Id.* at p. 2.

[6850] *Id.* at p. 3.

counsel) contacted Taylor and consented to the CME's disclosure of LBI's house positions to potential buyers.[6851]

The CME selected a handful of firms from which to solicit contingent bids on LBI's house positions, including the positions of LBI affiliates such as LBCS that were cleared through LBI. The firms selected by the CME to participate in the bidding process were [redacted][6852] The CME selected these [redacted] firms based on their capital, market concentration considerations and risk management expertise.[6853]

The CME delivered the portfolio information regarding LBI's house positions to potential bidders on Sunday and, by Monday morning, had received bids on LBI's proprietary positions from [redacted]. [redacted]

[6851] *Id.*

[6852] *Id.*

[6853] *Id.*

[redacted]

On Monday morning, September 15, 2008, the members of the CME Emergency Financial Group – Craig Donohue (CME Chief Executive Officer), Phupinder Gill (CME President), Terrence Duffy (Chairman of the Board), Jim Oliff and Howard Siegel (Co-Chairmen of the Clearing House Risk Committee) and Taylor – met and decided to (i) place LBI on "liquidation only" status for its proprietary positions, and (ii) give the CME Clearing House Division authority to sell or transfer LBI's house positions in bulk.[6857] The CME "liquidation only" instructions were communicated to Jennings, who Doar

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[6857] *See* Rule 975, Emergency Financial Conditions, http://www.cmegroup.com/rulebook/CBOT/I/9/75.html.

CME Rule 975 (Emergency Financial Conditions) provides, in its entirety:

> If the President of the Exchange or the President of the Clearing House determines that the financial or operational condition of a clearing member or one of its affiliates is such that to allow that clearing member to continue its operation would jeopardize the integrity of the Exchange, or negatively impacts the financial markets by introducing an unacceptable level of uncertainty, volatility or risk, whether or not the clearing member continues to meet the required minimum financial requirements, he may empanel the Chief Executive Officer, the President of the Exchange, Chairman of the Board, the Chairman of the Clearing House Risk Committee and the President of the Clearing House. ("Emergency Financial Committee") Such panel shall be duly authorized and, upon a unanimous vote of the panel, be empowered to order (a) an immediate position limitation, (b) an immediate suspension of the clearing member, (c) that all open trades of said clearing member be for liquidation only, (d) the liquidation or transfer of all or a portion of the open positions of the clearing member, (e) additional performance bond to be deposited with the Clearing House and/or (f) any other action necessary to protect the financial integrity of the Clearing House. The clearing member affected by action taken shall be notified and may request a hearing before the Board as provided in Rule 412. In the event of suspension, the Chief Executive Officer shall, promptly after a suspension, set the matter for hearing before the Board for final determination. To the extent that the panel orders that all open trades of a clearing member be for liquidation only, or the panel orders the liquidation or transfer of all of the open positions of a clearing member, Rule 913.B. shall apply and the clearing member shall be treated as a withdrawing clearing member.

Id.

believes passed the instruction along to Amin and Parikh, along with instructions to attempt to sell LBI's house positions in bulk.[6858] The CME did not give LBI a deadline to sell or liquidate its positions at the CME.[6859] Rather than liquidating its positions, however, LBI modestly added to its positions over the next two days.[6860] This continued trading activity was attributed to confusion and chaos at LBI.[6861]

The CME did not give "liquidation only" instructions to LBI because it was in default with respect to any CME margin requirements, but rather for general financial insecurity reasons related to LBHI's bankruptcy filing.[6862] Doar stated that with the bankruptcy of LBHI and LBIE, even a significant increase in Lehman's cash and liquidity positions would not have enabled LBI to survive as a CME clearing member for long.[6863] Rather, the CME viewed it as only a matter of time before LBI – which was ineligible for Chapter 11 relief – would need to commence a SIPC or Chapter 7 liquidation proceeding.[6864] The CME also was concerned that JPMorgan might cease acting as LBI's settlement bank with the CME Clearing Division. Although it was technically possible to conduct transactions with the CME without a settlement bank,

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[6858] Examiner's Interview of Timothy Doar, Oct. 16, 2009, at p. 4.
[6859] *Id.*
[6860] *Id.*
[6861] *Id.*
[6862] *Id.*
[6863] *Id.*
[6864] *Id.*

no CME clearing member had ever done so.[6865] Doar stated that it would have presented an unprecedented situation and additional risk to the CME and noted that on Wednesday, September 17, BofA ceased acting as LBI's settlement bank with respect to the other dominant domestic derivatives clearing organization, the Options Clearing Corporation ("OCC").[6866]

The CME was in regular contact on Monday, September 15 through Wednesday, September 17, with Jennings, Amin and Parikh concerning the liquidation of LBI's house positions.[6867] On Wednesday, Parikh informed the CME that LBCS had arranged for [redacted] to purchase LBCS's natural gas positions, which it traded at the NYMEX through LBI, in bulk.[6868] LBI, however, did not find a buyer for any of its other house positions.

[redacted]

[6865] *Id.*

[6866] *Id.*

[6867] *Id.*

[6868] *Id.*

[redacted]

The aggregate Span Risk[6871] – or margin requirements – associated with these positions,

Sometime on Wednesday, September 17, the CME learned that the proposed sale to Barclays would not include the assumption of risk associated with LBI proprietary positions, only LBI public customer positions. The CME also learned on Wednesday that LBI was likely to file for bankruptcy on Friday, and that the Australian exchange was preparing to suspend Lehman's trading.[6873] Consequently, that evening the CME Emergency Financial Group met and determined to re-solicit bids in LBI's house portfolio from from which it had solicited bids on Sunday, September 14, 2008, and to transfer the positions in bulk to the winning bidders the following morning

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[6871] SPAN is a CME-developed system which evaluates overall portfolio risk by calculating the worst possible loss that a portfolio of derivative and physical instruments might reasonably incur over a specified time period (typically one trading day.) This is done by computing the gains and losses that the portfolio would incur under different market conditions. SPAN is the industry standard for portfolio risk assessment, and is the official performance bond (margin) mechanism of 50 registered exchanges, clearing organizations, service bureaus and regulatory agencies throughout the world. *See* SPAN, www.cmegroup.com/clearing/risk-management/span-overview.html.

[6873] Examiner's Interview of Timothy Doar, Oct. 16, 2009.

The CME communicated its intended course of action to Jennings and Herbert "Bart" McDade. Doar stated that McDade argued against the CME's bulk liquidation but did not provide an alternative course of action other than the *status quo*.[6875]

Overnight, the CME transmitted LBI's house position information to and instructed them to submit bids on the following baskets of LBI positions: (i) NYMEX/Clearport/COMEX (energy) derivatives; (ii) FX derivatives; (iii) interest rate derivatives; (iv) equity derivatives; and (v) agricultural and alternative investment derivatives. On Thursday morning, September 18, 2008, the CME evaluated the bids that it had received overnight and transferred LBI's house positions (including LBHI affiliate positions cleared through LBI) , as follows:

a. Energy Derivatives

[6875] Examiner's Interview of Timothy Doar, Oct. 16, 2009.

b. FX Derivatives

c. Interest Rate Derivatives

d. Equity Derivatives

e. Agricultural Derivatives

The bulk sale process (including the sale arranged by LBCS) resulted in a substantial loss to LBI This process represented the first and only time the

CME had conducted a forced transfer/liquidation of a clearing member's positions. The CME currently holds roughly $150 million of former LBI margin collateral remaining from the transfer and liquidation process.

Thus, LBI may have a colorable claim against CME, or any of the firms that bought LBI's positions at a steep discount during the liquidation ordered by the CME, for the losses that LBI sustained as a result of the forced sale of house positions held for the benefit of LBI and its affiliates.

(iii) Defenses to Avoidability of Claims

a. Applicability of CEA Preemption

The Supremacy Clause of the United States Constitution authorizes Congress to displace state law in any area that Congress has the power to regulate. In general, a federal statute preempts state law in one of three instances: (1) when Congress expressly states its intent to preempt or displace relevant state law ("express preemption");[6887] (2) when a federal regulatory scheme is "so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it"[6888] within an entire field of regulation ("field preemption"); or (3) when it is impossible to comply with both federal and state law, or where state law "stands as an obstacle to the

[6887] *Fid. Fed. Sav. & Loan Ass'n v. De la Cuesta*, 458 U.S. 141, 152-53 (1982).
[6888] *Id*. at 153 (quoting *Rice v. Santa Fe Elevator Corp*., 331 U.S. 218, 230 (1947)).

accomplishment and execution of the full purposes and objectives of Congress" ("conflict preemption").[6889]

The term "preemption" generally refers to whether a federal statute or regulation supersedes any *state* law to the contrary. Some of the potential claims against CME, however, are *federal* claims (*e.g.*, fraudulent transfer claims under Section 548 of the Bankruptcy Code). Because preemption law deals with federal-trumping-state-law situations, it may not apply to whether the CEA precludes non-CEA federal causes of action. However, the CEA could still foreclose other federal claims if a court concludes the CEA implicitly repealed those claims or that Congress intended the CEA to be the exclusive remedy for claims arising out of futures markets. Whatever the technical resolution of that question, courts analyzing whether the CEA forecloses non-CEA claims (state or federal) use similar standards for both federal and state claims.[6890] Indeed, the primary case upon which this section relies held that the CEA effectively preempts the Sherman Act.[6891] Therefore, the CEA provides the sole mechanism for regulating commodities, and any state or federal statute or claim that frustrates Congress' regulatory scheme is likely precluded by the CEA.

[6889] *Am. Agric. Movement, Inc. v. Bd. of Trade of the City of Chi.*, 977 F.2d 1147, 1155 (7th Cir. 1992), *abrogated on other grounds by Freightliner Corp. v. Myrick*, 514 U.S. 280, 288-89 (1995), *as recognized by Time Warner Cable v. Doyle*, 66 F.3d 867, 875 n.7 (7th Cir. 1995).

[6890] *See, e.g.*, *W & W Farms, Inc. v. Chartered Sys. Corp. of New York, Ltd.*, 542 F. Supp. 56, 60 (N.D. Ind. 1982) ("It logically follows that the Act preempts private actions based on *federal* or state statutory schemes. . ." (emphasis added)).

[6891] *See Am. Agric. Movement*, 977 F.2d at 1158.

Through the CEA, Congress "establishe[d] an ambitious scheme for the regulation of commodities trading."[6892] The CEA is enforced by the Commodity Futures Trading Commission (the "CFTC"), which "shall have exclusive jurisdiction . . . with respect to accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery . . . ."[6893] Though that provision would appear to expressly preempt any state law or claim that merely "involv[ed] contracts of a sale of a commodity for future delivery,"[6894] the CEA has a "savings clause" that protects at least some non-CEA claims: "Nothing in this section shall supersede or limit the jurisdiction conferred on courts of the United States or any State."[6895] Thus, Congress did not expressly preempt state law through the CEA.[6896] Further, the savings clause "tells us that Congress did not intend to preempt the field of futures trading."[6897] That leaves only conflict preemption as the means through which the CEA could preempt claims against the CME.

There are two variants of conflict preemption. First, a state law is preempted where it would be impossible to comply with both the state and federal law. Whether the CEA preempts state law because it is impossible to comply with both the state and

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[6892] *Kerr v. First Commodity Corp. of Boston*, 735 F.2d 281, 288 (8th Cir. 1984).
[6893] 7 U.S.C. § 2(a)(1)(A).
[6894] *Id*. "Standing alone, this would appear to grant exclusive authority to the Commission over cases involving futures contracts, and to completely preempt state law as a result." *Am. Agric. Movement*, 977 F.2d at 1155.
[6895] 7 U.S.C. § 2(a)(1)(A).
[6896] *Am. Agric. Movement*, 977 F.2d at 1154.
[6897] *Id.* at 1155.

federal law depends on the particular state law at issue. Most of the common law or statutory claims that could conceivably be brought against the CME (such as a fraudulent transfer claim) would not involve an unavoidable conflict with the CEA.

Second, conflict preemption exists where state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[6898] At least one federal appellate court has held that a state law claim, whether based on a statute or common law, can be preempted if it frustrates the "purposes and objectives of Congress" in passing the CEA.[6899] In *American Agricultural Movement, Inc. v. Board of Trade of the City of Chicago*, the Seventh Circuit held, in relevant part, that the CEA preempted a suit against the CBOT that was premised on the CBOT's adoption of an emergency resolution, pursuant to its self-regulatory powers, ordering the liquidation of excessively high short or long positions to ensure the stability of the soybean market. The order caused the long positions in the futures market to fall in value, with a proportionate decline in the cash market. Soybean farmers sued the CBOT, claiming that the CBOT acted in bad faith in adopting the emergency resolution because some of the members of the committee that approved the resolution had clients that would benefit from the drop in price.[6900]

[6898] *Id.* (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941).
[6899] *Id.*
[6900] *Id.* at 1150-51.

The Seventh Circuit held that the CEA preempted the farmers' claims. The court concluded that the combined effect of the savings clause (which kept alive some state law claims) and the clause granting exclusive jurisdiction to the CFTC over claims "with respect to accounts, agreements . . ., and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market . . . ." led to a conclusion that: "[g]iving full effect to both clauses compels the conclusion that Congress intended to preempt some, but not all, state laws that bear upon the various aspects of commodity futures trading."[6901]

The court noted, however, that the statutory text did not resolve which particular claims the CEA preempted. Thus, the court declared, "we must take our guidance from the goals and policies underlying the statute."[6902] Examining the history of the 1974 amendments to the CEA, the court found that the purpose of the CEA was to ensure uniform, national rules for the operation of commodities markets:

> The circumstances surrounding passage of the 1974 Act shed a great deal of light upon the preemptive scope of the CEA. It appears that a confluence of events in the early 1970s-including a drastic surge in commodities trading, rapidly rising food costs, and a highly publicized and costly futures trading scandal-led Congress to modernize and fortify the CEA and fill some fairly significant regulatory gaps. The Act's proponents were concerned that the states, in light of these circumstances, might step in to regulate the futures markets themselves. This, they feared, might have subjected the national futures trading apparatus to conflicting regulatory demands. The solution, the House Committee on Agriculture believed, was to put all exchanges and all persons in the

[6901] *Id.* at 1155.

[6902] *Id.*

> industry under the same set of rules and regulations for the protection of all concerned. The Senate Committee on Agriculture and Forestry apparently concurred, as indicated by its deletion of a CEA provision which appeared to preserve the states' authority over futures trading.[6903]

Thus, the Seventh Circuit held that "[w]hen application of state law would directly affect trading on or the operation of a futures market, it would stand as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress, and hence is preempted."[6904] The emergency resolution adopted by CBOT was an exercise of its self-regulatory power under the CEA, which is at the very core of the comprehensive regulatory scheme Congress enacted over the futures market. "Accordingly, the [farmers'] state law claims against the CBOT for implementing the emergency Resolution are preempted by the CEA because they are intimately tied to the operation of a contract market."[6905]

The Seventh Circuit's decision, however, did not broadly sweep aside all state law claims that arose in the context of the futures' markets. Rather, "[w]hen . . . the application of state law would affect only the relationship between brokers and investors or other individuals involved in the market, preemption is not mandated."[6906] Thus, the Seventh Circuit was concerned with ensuring that self-regulating commodity exchanges were subject only to the uniform commands of the CEA, rather than the

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[6903] *Id.* at 1155-56 (citations and quotations omitted).
[6904] *Id.* at 1156-57 (citations and quotations omitted).
[6905] *Id.* at 1157.
[6906] *Id*.

patchwork of rules that would result from broad application from state common law or statutory claims against those exchanges. Because claims among parties that are not the exchange itself (*e.g.*, brokers and investors) do not implicate the exchange's operation of its market, those claims are not preempted.

Neither the Second Circuit nor the Supreme Court has expressly adopted the holding or reasoning of the Seventh Circuit. In an analogous context, however, the Second Circuit has held that federal law grants self-regulatory organizations immunity from suit when acting in their regulatory function.[6907] Citing *American Agricultural Movement* with approval, the Second Circuit concluded immunity for officials was necessary to carry out Congress's regulatory goals under the CEA.[6908] Further, lower courts (even those outside the Seventh Circuit) have followed the holding of *American Agricultural Movement*.[6909] Thus, there is strong reason to conclude that *American Agricultural Movement* is a correct statement of the law of preemption under the CEA.

Applying the Seventh Circuit's reasoning to any claims against the CME for its liquidation of LBI's proprietary positions, the Examiner concludes that the CEA likely preempts any claims against CME. As in *American Agricultural Movement*, any claim against the CME would attack a formal resolution made by an exchange as the

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[6907] *Barbara v. N.Y. Stock Exch., Inc.*, 99 F.3d 49, 59 (2d Cir. 1996).

[6908] *Id.*

[6909] *See DGM Invs, Inc. v. N.Y. Futures Exch., Inc.*, No. 01 CV 11602 (RWS), 2002 WL 31356362, at *4-5 (S.D.N.Y. Oct. 17, 2002); *W. Capital Design, LLC v. N.Y. Mercantile Exch.*, 180 F. Supp. 2d 438, 443 (S.D.N.Y. 2001).

regulator of its market. The CME directed the liquidation of LBI's positions pursuant to an order from its Emergency Financial Committee to protect the integrity and stability of CME contract markets. Any challenge to that decision in court would attack a decision of the CME that is "intimately tied to the operation of a contract market."[6910] Under *American Agricultural Movement*, that claim would be preempted.

There is no case law directly addressing whether the CEA also preempts claims against the firms that participated in the liquidation sale ordered by the CME, but those claims likely are also preempted. After all, the claims would be predicated on the very same act as claims directly against the CME: CME's liquidation order. A court would likely hold that a claim against a third party for participating in a transaction ordered by an exchange in carrying out the exchange's regulatory function would be "intimately tied to the operation of a contract market," and thus preempted. After all, it would frustrate the ability of an exchange to regulate its market if third-parties could not participate in an auction or other emergency process without fear of liability. Thus, claims against the firms that participated in the CME-ordered liquidation sale would likely be preempted to the same extent that claims against CME are preempted.

b. Applicability of Self-Regulatory Organization Immunity

Even if the CEA did not preempt any claims against the CME or firms participating in the liquidation sale, the immunity provided to self-regulatory

[6910] *Am. Agric. Movement*, 977 F.2d at 1157.

organizations like the CME, and its officers, would likely foreclose any suit against the CME.

The CME is a "self-regulatory organization," or SRO. Congress gives SROs the authority to regulate, police, and discipline those who participate in their markets, subject to the supervision of federal agencies. Thus, SROs (*e.g.*, the NYSE, NASDAQ, and CME, among others) establish rules for their exchanges, license those who can participate in them, investigate violations of rules and laws, and discipline members through internal adjudications. All of those activities are subject to the oversight and regulation of federal administrative agencies like the SEC and CFTC.

SROs, as well as their officers personally in most situations, are absolutely immune from suit for acts taken within the scope of their regulatory or adjudicative functions. That immunity is premised on the notion that, when acting in such a capacity, an SRO is exercising quasi-governmental power, and should enjoy the same immunity from suit that a governmental organization would have. As the Second Circuit stated in *Barbara v. New York Stock Exchange*: "Although the [New York Stock] Exchange is a private, rather than a government entity, immunity doctrines protect private actors when they perform important governmental functions."[6911]

[6911] *Barbara v. N.Y. Stock* Exch., *Inc.*, 99 F.3d 49, 58 (2d Cir. 1996). The *Barbara* court expanded:

> We think that absolute immunity is particularly appropriate in the unique context of the self-regulation of the national securities exchanges. Under the Exchange Act, the Exchange performs a variety of regulatory functions that would, in other circumstances, be performed by a government agency. Yet government agencies, including the SEC, would be entitled to sovereign immunity from all suits for money damages. As a private corporation, the Exchange does not

As with the preemption analysis discussed above, courts have predicated SRO immunity on the fact that allowing suits against SROs and their officers would frustrate the purpose of Congress in authorizing SROs to exercise broad discretion in regulating exchanges:

> Furthermore, allowing suits against the Exchange arising out of the Exchange's disciplinary functions would clearly stand as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress, namely, to encourage forceful self-regulation of the securities industry. Other courts have relied upon this rationale in holding that state law claims against self-regulatory organizations are preempted by the Exchange Act. Although we do not rely on the doctrine of federal preemption in this case, we think that the reasoning of these cases supports our conclusion that the Exchange is immune from damages claims with respect to its conduct of disciplinary proceedings.[6912]

Early SRO immunity cases suggested that absolute immunity might only attach to the prosecutorial or adjudicative functions of the SRO, while qualified immunity would apply to other regulatory functions of the SRO. In *Austin Mun. Secs., Inc. v. Nat'l Ass'n of Sec. Dealers, Inc.* ("*Austin*"), the Fifth Circuit became the first court to recognize SRO immunity.[6913] The court based its holding on an SRO's quasi-governmental nature, and the cases that grant government officials some form of immunity for their official acts.[6914] Only certain governmental functions are protected by absolute immunity; most

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> share in the SEC's sovereign immunity, but its special status and connection to the SEC influences our decision to recognize an absolute immunity from suits for money damages with respect to the Exchange's conduct of disciplinary proceedings.

Id. at 59 (citations omitted).

[6912] *Id.* (quotations and citations omitted).

[6913] 757 F.2d 676, 686 (5th Cir. 1985).

[6914] *Id.* at 686-88.

are subject only to qualified immunity, which provides more limited protection. The Fifth Circuit, therefore, engaged in an extensive analysis of which type of immunity a SRO should enjoy. The claims in *Austin* involved the investigation, charge, and prosecution of claims by NASD against one of its members.[6915] The *Austin* court held that the NASD was entitled to absolute immunity from the claims because governmental actors generally are entitled to absolute immunity for judicial or prosecutorial functions.[6916] But *Austin* suggested that SROs would not be completely protected from claims arising from *all* their official functions, as *Austin* denied absolute immunity to NASD staff for claims arising from their investigation (not prosecution) of the wrongdoing at issue.[6917] The Court left open the possibility that the NASD staff would be entitled to qualified immunity for their investigatory acts.[6918]

The Second Circuit, however, has rejected the claim that a SRO is entitled to less than absolute immunity for its non-prosecutorial and adjudicative functions. In *D'Alessio v. New York Stock Exchange*, the Second Circuit held that the NYSE was entitled to absolute immunity for claims that it improperly interpreted the Securities Exchange Act, improperly failed to alert the plaintiff he was violating the Act, and improperly cooperated and assisted the U.S. Attorney's Office in its investigation of the plaintiff.[6919]

[6915] *Id.* at 681-82.
[6916] *Id.* at 689.
[6917] *Id.* at 693.
[6918] *Id.*
[6919] 258 F.3d 93, 106 (2d Cir. 2001), *aff'g* 125 F. Supp. 2d 656 (S.D.N.Y. 2000).

The plaintiff argued the NYSE did not have absolutely immunity because the claims did not flow from the NYSE's prosecutorial or adjudicative authority, which the plaintiff argued were the only claims for which *Barbara* held SROs had absolute immunity.

The court rejected that argument.[6920] "[A]lthough the immunity inquiry in *Barbara* was confined to the NYSE's conduct in connection with disciplinary proceedings, *Barbara* stood for the broader proposition that a SRO, such as the NYSE, may be entitled to immunity from suit for conduct falling within the scope of the SRO's regulatory and general oversight functions."[6921] The court held that the NYSE's interpretation of the Act, and its decision to charge the plaintiff with misconduct and refer his case to the U.S. Attorney's office were "quasi-public adjudicatory" and "quasi-prosecutorial" acts, and thus fell even under the plaintiff's proposed limitation of absolute immunity.[6922] The court then extended absolute immunity outside the adjudicatory or prosecutorial context to include the NYSE's alleged failure to monitor the plaintiff's compliance with the Act, because those acts related to the "proper functioning of the regulatory system."[6923] Thus, *D'Alessio* stands for the broad proposition that an SRO has absolute immunity for all of its official actions within the scope of its delegated authority: "[W]e hold that the NYSE, when acting in its capacity as a SRO, is entitled to immunity from suit when it engages in conduct consistent with

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[6920] *Id.* at 104-05.
[6921] *Id.* at 105.
[6922] *Id.* at 106.
[6923] *Austin*, 757 F.2d at 687 (quoted in *D'Alessio*, 258 F.3d at 106).

the quasi-governmental powers delegated to it pursuant to the Exchange Act and the regulations and rules promulgated thereunder."[6924]

Where claims go to the heart of a SROs regulatory function, courts have not hesitated to immunize SROs and their officers from liability. Thus, the Ninth Circuit threw out a suit arising from the NASDAQ's decision to de-list the plaintiff's stock on the first day of its public offering.[6925] The court held that "there are few functions more quintessentially regulatory than suspension of trading," so the de-listing decision was immune from attack.[6926]

Immunity applies to decisions of an SRO under the CEA. In *Mandelbaum v. New York Mercantile Exchange*, Mandelbaum sued NYMEX for what Mandelbaum alleged was NYMEX's improper use of its investigative and adjudicative authority to harass him and require him to have to sell his seat on the exchange.[6927] The district court held that Mandelbaum's claims were foreclosed by NYMEX's absolute immunity as an SRO.[6928]

An SRO, however, is not absolutely immune from all suits. If the SRO is acting in its private, rather than regulatory, manner, it is not immune from suit. In *Weissman v.*

[6924] *D'Alessio*, 258 F.3d at 106; *see also DL Capital Group, LLC v. Nasdaq Stock Mkt, Inc.*, 409 F.3d 93, 97-98 (2d Cir. 2005) (holding Nasdaq absolutely immune from suit challenging manner in which Nasdaq publicly announced suspension or cancellation of trades); *MFS Sec. Corp. v. N.Y. Stock Exch., Inc.*, 277 F.3d 613, 617 (2d Cir. 2002) (holding NYSE immune from contract claim by securities firm that had been stripped of its NYSE membership).

[6925] *Sparta Surgical Corp. v. Nat'l Ass'n of Sec. Dealers, Inc.*, 159 F.3d 1209, 1213-14 (9th Cir. 1998).

[6926] *Id.* at 1214.

[6927] 894 F. Supp. 676, 677 (S.D.N.Y. 1995).

[6928] *Id.* at 679-80.

Nat'l Assoc. of Securities Dealers, an owner of WorldCom stock (Weissman) sued NASDAQ for its advertising touting WorldCom stock, which plummeted when WorldCom imploded.[6929] NASDAQ claimed it was immune from suit, but the Eleventh Circuit (sitting en banc) disagreed. The Court held that "because immunity is appropriate only when an SRO is performing regulatory, adjudicatory, or prosecutorial functions that would otherwise be performed by a government agency, it follows that absolute immunity must be coterminous with an SRO's performance of a governmental function."[6930] Thus, the question was whether the NASD was acting in its private or governmental capacity with respect to the advertisements at issue. The Court held that the advertisements were of a private nature: "These advertisements by their tone and content were in the service of NASDAQ's own business, not the government's, and such distinctly non-governmental conduct is not protected by absolute immunity."[6931]

Applying these standards here, CME likely has absolute immunity from any suit by LBI arising from CME's decision to liquidate LBI's proprietary positions. CME was acting in its regulatory, not private, capacity when it ordered the liquidation. The point of the forced sale was to wind down LBI's positions (which were large relative to the

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[6929] 500 F.3d 1293, 1294 (11th Cir. 2007).

[6930] *Id.* at 1297.

[6931] *Id.* at 1299. Four dissenting judges held that while NASDAQ was not entitled to immunity for most of the advertisements, it was immune from liability for its advertisement in the *Wall Street Journal*. "That advertisement communicated to investors that companies listed on NASDAQ must satisfy rigorous financial standards. Because the establishment of those standards was a duty delegated to NASDAQ by the SEC, NASDAQ is entitled to absolute immunity for its communication of those standards to investors." *Id.* at 1300 (Pryor, J., concurring in part and dissenting in part).

size of the CME market) without substantially disrupting the market. The CEA expressly grants the CME the authority to promulgate rules for the emergency liquidation of open positions in its market, which rules the CME implemented when ordering the liquidation of LBI's positions.[6932] Whether the CME's decision was a wise one is irrelevant; it is the nature of the SRO's acts, not the wisdom or legality of those acts, that determines whether the SRO is immune from suit.[6933] Thus, because the CME was acting pursuant to its obligations under the CEA, it is likely immune from suit.

SRO immunity probably does not preclude a suit, however, against the firms that participated in the liquidation sale. There is scant case law on the liability of third parties arising from their participation in an SRO-ordered transaction for which the SRO would enjoy absolute immunity. The firms could claim that the structure and purpose of the CEA suggest that third parties would be immune from suit as well. CME's liquidation order was expressly contemplated by the CEA.[6934] The buyers in any liquidation proceeding would almost always be private actors, not SROs. If those private actors could be sued for participation in a liquidation for which the SRO is immune, then the SRO's authority to order liquidation would be severely impeded: it would be difficult to find buyers if those buyers fear their participation in the

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[6932] *See* 7 U.S.C. § 7(d)(6)(A).

[6933] *See Barbara*, 99 F.3d at 58; *D'Alessio*, 258 F.3d at 104-05; *see also Mandelbaum*, 894 F. Supp. at 682 (immunity analysis "focuses solely on the function performed by the official, and not on the correctness or even constitutionality of his or her actions").

[6934] *See* 7 U.S.C. § 7(d)(6)(A).

liquidation would subject them to liability. However, there is no case law support for this argument, and it conflicts with the notion that CEA immunity is premised on the nature of the actor and its acts -- a quasi-governmental actor exercising governmental power. The participating firms, after all, were acting in their private interest when participating in the sale. Thus, CEA immunity likely does not apply to claims against the private firms, but the Examiner can offer no definitive conclusion as to that issue.

c. Applicability of the Safe Harbor Provisions of the Bankruptcy Code

The Bankruptcy Code's safe-harbor provisions provided in Section 546 are described in detail in Appendix 1, Legal Issues, Section IV.E, and thus will not be described in detail here. In summary, Section 546(e) protects from avoidance margin payments, settlement payments, and transfers to certain protected parties in connection with securities contracts, commodity contracts, or forward contracts.[6935] Further, the Financial Netting Improvements Act of 2006 ("FNIA") substantially broadened Section 546(e) to protect not only settlement or margin payments, but also transfers made by, to, or for the benefit of Protected Parties in connection with securities, commodity, or forward contracts. Recently, the courts of appeals have read the statute literally, and

[6935] *See* 11 U.S.C. § 546(e).

thus have broadly held that any transfer in connection with a securities or commodity contract is protected by Section 546(e).[6936]

The Examiner concludes that there is evidence to support a finding that the transfers at issue were in connection with the sale of commodity contracts, as defined by Section 761(4) and thus likely protected from avoidance pursuant to Section 546(e). Thus, because the transfers are likely protected from avoidance by the safe-harbor provisions, the Examiner has found the evidence does not support the existence of a colorable claim for their avoidance.

h) Avoidance Analysis of LBHI Affiliate Payments to Insider Employees (Fourth Bullet)

(1) Summary

In connection with bullet four of the Examiner Order, which asks whether any LBHI Affiliate has colorable claims against LBHI or any other entities for potentially voidable transfers, the Examiner identified and investigated potential constructively fraudulent transfers made by LBHI Affiliates to insider employees.[6937]

The Examiner analyzed these transfers as potential constructively fraudulent transfers under Section 548 of the Bankruptcy Code, rather than as potential preferences

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[6936] *See Brandt v. B.A. Capital Co. (In re Plassein Int'l Corp.),* No. 08-2616, 2009 WL 4912137, at *4 (3d Cir. Dec. 22, 2009) (safe harbors not intended to exclude privately held securities transactions); *Contemporary Indus.,* 564 F.3d at 986 (safe harbors are not limited to public securities transactions, nor is there a requirement that the financial intermediary involved have a "beneficial interest"); *QSI Holdings,* 571 F.3d at 550 (same) *Kaiser Steel Corp. v. Charles Schwab & Co., Inc.*, 952 F.2d 1230, 1240 (10th Cir. 1991) (*Kaiser II*) (rejecting notion that safe-harbor protected payments only to extent recipient was a participant in the clearance and settlement system).

[6937] Examiner Order at p. 3, fourth bullet.

under Section 547 of the Bankruptcy Code, because there was insufficient evidence to establish a finding that the respective LBHI Affiliates were insolvent at the time of the transfers. In addition, the Examiner did not investigate transfers made by LBHI to insider employees since that was not within the scope of the Examiner Order. Finally, the Examiner did not investigate transfers that constituted annual discretionary performance bonuses paid to insider employees on January 31, 2008 for the 2007 performance year[6938] because such transfers fell outside the pertinent statutory requirements for both preferences and fraudulent conveyances.

The transfers identified and investigated by the Examiner included severance payments LBHI Affiliates paid to insider employees pursuant to separation agreements, as well as bonus buyouts and bonuses guaranteed at hiring to insider employees made pursuant to employment contracts. The Examiner concludes that an argument can be made that certain transfers made by LOTC may be constructively fraudulent and avoidable pursuant to Section 548(a)(1)(B)(ii)(IV) of the Bankruptcy Code because the transfers were made (1) for less than reasonably equivalent value, (2) to or for the benefit of an insider, (3) under an employment contract and (4) not in the ordinary course of business.

Although the Examiner was not asked to investigate or make conclusions with respect to LBHI's transfers to insider employees, the Examiner does note two

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[6938] *See e.g.*, Global Notes Pertaining to Debtors' Schedules and Statements, at 36-40, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Mar. 13, 2009) (the "LOTC SOFA").

substantial transfers that LBHI made to Richard Fuld and Joseph Gregory two months prior to LBHI's bankruptcy. The Examiner sets forth the information gathered with respect to these transfers, including evidence that appears to support a finding that LBHI received reasonably equivalent value in exchange for those transfers.

(2) Methodology

Transfer information was collected from the Debtors' Statements of Financial Affairs, Schedules 3c ("SOFA 3c"), which sets forth a list of payments made to insiders within one year before bankruptcy.[6939] The Debtors' SOFA 3cs revealed that the Debtors made 47 different types of transfers to insiders during this period.[6940] These transfers fell within two major categories: (1) payments made pursuant to employment contracts and (2) non-contract-related payments. For employment contract-related payments, the Examiner focused on payments to insiders exceeding $50,000 in the applicable twelve-

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[6939] The Examiner recognizes that the fraudulent transfer period extends back two years from the respective petition dates (2006-2008). Because SOFA 3cs were not available during the first twelve months of such period (2006-2007), the Examiner would have had to derive the necessary payment data from the Debtors' accounting systems and underlying contractual documentation. In light of the considerable time and expense necessary to do so, the Examiner limited the analysis to the 2007-2008 twelve-month period.

[6940] The Examiner confirmed that the insiders identified in the SOFA 3cs were insiders as defined under the Bankruptcy Code. The SOFA 3cs define insiders as follows: "[F]or its response to Statement questions 3c and 21, (i) LBHI has listed members of its Board of Directors and all employees that are, or were, Executive Officers (Chairman and Chief Executive Officer, Chief Financial Officer, Chief Administrative Officers, President and Chief Operating Officer, and Chief Legal Officer) and Global Heads and (ii) the remaining Debtors have listed Presidents, and certain Directors, Managing Directors, Senior Vice Presidents, and Vice Presidents, as appropriate for their particular personnel structure." LOTC SOFA at 4; *see also id.* at 9 (citing 11 U.S.C. § 101 for the definition of "insider," but noting that a narrower list of insider employees was disclosed in view of the large number of employees who would have otherwise met the statutory definition of insider). The Debtors' definition of "insider" is consistent with how the term is defined in the Bankruptcy Code. 11 U.S.C. § 101(31)(B) (defining "insider" to include, *inter alia*, "(i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor . . . .").

month time period leading up to each Debtor's respective petition date. For the non-contract-related payments, the Examiner focused on payments to insiders exceeding $50,000 between the date on which there was sufficient evidence to establish a finding that the respective Debtor had unreasonably small capital and the date that entity filed its bankruptcy petition.

To understand these transfers, the Examiner collected and reviewed employment agreements, separation agreements, limited partnership agreements, Compensation Committee meeting minutes, employment manuals, expense memoranda, expense summary reports, receipts, and other relevant documentation.[6941] The Examiner also conducted interviews with current and former Lehman employees.

(3) Applicable Legal Standards

Constructively fraudulent transfers may be avoided pursuant to Section 548(a)(1)(B) of the Bankruptcy Code and under state law.[6942] The Bankruptcy Code requires, as a threshold matter, that the potentially avoidable transfer have been made within two years of the debtor's petition date[6943] and that the debtor received less than reasonably equivalent value in exchange for such transfer.[6944] Section 548 then sets

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[6941] The Examiner notes that the Debtors were unable to produce all relevant employment contracts, including hiring and separation agreements, as well as other supporting documentation for many of the payments to insiders identified in the Debtors' respective SOFAs.

[6942] The Examiner did not review the payments discussed herein under state law. *See* 11 U.S.C. § 544(b). For a more detailed discussion of the law of fraudulent transfers, see Appendix 1, Legal Issues, at Sections IV.A., IV.C.

[6943] 11 U.S.C. § 548(a)(1).

[6944] 11 U.S.C. § 548(a)(1)(B)(i).

forth four alternative subsections outlining the factual scenarios under which a particular transfer may be avoided, assuming the threshold requirements are met. Two of the subsections have potential relevance here.

Subsection II, relevant to the non-contract-related payments, allows for avoidance when, at the time of transfer, the debtor had unreasonably small capital.[6945] Subsection IV, relevant to the payments made pursuant to employment contracts, allows for avoidance regardless of the financial condition of the Debtor when the transfer was made (1) to or for the benefit of an insider, (2) under an employment contract and (3) not in the ordinary course of business.[6946] The relevant elements of Section 548(a) are discussed below.

"Reasonably Equivalent Value" as Used in Section 548(a)(1)(B)(i). The Bankruptcy Code does not define "reasonably equivalent value" as that term is used in Section 548(a)(1)(B)(i).[6947] Courts interpreting this term, however, have indicated that determination of whether a debtor received reasonably equivalent value is a two-step

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[6945] 11 U.S.C. § 548(a)(1)(B)(ii)(II) (allowing for avoidance when the debtor "was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital").

[6946] 11 U.S.C. § 548(a)(1)(B)(ii)(IV) (allowing for avoidance when the debtor "made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business").

[6947] *See, e.g., Official Employment-Related Issues Comm. of Enron Corp. v. Arnold (In re Enron Corp.)*, 2005 Bankr. LEXIS 3261, at *120 (Bankr. S.D.N.Y. Dec. 9, 2005); *Congrove v. McDonald's Corp. (In re Congrove)*, 45 Bankr. Ct. Dec. 59 at *9 (B.A.P. 6th Cir. 2005) (non-precedential); *see also* 11 U.S.C. § 101 (providing no definition for "reasonably equivalent value").

analysis: "(1) did the debtor receive value, and (2) was the payment reasonably equivalent to the value extended?"[6948]

If the debtor received "at least some value," reasonably equivalent value is then analyzed based upon the totality of the circumstances,[6949] which is a fact-intensive inquiry.[6950] Courts have articulated a number of factors that may be considered under the "totality of the circumstances" analysis. These include: (1) the fair market value of the benefit received from the transfer; (2) whether an arm's-length relationship existed between the debtor and the transferee; (3) "the economic circumstances and relationship of the parties"; and (4) "industry standards."[6951] Moreover, whether a payment was reasonably equivalent to the value extended does not have to be "precisely calculated."[6952] Rather, the issue is "whether the debtor got roughly the value it gave."[6953] Courts have examined these and other factors in determining the existence of reasonably equivalent value in a variety of circumstances that appear relevant here.

[6948] *Cohen v. Un-Ltd. Holdings, Inc. (In re Nelco, Ltd.)*, 264 B.R. 790, 813 (Bankr. E.D. Va. 1999); *see also Pension Transfer Corp. v. Beneficiaries Under the Third Amend. to Fruehauf Trailer Corp. Ret. Plan No. 003 (In re Fruehauf Trailer Corp.)*, 444 F.3d 203, 212-13 (3d Cir. 2006).

[6949] *Id*. at 212-13.

[6950] *Sharp v. Chase Manhattan Bank USA, N.A. (In re Commercial Fin. Servs., Inc.)*, 350 B.R. 559, 577 (Bankr. N.D. Okla. 2005).

[6951] *In re Fruehauf Trailer Corp.*, 444 F.3d at 213 (factors (1) and (2)); *Brandt v. nVidia Corp. (In re 3DFX Interactive, Inc.)*, 389 B.R. 842, 863 (Bankr. N.D. Cal. 2008) (factors (3) and (4)) (citations omitted). *In re Fruehauf Trailer Corp.* recites an additional factor, "the transferee's good faith." 444 F.3d at 213. However, at least one bankruptcy court in the Second Circuit has held that this factor is not relevant under Section 548. *See Mishkin v. Ensminger (In re Adler, Coleman Clearing Corp.)*, 247 B.R. 51, 106-07 (Bankr. S.D.N.Y. 1999).

[6952] *In re Fruehauf Trailer Corp.*, 444 F.3d at 205.

[6953] *Id*.

For example, in holding that certain bonuses were avoidable due to lack of reasonably equivalent value, the bankruptcy court in *Arnold* considered, *inter alia*, that (1) the debtor knew that the profits from which to pay bonuses "would be significantly lower than in prior years or non-existent;" (2) certain defendants were aware that Enron would soon declare bankruptcy; (3) bonuses were "substantially higher" than in the preceding year, which was considered Enron's best; and (4) the bonuses were paid immediately and absent negotiation.[6954] The court further agreed with expert testimony that "performance bonuses should not go up when performance goes down."[6955] Bonus payments have also been avoided where, among other reasons, there was no explanation as to how the bonus amounts were calculated.[6956] In holding that a modification to a pension plan lacked reasonably equivalent value and was therefore fraudulent, the court in *In re Fruehauf Trailer Corp.* noted that (1) the modification cost twice the amount of what a retention plan should cost (*i.e.*, the retention plan was not purchased for fair market value); (2) the "benefits inured substantially to corporate insiders"; and (3) the modification was reviewed by those who would gain most, suggesting that the modification was not conducted at arm's length.[6957]

[6954] *Arnold*, 2005 Bankr. LEXIS 3261, at *122-23.
[6955] *Id.* at *123.
[6956] *Lichtenstein v. Buttery (In re Computer Personalities Sys.)*, 2002 Bankr. LEXIS 1625, at *16 (Bankr. E.D. Pa. 2002).
[6957] 444 F.3d at 215-16.

The Examiner notes that the Second Circuit has not addressed whether a debtor has received reasonably equivalent value with respect to pre-petition severance payments in the context of Section 548 of the Bankruptcy Code.[6958] As such, the Examiner has relied upon the "totality of the circumstances test."

"Employment Contract" as Used in Section 548(a)(1)(B)(ii)(IV). Section 548(a)(1)(B)(ii)(IV) requires the transfer to be made "under an employment contract." To date, there are no reported decisions interpreting the term "employment contract" for purposes of this Section, nor is this term defined in the Bankruptcy Code.[6959] Notably, neither the Bankruptcy Code nor case law provides insight into whether an

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[6958] The Second Circuit and others have extensively addressed separation agreements in the post-petition setting, namely whether a post-petition severance payment is entitled to priority as an administrative expense. In *Straus-Duparquet, Inc. v. Local Union No. 3 Int'l Brotherhood of Elec. Workers, AFL-CIO (In re Straus-Duparquet)*, the Second Circuit held that such post-petition severance payments are earned at the time of severance. 386 F.2d 649, 651 (2d Cir. 1967) (holding that employees had earned severance pay when terminated during pendency of bankruptcy were entitled to administrative claim, because such payment served to "recompense [them] for certain losses attributable to dismissal" (citation omitted)); *see also Supplee v. Bethlehem Steel Corp. (In re Bethlehem Steel Corp.)*, 479 F.3d 167, 174-75 (2d Cir. 2007). Courts in other circuits, however, have held that such payments are earned over the course of employment. *See, e.g., United Steelworkers of Am., AFL-CIO, CLC v. Ohio Corrugating Co. (In re Ohio Corrugating Co.)*, 116 B.R. 572, 579 (Bankr. N.D. Ohio 1990); *In re Chicago Lutheran Hosp. Ass'n*, 75 B.R. 854, 856 (Bankr. N.D. Ill.). These cases have limited applicability to the pre-petition severance payments at issue here because (1) they address post-petition severance payments and (2) the *Duparquet* line of cases may be limited to an analysis of more modest severance payments than those at issue here. *See, e.g., In re Hooker Investments, Inc.*, 145 B.R. 138, 146-150 (Bankr. S.D.N.Y 1992) (questioning vitality of *Duparquet* line of cases in view of intervening changes to the Bankruptcy Code and Supreme Court precedent, noting that the Second Circuit's rule conflicts with other circuits, and explaining that the rule may have "no continuing vitality when applied to high-powered, high-priced executives with individually negotiated contracts providing for substantial termination payments"); *cf. In re Jamesway Corp.*, 199 B.R. 836, 839-40 (Bankr. S.D.N.Y. 1996).

[6959] *See In re WorldCom, Inc.*, 361 B.R. 675, 681 (Bankr. S.D.N.Y. 2007); *see also* 11 U.S.C. § 101 (providing no definition for "employment contract").

agreement at the time of separation, as opposed to at the time of employment, constitutes an "employment contract" for purposes of Section 548(a)(1)(B)(ii)(IV).

While the text of the statute does not indicate whether separation agreements are a type of employment contract, the legislative history of Section 548(a)(1)(B)(ii)(IV) suggests that separation agreements could be interpreted to fall within the ambit of employment contracts. The legislative history generally notes that subsection IV was added to "make it easier for a trustee to avoid prepetition transfers."[6960] Moreover, Congress added subsection IV "to enhance the recovery of avoidable transfers and excessive pre-petition compensation, such as bonuses, paid to insiders of a debtor."[6961] The types of transfers that Congress sought to avoid include "golden parachutes" and other payments made to a debtor's executives.[6962] And, as one court has noted, golden parachutes and separation agreements share certain key similarities, such that a golden parachute may be viewed as a type of severance pay.[6963]

In view of the legislative intent behind Section 548(a)(1)(B)(ii)(IV) that suggests that this provision be construed broadly so as to facilitate the recovery of "excessive pre-petition compensation," the Debtors' severance payments made pursuant to

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[6960] H.R. REP. NO. 109-31(I), § 1402 (2005).

[6961] *Id.*

[6962] *See* 5 Collier on Bankruptcy, ¶ 548.05[5] (15th ed. 2005). At the same time, "regular bonuses granted to a sales force, or to a division, will likely not be vulnerable under this section, even if the debtor did not receive reasonably equivalent value in exchange." *Id.*.

[6963] *In re Hooker*, 145 B.R. at 149 ("Since the triggering events of a golden parachute include the severance of the employment relationship, characterization of a particular payment as a golden parachute would not preclude the possibility that a golden parachute could be viewed as a form of severance pay.").

separation agreements may be appropriately reviewed under subsection IV in the event that a court determined that such agreements qualify as "employment contracts."[6964]

"Not in the Ordinary Course of Business" as Used in Section 548(a)(1)(B)(ii)(IV). As with the term "reasonably equivalent value," neither the Bankruptcy Code nor its legislative history provide any guidance as to how the term "not in the ordinary course of business" should be interpreted for purposes of Section 548(a)(1)(B)(ii)(IV).[6965] Likewise, as of this writing, no Court has issued a decision interpreting this term for purposes of a constructive fraudulent transfer analysis.

Courts have interpreted "ordinary course of business" and related terms extensively in connection with preferences under Section 547,[6966] indicating that the ordinary course of business exception under Section 547(c)(2) is to be construed narrowly.[6967] A narrow construction of the ordinary course of business exception in

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[6964] The Examiner notes that the court *In re WorldCom* articulated a number of factors to consider in evaluating whether an agreement is an "employment contract" for purposes of 11 U.S.C. § 502(b)(7) (limiting the amount of a pre-petition claim arising from the termination of an employment contract). The *In re WorldCom* factors that support characterizing the agreements at issue here as "employment contracts" include: (1) provision for compensation and benefits; (2) withholding for taxes and social security benefits; and (3) "constrain[t]s [on] the 'employee' from certain other activities." 361 B.R. at 682.

[6965] *See* 11 U.S.C. § 101 (providing no definition for "not in the ordinary course of business"); *see also* H.R. Rep. No. 109-31(I) (same).

[6966] For a more detailed discussion of the law of preferences, see Appendix 1, Legal Issues, at Section IV.D.

[6967] *Official Comm. of Unsecured Creditors of Enron Corp. v. Martin (In re Enron Creditors Recovery Corp.)*, 376 B.R. 442, 458 (Bankr. S.D.N.Y. 2007) ("Further, the [Section 547(c)(2)] defense is narrowly construed."); *see also Jobin v. McKay (In re M & L Bus. Mach. Co.)*, 84 F.3d 1330, 1339 (10th Cir. 1996) ("Additionally, the defense should be narrowly construed."); *J.P. Fyfe, Inc. v. Bradco Supply Corp.*, 96 B.R. 474, 476 (D.N.J. 1988) (noting that the court "should not give untrammeled access to section 547(c)(2), but should construe the statute narrowly").

Section 548(a)(1)(B)(ii)(IV) would likewise seem appropriate in view of Congress' intent to "make it easier" to recover "excessive prepetition compensation."[6968]

While the aim of the preference exception under Section 547(c)(2) is to leave ordinary financial relationships undisturbed, "the exception does not interfere with the goal of discouraging unusual action when the debtor is financially distressed and sliding into bankruptcy."[6969] In addition, as particularly relevant here, the Bankruptcy Court for the Southern District of New York stated, in the context of whether severance payments were preferences, that "section 547(c)(2) is intended to protect recurring, customary trade transactions, but not one-time payments in settlement of contractual claims. Thus, certain courts have refused to apply it when confronted with a single transaction between a creditor and a debtor."[6970]

Courts have noted that, as a general matter, evaluation of "ordinary course of business" under Section 547(c)(2) is a "peculiarly factual" analysis[6971] such that determination of whether a transfer occurred in the ordinary course of business depends on the "facts and circumstances surrounding the payments."[6972]

[6968] H.R. Rep. No. 109-31(I), at 154.

[6969] *Martin*, 376 B.R. at 459 (citing *McKay*, 84 F.3d at 1339-40).

[6970] *Id.* at 459-60; *see also id.* at 462-64 (not applying the ordinary course of business exception to severance payment); *see also Intercont'l Publ'ns, Inc. v. Perry (In re Intercont'l Publ'ns, Inc.)*, 131 B.R. at 550 (same). The Examiner notes, however, that some courts have determined that a first-time transfer may be considered to have been within the ordinary course of business. *See Kleven v. Household Bank F.S.B.*, 334 F.3d 638, 642-43 (7th Cir. 2003).

[6971] *McClarty v. Colletta (In re D.C.T. Inc.)*, 295 B.R. 236, 239 (Bankr. E.D. Mich. 2003).

[6972] *Jacobs v. Matrix Capital Bank* (*In re AppOnline.com, Inc.*), 315 B.R. 259, 284 (Bankr. E.D.N.Y. 2004) (citing *Tolz v. Signal Capital Corp*. (*In re Mastercraft Graphics, Inc.*), 157 B.R. 914, 919 (Bankr. S.D. Fla. 1993)); *see*

(4) Findings

(a) LBHI Affiliate Severance Payments[6973]

The Examiner's concludes that an argument can be made that severance payments made by LOTC to Director Mark C. Malin may be constructively fraudulent and avoidable pursuant to Section 548 of the Bankruptcy Code because they appear to have been made (1) for less than reasonably equivalent value, (2) to or for the benefit of an insider, (3) under an employment contract and (4) not in the ordinary course of business.

Malin had dual titles as a Director of LOTC[6974] and as a Vice President of LBHI.[6975] For his services in 2007, his previous full year at Lehman, Malin received $200,000 in base pay and $2.7 million in additional compensation.[6976] Pursuant to his May 13, 2008 separation agreement, Malin was to receive a total of $790,000 from LOTC in payments over two dates. Malin was to receive a $250,000 payment about four weeks after his "successful completion of [a] transition period," (the period from May 13, 2008 to July

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also, e.g., *Everlock Fastening Sys., Inc. v. Health Alliance Plan* (*In re Everlock Fastening Sys.*), 171 B.R. 251, 254 (Bankr. E.D. Mich. 1994) (applying totality of circumstances test in evaluating ordinary course of business defense); *Richardson v. Phila. Hous. Auth. (In re Richardson)*, 94 B.R. 56, 62 (Bankr. E.D. Pa. 1988) (same).

[6973] For the severance payments discussed herein, the Examiner requested additional supporting documentation, including Malin's hiring agreement, but such information was not obtained.

[6974] LOTC SOFA at 37.

[6975] Statement of Financial Affairs of Lehman Brothers Holdings Inc., at 338, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Mar. 13, 2009) (hereinafter "LBHI SOFA").

[6976] Debtors' PeopleSoft HR System; e-mail from Lauren Sheridan, Alvarez & Marsal, to Heather McArn, Jenner & Block, *et al.* (Jan. 4, 2010) (hereinafter "Sheridan E-mail"). Of Malin's $2.7 million in additional compensation, $1,250,000 was in cash and $1,450,000 was in stock. *Id*.

31, 2008), and "an additional lump separation payment" of $540,000 in January 2009.[6977] In addition, Malin would continue to receive his regular salary through the earlier of August 13, 2009 or his employment with another firm.[6978] Finally, Malin's agreement provided no details concerning any entitlement to equity awards.[6979]

In fact, LOTC paid Malin $250,000 on August 26, 2008, $135,000 on September 19, 2008, and a total of $50,000 in regular salary in payments between June and September 2008.[6980] The Examiner notes that the $135,000 payment is exactly twenty five percent of the $540,000 "additional lump sum separation payment" payable in January 2009

[6977] Letter from Anthony J. Collerton, Managing Dir., Lehman, to Mark Malin, Dir., Lehman, re: separation from employment (May 13, 2008) [LBEX-AM 340331], at ¶¶ 5, 6 (hereinafter "Malin Agreement"); LOTC SOFA at 37.

[6978] Malin Agreement, ¶¶ 2, 4 [LBEX-AM 340331].

[6979] However, Malin did receive equity awards at the time of his termination. The Examiner's review of Malin's Executive Compensation Summary and Lehman's annual equity benefits plans setting forth eligibility and vesting provisions indicates that Malin's equity awards at termination were consistent with those benefits plans. In more detail, prior to July 31, 2008, Malin had 15,327 vested restricted stock units ("RSUs") valued at approximately $264,207, and 6,850 stock options having no value at that point in time because their exercise price was above Lehman's stock price. Pursuant to Lehman's policies set forth in its annual equity benefits plans for employees involuntarily terminated without cause, Malin became entitled as of his termination date to additionally receive vesting of 86,142 RSUs valued at approximately $1,493,707, and to exercise 24,417 options that, however, had no value at that point in time because their exercise price was higher than Lehman's stock price. Lehman Brothers, Mark C. Malin Executive Compensation Summary as of September 12, 2008 [LBEX-AM 5641402]; Lehman Brothers, 2003 Equity Award Program Managing Director, pp. 3, 9 [LBEX-AM 5641446]; Lehman Brothers, 2004 Managing Director Equity Award Program, p. 2 [LBEX-AM 5641442]; Lehman Brothers, 2005 Equity Award Program for Bonus-Eligible and Production-Based Employees, pp. 4, 8 [LBEX-AM 5641430]; Lehman Brothers, 2006 Equity Award Program for Bonus-Eligible and Production-Based Employees, pp. 4, 9 [LBEX-AM 5641417]; Lehman Brothers, 2007 Equity Award Program, pp. 2, 5 [LBEX-AM 5641408]; Lehman Brothers, 2003 Stock Option Award, p. 2 [LBEX-AM 5641466]; Lehman Brothers, 2004 Stock Option Award, p. 2 [LBEX-AM 5641404]. The Examiner notes that pursuant to Lehman's annual equity benefits plans, Malin would have received the same quantities and values of RSUs and stock options had he voluntarily terminated. The Examiner also notes that Malin could not have received value for his RSUs at the time of his termination because, though they were vested, they were not issued.

[6980] LOTC SOFA at 37.

pursuant to his separation agreement.[6981] In exchange for his payments and continued salary, Malin agreed (1) to remain an active employee for approximately two and a half months, (2) not to disparage Lehman and (3) to release Lehman from any employment-related claims.[6982]

Reasonably Equivalent Value. The Examiner's review of the circumstances surrounding Malin's severance payments indicates that the conditions that Malin agreed to perform in his separation agreement may not have provided LOTC with "roughly the value it gave" in exchange for its payments.[6983]

Foremost, Malin was free to take employment at another firm at any point in time, yet would nonetheless "remain eligible" to receive the $250,000 and $540,000 separation payments.[6984] Because Malin would not forfeit his separation payments even if he commenced employment at a different firm, he effectively did not provide LOTC with any guaranteed period of non-competition.[6985] Had Malin been required to remain

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[6981] The Examiner notes that the $135,000 payment could also represent a lump sum payment for the remainder of Malin's regular salary through August 13, 2009, minus applicable withholding. Malin Agreement, ¶ 10 [LBEX-AM 340331]. Yet, pursuant to his agreement, Malin was only to receive his regular salary in a lump sum in the event that he became employed by another firm. *Id.* The Examiner also notes that both the $250,000 and the $135,000 payment are listed in the LOTC SOFA as "LB Special Term Pay," and that the term "special term" is used by LBHI to denote separation payments for other insider employees. *See* LBHI SOFA at 246, 253.

[6982] Malin Agreement ¶ 3, Disparaging Remarks, Complete Release [LBEX-AM 340331].

[6983] *In re Fruehauf Trailer Corp.*, 444 F.3d at 205.

[6984] Malin Agreement, ¶ 10 [LBEX-AM 340331]. Moreover, Malin was only required to be "on call" during regular business hours during his transition period, and did not have to appear in the office otherwise. *Id.* at ¶ 3.

[6985] In the course of the Examiner's investigation of potentially constructive fraudulent transfers made by LBHI Affiliates to insider employees, the Examiner received and reviewed information concerning severance payments made by LBHI to several insider employees. The Examiner notes that, unlike Malin,

at LOTC or to have been unable to compete for a specific duration, his severance payments could be viewed as approximating the compensation Malin would otherwise have been paid for that same duration.[6986]

Moreover, Malin was aware of Lehman's failing financial condition and, by September 15, 2008, LBHI's bankruptcy. At the time Malin received the August 26, 2008 ($250,000) severance payment, LBHI was twenty days from filing its bankruptcy petition. At the time Malin received the accelerated September 19, 2008 ($135,000) severance payment, LBHI had already filed for bankruptcy. Courts have avoided bonus payments to insiders as lacking reasonably equivalent value where, in part, the parties were aware of the debtor's declining financial condition.[6987]

In addition, several courts have indicated that payments to insiders suggest the absence of an arm's length transaction between the debtor and its creditor, such that the

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the LBHI insider employees were required to not compete with or disparage Lehman for the periods of time between their separation agreements and their severance payments. These insider employees would forfeit their severance payments if they commenced other employment prior to the scheduled payment dates. *See, e.g.,* Letter from Tracy Binkley, Managing Dir., Lehman, to Michael Gelband, Global Head, Lehman, re: separation from employment (May 1, 2007), at p. 2 [LBEX-AM 340311]; Letter from Tracy Binkley, Managing Dir., Lehman, to Alex Kirk, Co-Chief Operating Officer, Lehman, re: separation from employment (Feb. 4, 2008), at pp. 1-2 [LBEX-AM 340324].

[6986] Malin's total compensation for his previous full year was $2.9 million. Sheridan E-mail. For example, if Malin's agreement had a six month non-compete, a severance agreement of about $1.5 million could be viewed as approximating the compensation he otherwise would have earned during that time.

[6987] The court in *Arnold* avoided bonus payments to insiders as lacking reasonably equivalent value in part because "it was obvious to defendants and Enron that Enron's 2001 profits, if any, from which to pay any 2001 bonuses would be significantly lower than in prior years or non-existent." *Arnold*, 2005 Bankr. LEXIS 3261, at *122.

debtor has not received reasonably equivalent value in the course of the transaction.[6988] Finally, the non-specific releases from claims or litigation contained in Malin's separation agreement do not appear to have provided LOTC with any significant value.[6989] The Examiner in *In re Revco D.S., Inc.* questioned the value provided by such releases because they "did not relate to any specific claims or litigation."[6990]

To or For the Benefit of an Insider Under an Employment Contract. The Examiner finds that, as a director of LOTC, Malin was likely an insider.[6991] The Examiner also finds that, consistent with the legislative intent behind Section 548(a)(1)(B)(ii)(IV), Malin's separation agreement may be considered an employment contract.[6992]

Not in the Ordinary Course of Business. While no court has interpreted "not in the ordinary course of business," the Examiner finds that the timing of Malin's severance payments does not appear to be ordinary. The payments were made just prior to and just following LBHI's bankruptcy. Moreover, the $135,000 September 19, 2008 payment was not made in accordance with Malin's separation agreement. Such

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[6988] *See, e.g., In re Fruehauf Trailer Corp.*, 444 F.3d at 216 (holding that benefit of amendment to pension plan reviewed and approved by insiders lacked reasonably equivalent value in part due to lack of arm's length transaction); *In re Computer Personalities Sys.*, 2002 Bankr. LEXIS 1625, at *14.

[6989] Malin Agreement, ¶ Complete Release [LBEX-AM 340331].

[6990] 1990 Bankr. LEXIS 2966, pt. 1 at *130 (Bankr. N.D. Ohio 1990). The Examiner also notes that the separation agreements do not contain evidence of any calculation in support of the amounts of the severance payments. The bankruptcy court in *In re Computer Personalities Sys.* held that a bonus lacked reasonably equivalent value in part due to the absence of evidence for its calculation. 2002 Bankr. LEXIS 1625, at *16.

[6991] LOTC SOFA at 4.

[6992] H.R. REP. NO. 109-31(I), § 1402 (2005).

payment, if it represented a portion of the $540,000 payable in January 2009, was paid more than three months in advance of the date set forth in Malin's separation agreement.[6993] And if the $135,000 payment was not made pursuant to Malin's agreement, then it also appears to have been made not in the ordinary course of business. Finally, in *Martin*, the U.S. Bankruptcy Court for the Southern District of New York stated, in the context of analyzing potential preferences, that one-time transfers such as severance payments are not "recurring, customary trade transactions" for which the ordinary course of business defense under Section 547 applies.[6994]

(b) LBHI Affiliate Bonus Payments

The Examiner concludes that there does not appear to be sufficient evidence to support colorable claims that bonus guarantees at hiring and bonus buyouts paid by LBHI Affiliates pursuant to employment contracts were constructively fraudulent and avoidable pursuant to Section 548 of the Bankruptcy Code.

Certain LBHI Affiliate insiders received bonus guarantees at hiring. On January 31, 2008, LBDP paid Managing Director Locke Randall McMurray a $567,529 bonus guarantee at hiring pursuant to a June 27, 2007 employment contract.[6995] On that same

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[6993] Malin Agreement, ¶ 6 [LBEX-AM 340331].

[6994] *Martin*, 376 B.R. at 459 (citing *McKay*, 84 F.3d at 1339-40).

[6995] Letter from Scott Willoughby, Managing Dir., Lehman, to Locke McMurray, Managing Dir., Lehman, re: employment contract (June 27, 2007) [LBEX-AM 023996] (hereinafter "McMurray Agreement"); Global Notes Pertaining to Debtors' Schedules and Statements, at 31, *In re Lehman Bros. Holdings, Inc.*, No. 08-13899 (Bankr. S.D.N.Y. Mar. 13, 2009), (hereinafter "LBDP SOFA").

date, BNC Mortgage paid Managing Director Thomas Noto a $621,669 bonus guarantee at hiring pursuant to an April 2, 2007 employment contract.[6996]

McMurray and Noto also received bonus buyouts pursuant to their employment contracts. On September 21, 2007, McMurray received a $78,770 bonus buyout from LBDP pursuant to a June 27, 2007 employment contract.[6997] McMurray's employment contract provided him with this compensation in the form of "special cash awards" because McMurray would "forfeit certain [] awards as a result of [his] separation . . ." from his previous employer.[6998]

Similarly, on October 5 and December 28, 2007, Noto received a total of $1,219,167 from BNC Mortgage pursuant to an April 2, 2007 employment contract.[6999] Noto's contract provided him with compensation in the form of "Special Cash Awards" because Noto would "forfeit certain long-term incentive payments as a result of [his] separation . . ." from his previous employer.[7000] Noto's contract additionally provided him with $816,667 in the event of the sale or transfer of the stock or assets of his former

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[6996] Letter from Scott Kimmel, Managing Dir., Lehman, to Thomas Noto, Dir., Lehman, re: employment contract (Apr. 2, 2007) [LBEX-AM 024128] (hereinafter "Noto Agreement"); Global Notes Pertaining to Debtors' Schedules and Statements, at 31, *In re Lehman Bros. Holdings, Inc.*, No. 09-10137 (Bankr. S.D.N.Y. Mar. 13, 2009) (hereinafter "BNC SOFA"). The Examiner notes that Noto is identified on BNC's Schedule 3c, though his hiring agreement indicates that he is an employee of LBI.

[6997] McMurray Agreement at p. 3 [LBEX-AM 023996]; LBDP SOFA at 31.

[6998] McMurray Agreement at p. 3 [LBEX-AM 023996].

[6999] Noto Agreement at p. 2 [LBEX-AM 024128]; BNC SOFA at 31.

[7000] Noto Agreement at p. 2 [LBEX-AM 024128].

employer, Ameriquest.[7001] Ameriquest was sold to Citigroup on or around August 31, 2007.[7002]

The Examiner concludes that there is insufficient evidence to support colorable claims that transfers made by LBDP and BNC Mortgage were constructively fraudulent and avoidable pursuant to Section 548 of the Bankruptcy Code because LBDP and BNC Mortgage appear to have received reasonably equivalent value in exchange for the respective bonus payments.

McMurray and Noto's bonus buyouts and bonus guarantees at hiring appear to have served as inducements for them to leave their prior employment and to come work for LBDP and BNC Mortgage, respectively.[7003] The Examiner also notes that McMurray and Noto's employment contracts specify what each insider forewent in leaving his prior employment, and how the particular bonus buyout was meant to compensate for that loss.[7004]

(c) LBHI's Assumptions of Limited Partnership Interests

The Examiner notes that LBHI assumed certain Fuld and Gregory limited partnership interests prior to LBHI's bankruptcy. Specifically, approximately two

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[7001] *Id.*

[7002] The amounts presented in Noto's employment contract dated April 2, 2007 were exactly 5% higher than the bonus buyout amounts disbursed to him. The Examiner does not perceive this difference to materially impact the analysis.

[7003] *In re Intercont'l Publ'ns, Inc.*, 131 B.R. at 549 (holding that bonus payments were made in exchange for reasonably equivalent value in part when those payments were "necessary and reasonable to induce [the employee] to work for [them]").

[7004] *Cf. In re Computer Personalities Sys.*, 2002 Bankr. LEXIS 1625, at *16 (holding that a bonus lacked reasonably equivalent value in part due to the absence of evidence for its calculation).

months prior to the date of LBHI's bankruptcy petition, Fuld and Gregory received, by wire transfer from LBHI, cash payments in exchange for their individual ownership interests in limited partnerships.[7005] Significantly, both Fuld and Gregory sold their limited partnership interests to LBHI because they apparently faced financial difficulties and needed liquidity.[7006] Fuld noted that he sold his limited partnership interests rather than his stocks for fear of sending negative signals to the market.[7007] The Board employed this same reasoning in approving Fuld and Gregory's sale of their limited partnerships in lieu of stock.[7008] Before analyzing whether these payments constitute constructively fraudulent transfers, it is first necessary to understand how the partnership funds operated.

[7005] Those partnership funds were "Lehman Brothers Capital Partners I," "Lehman Brothers Capital Partners II," "Lehman Brothers Capital Partners III," "Lehman Brothers Capital Partners IV," "Lehman Brothers Merchant Banking Capital Partners VI (Global)," "Lehman Brothers Merchant Banking Capital Partners VI (Europe)," "Lehman Brothers Venture Capital Partners I," "Lehman Brothers Venture Capital Partners II," "Lehman Brothers Venture Capital Partners II (Escrow)," "Lehman Brothers Communication Capital Partners I," "Lehman Brothers Partnership Account 2000/2001, L.P.," "Lehman Brothers MLP Opp Cap Partners," and "Lehman Brothers Loan Opp Group Fund." Debtors, DF-JG Buyout Analysis, at pp. 2-9 [LBEX-AM 312390]; *see also* Debtors, Entries related to Richard Fuld & Joseph Gregory's Partnership Interest Disbursements (hereinafter "Disbursement Schedule") [LBEX-AM 312400]; Lehman Brothers, Assumption Agreement at p. 5 (hereinafter "Fuld Assumption Agreement") [LBEX-AM 154086]; Lehman Brothers, Assumption Agreement, at p. 6 (hereinafter "Gregory Assumption Agreement") [LBEX-AM 154232]; Memorandum of Conference between B. McCarthy and A. Rao, Alvarez & Marsal, and T. Fleming, Duff & Phelps, *et al.* (Oct. 1, 2009), at p. 2; Memorandum of Conference between B. McCarthy, Alvarez & Marsal, and A. Kopelman, Jenner & Block, *et al.* (Oct. 20, 2009), at p. 1.

[7006] Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at pp. 4, 16; Examiner's Interview of John Akers, Apr. 22, 2009, at p. 9.

[7007] Examiner's Interview of Richard S. Fuld, Jr., Dec. 9, 2009, at pp. 4, 16.

[7008] LBHI, Minutes of the Compensation and Benefits Committee, June 19, 2008, at p. 5 [LBEX-AM 003769] (discussing "potential disclosure implications" for a contemplated loan to "certain senior executives." *See also* LBHI, Minutes of the Compensation and Benefits Committee, July 1, 2008, at pp. 4-5 [LBEX-AM 003812] (discussing "Loan and Liquidity for Certain Executives").

The Debtors offered certain employees the opportunity to participate in employee-only investment funds structured as limited partnerships (hereinafter "employee-only funds").[7009] These funds were only available to employees who were "accredited investors,"[7010] and included up to approximately 1,200 participants at a given time.[7011] With one exception, the assets in those funds were identical to those in investment funds offered to third-party accredited investors by LBHI's Private Equity group (hereinafter "third-party funds").[7012]

Significantly, the limited partnership interests were considered "illiquid" investments.[7013] The interests typically had ten-year terms and were not designed to be readily redeemed. Indeed, a buyback of interests normally occurred only if a

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[7009] Participation in limited partnerships required a commitment to invest a certain dollar amount in the fund. Memorandum of Conference between B. McCarthy, Alvarez & Marsal, and A. Kopelman, Jenner & Block, *et al.* (Oct. 20, 2009), at p. 1. This amount was not collected in full at the initial funding. *Id.* Rather, portions of it were "called" or collected at various times from the initial funding onward. *Id.* Failure to provide a contribution on a "call" resulted in "default," i.e., forfeiture of 25% of the participant's total investment (not total commitment) back to the fund. *Id.* In addition, even after a participant experienced a 25% forfeiture penalty, the fund still exercised full discretion over the interest and could subject that interest to further forfeiture penalties for missed capital calls going forward. *Id.* The ability to invest in the employee-only funds was subject to the Compensation and Benefits Committee, as participation in these funds was a benefit to the participants. *See* LBHI, Minutes of the Compensation and Benefits Committee, July 1, 2008, at pp. 4-5 [LBEX-AM 003812].

[7010] *See* 17 C.F.R. § 230.501 (1989); Memorandum of Conference between B. McCarthy, Alvarez & Marsal, and A. Kopelman, Jenner & Block, *et al.* (Oct. 20, 2009), at p. 1.

[7011] *Id.*

[7012] *Id.*; Memorandum of Conference between B. McCarthy, Alvarez & Marsal, and J. Molenda, Jenner & Block, *et al.* (Nov. 6, 2009), at p. 1 (stating that Lehman Brothers Capital Partners III, L.P. fund held one unique asset not held by a third-party fund).

[7013] Memorandum of Conference between B. McCarthy and A. Rao, Alvarez & Marsal, and T. Fleming, Duff & Phelps, *et al.* (Oct. 1, 2009), at p. 1.

participant left the company or passed away.[7014] The only way for a participant to monetize an interest was to sell it to another employee participant, or to LBHI, an LBHI Affiliate, or another Lehman entity.

As for valuation of the private assets within the third-party and employee-only funds, prices were determined by an internal valuation committee, which included personnel in charge of private equity and merchant banking, as well as representatives from risk management and the relevant product controller groups.[7015] As for valuation of the public assets within the third-party and employee-only funds, pricing information was obtained from publicly available pricing sources. Because the internal committee valued the common assets in the employee-only and third-party funds on a consistent basis, the Examiner did not investigate further the valuation of the component assets of the employee-only funds.

Payment Recipients and Amounts. Against this backdrop, on July 17, 2008 Fuld and Gregory received wire payments of $3,933,929 and $4,614,564, respectively, from LBHI on its own behalf and on behalf of other non-Debtor entities in exchange for their limited partnerships interests. The Compensation and Benefits Committee authorized

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[7014] *Id.*; Memorandum of Conference between B. McCarthy, Alvarez & Marsal, and J. Molenda, Jenner & Block, *et al.* (Nov. 6, 2009), at p. 1.

[7015] Memorandum of Conference between B. McCarthy, Alvarez & Marsal, and A. Kopelman, Jenner & Block, *et al.* (Oct. 20, 2009), at p. 1; Memorandum of Conference between B. McCarthy, Alvarez & Marsal, and J. Molenda, Jenner & Block, *et al.* (Nov. 6, 2009), at p. 1.

and directed LBHI's purchases of the interests.[7016] The purchases of Fuld and Gregory's interests appear to have been an exception to Lehman's rule that partnership interests were not redeemable except on events such as death or severance.[7017]

Analysis. The Examiner analyzed LBHI's purchases of Fuld and Gregory's interests as potentially constructive fraudulent transfers under Subsection II of Section 548.[7018]

Interest of the Debtor in Property. As a threshold matter, LBHI's purchases of the Fuld and Gregory limited partnership interests involved a transfer "of an interest of the debtor in property." LBHI directly or indirectly funded the purchases of Fuld and Gregory's limited partnership interests. With respect to two of the funds, LBHI directly purchased the limited partnership interests on behalf of itself as a general partner.[7019] With respect to the remaining funds, LBHI indirectly funded the purchases of the limited partnership interests by funding the general partners' purchases of those interests.[7020] In the latter case, LBHI then recorded intercompany receivables from each

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[7016] Minutes from Compensation & Benefits Committee (July 1, 2008), at pp. 4-5 [LBEX-AM 003812]; *see also* Examiner's Interview of John Akers, Apr. 22, 2009, at p. 9 (discussing how LBHI Board of Directors did not want Fuld or Gregory to sell stock).

[7017] Memorandum of Conference between B. McCarthy, Alvarez & Marsal, and A. Kopelman, Jenner & Block, *et al.* (Oct. 20, 2009), at p. 1 (stating that only Fuld and Gregory received limited partnership buyouts). The only apparent exception to this rule was one buyout in which the owner of the limited partnership interests had divorced, and because the interests were not severable, Lehman agreed to purchase the interests. *Id*.

[7018] 11 U.S.C. § 548(a)(1)(B)(ii)(II).

[7019] Fuld Assumption Agreement at p. 1 [LBEX-AM 154086]; Gregory Assumption Agreement at p. 1 [LBEX-AM 154232].

[7020] Disbursement Schedule, at p. 3 [LBEX-AM 312403].

of these general partners as a result of funding on their behalf.[7021] As of November 2009, LBHI had not yet collected those receivables.[7022]

Reasonably Equivalent Value. It appears that there is sufficient evidence to conclude that LBHI received reasonably equivalent value in exchange for the purchases of the Fuld and Gregory limited partnership interests. LBHI valued the public assets in the employee-only investment funds in accordance with publicly available pricing sources. LBHI valued the private assets in those funds in accordance with the values it derived by way of an internal valuation committee. LBHI applied those private asset valuations consistently to both the employee-only investment funds and third-party funds available to accredited investors in the general public.

4. Examiner's Investigation of Possible Breaches of Fiduciary Duty by LBHI Affiliate Directors and Officers (Fifth Bullet)

This Section of the Report addresses the fifth bullet of the Examiner Order, which asks whether there exist any "colorable claims for breach of fiduciary duties and/or aiding or abetting any such breaches against the officers and directors of LBCC and/or other Debtors arising in connection with the financial condition of the Lehman enterprise prior to the commencement of the LBHI Chapter 11 case on September 15,

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[7021] *Id.*

[7022] Memorandum of Conference between B. McCarthy, Alvarez & Marsal, and J. Molenda, Jenner & Block, *et al.* (Nov. 6, 2009), at p. 1.

2008."[7023] To carry out his investigation, the Examiner reviewed the actions of the officers and directors of the LBHI Affiliates[7024] and analyzed whether those officers and directors fulfilled or breached their fiduciary duties. The Examiner concludes:

1. The evidence does not support the existence of colorable claims for breaches of fiduciary duty by the officers and directors of any of the LBHI Affiliates in connection with the financial condition of the Lehman enterprise prior to the commencement of the LBHI Chapter 11 case.

2. The evidence does not support the existence of colorable claims for aiding and abetting a breach of fiduciary duty by the officers and directors of any LBHI Affiliates in connection with the financial condition of the Lehman enterprise prior to the commencement of the LBHI Chapter 11 case.

Of the LBHI Affiliates considered in this Section, one entity – LCPI[7025] – was incorporated in New York, and the remaining seven entities – LOTC,[7026] LBDP,[7027] LBCC,[7028] BNC Mortgage LLC,[7029] LBFP,[7030] LBCS[7031] and LBSF[7032] – were incorporated in

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[7023] Order signed on 1/16/09 Directing Appointment of an Examiner Pursuant to Section 1104(c)(2) of the Bankruptcy Code, at p. 3, Docket No. 2659, *In re Lehman Brothers Holdings Inc., et al.*, No. 08-13555 (Bankr. S.D.N.Y. Jan. 16, 2009).

[7024] For this Section of the report the Examiner has excluded CES Aviation IX, CES Aviation V, CES Aviation and other LBHI Affiliate Single Purpose Entities. Because these entities were relatively insignificant when compared to the other LBHI Affiliates, the Examiner concluded that it was an imprudent use of estate resources to investigate any potential claims further. Thus, all references to LBHI Affiliates made in this Section III.B.4 should be construed as referring only to LOTC, LBDP, LBCC, BNC Mortgage LLC, LBFP, LBCS, LBSF and LCPI.

This Section III.B.4 addresses only the fiduciary duties of the LBHI Affiliates enumerated above. It does not address the fiduciary duties of the directors and officers of LBHI, which is dealt with elsewhere in this Report. See Section III.A.1 of this Report for a discussion of the fiduciary duties of the directors and officers of LBHI.

[7025] Lehman, LCPI World Records Report (Sept. 15, 2008) [LBEX-LL 027825].

[7026] Lehman, LOTC World Records Report (Sept. 15, 2008) [LBEX-LL 027852].

[7027] Lehman, LBDP World Records Report (Sept. 15, 2008) [LBEX-LL 027856].

[7028] Lehman, LBCC World Records Report (Sept. 15, 2008) [LBEX-LL 027848].

[7029] Lehman, BNC Mortgage LLC World Records Report (Sept. 15, 2008) [LBEX-LL 027795].

[7030] Lehman, LBFP World Records Report (Sept. 15, 2008) [LBEX-LL 027860].

[7031] Lehman, LBCS World Records Report (Sept. 15, 2008) [LBEX-LL 027844].

Delaware. This Section first analyzes the actions taken by the directors and officers of LOTC, LBDP, LBCC, BNC Mortgage LLC, LBFP, LBCS and LBSF under Delaware's fiduciary duty laws. Then this Section analyzes the actions taken by directors and officers of LCPI under New York's fiduciary duty laws. Finally, this Section analyzes the actions taken by directors and officers of LBSF under Delaware's aiding and abetting a breach of fiduciary duty laws.

a) Fiduciary Duty Standard for a Wholly-Owned Affiliate Subsidiary under Delaware Law

Because LOTC, LBDP, LBCC, BNC Mortgage LLC, LBFP, LBCS and LBSF are incorporated in Delaware, the actions of those entities are governed by Delaware law.[7033] In Delaware, directors and officers have fiduciary duties of care, loyalty, and good faith.[7034] Included in those duties are the duty to monitor and the duty of candor.[7035] The fiduciary duties of the directors of a wholly-owned subsidiary normally flow directly to the parent corporation as sole shareholder.[7036] Consequently, a director of a wholly-owned subsidiary corporation may act in a way that benefits the parent but nonetheless

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[7032] Lehman, LBSF World Records Report (Sept. 15, 2008) [LBEX-LL 027833].

[7033] *See Teleglobe USA Inc. v. BCE Inc. (In re Teleglobe Commc'ns Corp.)*, 493 F.3d 345, 385-86 (3d Cir. 2007). Appendix 1, Legal Issues, at Section II.

[7034] *Gantler v. Stephens*, 965 A.2d 695, 708-09 (Del. 2009) (holding that fiduciary duties of officers are identical to those of directors); *See, e.g., Desimone v. Barrows*, 924 A.2d 908, 935 (Del. Ch. 2007); *In re Transkaryotic Therapies, Inc.*, 954 A.2d 346, 356-63 (Del. Ch. 2008). Appendix 1, Legal Issues, at Section II.A.

[7035] *See, e.g., Desimone v. Barrows*, 924 A.2d 908, 935 (Del. Ch. 2007); *In re Transkaryotic Therapies, Inc.*, 954 A.2d 346, 356-63 (Del. Ch. 2008). Appendix 1, Legal Issues, at Section II.A.

[7036] *See Anadarko Petrol. Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1174 (Del. 1988).

causes financial harm to the subsidiary, without violating that director's fiduciary duty.[7037]

The above analysis assumes, as it must, that the subsidiary is solvent when such actions are made. If the subsidiary is insolvent, however, the duties of the directors of the subsidiary cease to flow to the parent corporation and flow instead to the subsidiary corporation itself and, through the corporation, to its creditors and shareholders.[7038] If the subsidiary subsequently becomes insolvent, however, that does not retroactively call into question the propriety of actions taken for the benefit of the parent while the subsidiary was still solvent. [7039]

Regardless of solvency, to establish a breach of a duty, one must first overcome the presumption established by the business judgment rule. Under the traditional formulation of the business judgment rule as to directors, there is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of

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[7037] *In re Teleglobe Commc'ns Corp.*, 493 F.3d at 366-67, n. 24 ("[T]here is nothing wrong (or even unusual) about a parent causing its wholly-owned subsidiary to act in a way that benefits the corporate family but harms the individual subsidiary.") (*citing Trenwick Am. Litig. Trust v. Ernst & Young.*, 906 A.2d 168, 192 (Del. Ch. 2006), *aff'd sub nom. Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438 (Del. 2007) ("[T]he final judgment of the Court of Chancery should be affirmed on the basis of and for the reasons assigned by the Court of Chancery. . . .")).

[7038] *In re Scott Acquisition Corp.*, 344 B.R. 283, 290 (Bankr. D. Del. 2006); *see also Trenwick*, 906 A.2d at 195, n. 75.

[7039] *Trenwick*, 906 A.2d at 202.

the company."[7040] Thus, "a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.'"[7041]

Directors or officers of an insolvent subsidiary still enjoy the protection of the business judgment rule in carrying out their duties, such that only grossly negligent actions or inactions will give rise to liability.[7042] Insolvency does not subject directors to any greater scrutiny in acting on behalf of creditors than the scrutiny to which a director of a solvent corporation would be subjected in undertaking acts on behalf of its parent corporation.[7043] While the party to whom the directors owe their fiduciary duties shifts upon insolvency, the degree of scrutiny applied to their actions and the applicability of the business judgment rule remains unchanged.[7044]

Directors or officers who hold obligations to parties other than the party to whom they owe fiduciary duties are not protected by the business judgment rule.[7045] The Delaware General Corporation Law, however, establishes that a transaction is not void or voidable solely because the party is interested if any one of the following three conditions is met: (1) the interested director's status is disclosed or known to the board of directors or committee, and the board authorizes the transaction; (2) the interested

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[7040] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)) (internal quotation marks omitted).

[7041] *Id.* (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)); See Appendix 1, Legal Issues, at Section II.A.1 of this Report for a more detailed analysis of the business judgment rule.

[7042] *Trenwick*, 906 A.2d at 174.

[7043] *Id.* at 195, n. 75.

[7044] For a more detailed discussion of fiduciary duties of directors and officers of wholly-owned-subsidiaries, see Appendix 1, Legal Issues, at Section II.D.

[7045] *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362 (Del.1993).

director's status is disclosed or known to the shareholders, and the transaction is approved in a good faith vote by the shareholders; or (3) the transaction is fair to the corporation.[7046] In *Trenwick*, the plaintiff – a litigation trust – attempted to argue that the directors and officers of the subsidiary were not disinterested in transactions with the parent corporation due to the directors' and officers' status as employees of the parent.[7047] At the point the subsidiary became insolvent, the litigation trustee argued, the directors were no longer disinterested in transactions with the parent because their relationship with the parent put them on both sides of the transaction.[7048] This placed the directors of the subsidiary in a position where their fiduciary duty to their parent-employer (transaction counterparty) conflicted with their fiduciary duty to the subsidiary's creditors. The court disagreed with the trustee's contention that the subsidiary was, in fact, insolvent at the time of the questioned transaction. The court did not reach the question of whether insolvency rendered the directors interested in a transaction with the parent but nonetheless commented in *dicta* that it was entirely reasonable in a parent-subsidiary relationship for the directors of the subsidiary to have a close relationship with the parent and interest in the parent's continued success.[7049]

The *Trenwick* Court recognized the unity of interest that exists between the directors of a wholly-owned subsidiary and the parent corporation when the subsidiary

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[7046] Del. Code Ann. tit. 8, § 144(a)(1)-(3).
[7047] *Trenwick*, 906 A.2d at 200-01.
[7048] *Id.*
[7049] *Id.* at 201.

is solvent. However, where a director or officer of an insolvent subsidiary is also an employee of the parent corporation, a court may find the loyalties of that director or officer are divided between its parent-employer and its creditor-fiduciaries. A court may find such director interested and not entitled to the business judgment rule's protection. Absent the protection of the business judgment rule, a court would review a transaction between parent and subsidiary under the heightened "entire fairness" standard.

The entire fairness rule requires the court to take a stricter view of a challenged transaction than under the more deferential business judgment rule.[7050] Under the entire fairness standard, directors must show that the transaction was a product of fair dealing and that the corporation received a fair price.[7051] The court will consider "all relevant factors" to determine whether the transaction was fair.[7052] In order for a transaction to satisfy entire fairness, directors must demonstrate "their utmost good faith and the most scrupulous inherent fairness of the bargain."[7053] Hence, if a director is interested, employment of proper procedures alone will not protect the director.

Applying the above-discussed framework, the Examiner analyzed the actions of the LBHI Affiliates' directors and officers. The Examiner found five LBHI Affiliates – LOTC, LBDP, LBCC, BNC Mortgage LLC, LBFP – were solvent as of as May 31, 2008

[7050] *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).
[7051] *Id.* 711.
[7052] *Id.*
[7053] *Id.*

and at least through August 31, 2008.[7054] The Examiner concludes that, since directors and officers of wholly-owned subsidiaries owe duties to their parents while solvent, the evidence does not support the existence of a colorable claim for breaches of fiduciary duties by the directors and officers of these five LBHI Affiliates.

The Examiner found two LBHI Affiliates – LBCS and LBSF – to have been borderline solvent as of May 31, 2008 and as of August 31, 2008, meaning that their balance sheets showed assets just slightly in excess of liabilities and a minimal write-down of asset values or a small unaccounted for liability would render these entities insolvent.[7055] Under Delaware law, becoming marginally solvent or entering the "zone of insolvency" does not broaden the fiduciary duties of a subsidiary's directors or officers to include a duty to creditors.[7056] Rather, the directors and officers of a marginally-solvent wholly-owned subsidiary owe duties to their parents, just as would the directors and officers of a firmly solvent wholly-owned subsidiary. For this reason, the Examiner concludes that the evidence does not support the existence of a colorable claim for breach of fiduciary duty against the directors and officers of LBCS or LBSF.

[7054] See Section III.B.3.c of this Report for an analysis of the solvency of the LBHI Affiliates.

[7055] See Section III.B.3.c of this Report for an analysis of the solvency of the LBHI Affiliates.

[7056] See *N. Am. Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007); *see also Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 173 (Del. Ch. 2006), *aff'd sub nom. Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438 (Del. 2007).

b) Fiduciary Duty Standard for a Wholly-Owned Affiliate Subsidiary under New York Law

LCPI was incorporated in New York, and the actions of its directors and officers will be evaluated under New York law. Directors and officers of New York corporations owe the shareholders of the corporations the same general duties of care, loyalty and good faith that directors of Delaware corporations owe shareholders.[7057] Although New York courts have not delineated a duty to monitor within the same parameters as Delaware courts, New York law does hold officers and directors of New York corporations liable for the actions of subordinates that should have been discoverable by reasonable inquiry.[7058] Thus, courts evaluating claims against officers and directors of New York corporations for breaches of fiduciary duty would utilize a very similar framework to that established under Delaware law for breaches of the duty to monitor.

In New York, the business judgment rule protects the decisions of disinterested directors and officers against inquiry into the substance of a business decision.[7059]

[7057] *See Nechis v. Gramatan Gardens, Inc.*, 231 N.Y.S.2d 383, 385 (N.Y. Sup. 1962) (holding that directors and officers owe duties of care, good faith and loyalty and that their own personal interests must be beholden to those of the shareholders) (quoting *Winter v. Anderson*, 275 N.Y.S. 373, 375 (N.Y. App. Div. 1934)); see also N.Y. Bus. Corp. Law § 717 (McKinney 2009).

[7058] *Higgins v. N.Y. Stock Exch., Inc.*, 806 N.Y.S.2d 339, 362 (N.Y. Sup. 2005) (holding that directors may be liable for the actions of another if they did not obtain material information or make a reasonable inquiry into material matters).

[7059] *See Jacobs v. Board of Ed., E. Meadow Union Free Sch. Dist.*, 409 N.Y.S.2d 234, 239 (N.Y. App. Div. 1978); *Dumont v. Raymond*, 49 N.Y.S.2d 865, 868 (N.Y. Sup. 1944); *Auerbach v. Klein*, No. 15391-02, 2008 WL 680730, at *10 (N.Y. Sup. Feb. 15, 2008).

Consequently, if the directors or officers of LCPI were disinterested and made a good faith decision on an informed basis, a court will not substitute its own judgment.

A director or officer is interested if that director has "dual relations that prevent an unprejudicial exercise of judgment."[7060] "A director is interested (1) if he is an officer or director of another corporation involved in the challenged or questioned transaction, (2) if he receives a direct financial benefit from the questioned transaction that is different from the benefit received generally by the shareholders, and (3) even though he has no personal interest in the questioned transaction, he is controlled by a director who has an interest in the transaction."[7061] New York law establishes that a transaction is not void or voidable solely because the party is interested if either of the following two conditions is met: (1) the interested director's status is disclosed or known to the board of directors or committee and the board approves the transaction by a vote sufficient for such purpose once the votes of interested directors are excluded or, if there are insufficient votes to constitute a board action once interested voters are excluded, by unanimous vote of the disinterested directors; or (2) the interested directors' status as such is disclosed or known to the shareholders and the transaction is approved in a good faith vote by the shareholders.[7062]

[7060] *Auerbach*, 2008 WL 680730, at *11.

[7061] *Id.*

[7062] N.Y. BUS. CORP LAW § 713 (McKinney 2009).

The evidence suggests that LCPI's directors and officers were employees of LBHI at all times relevant to this Section's inquiry.[7063] LCPI was a wholly-owned subsidiary of LBI, which in turn was owned by LBHI. LCPI's directors' and officers' status as LBHI employees ordinarily would not give rise to any conflict of interest; the directors' and officers' duty of loyalty as employees and as fiduciaries to shareholders was aligned.[7064] The analysis, however, may change once LCPI became insolvent, at which point the directors and officers also owed a duty of loyalty to LCPI's creditors.[7065] Therefore, a party may argue that the directors and officers were not disinterested during 2008 and would not be entitled to rely on the business judgment rule. In the discussion that follows, the Examiner analyzes whether the LCPI directors' and officers' breached their fiduciary duty absent the protections of the business judgment rule. The LCPI directors and officers would only be deprived of the protection of the business judgment rule at times when LCPI was insolvent.

[7063] Lehman, spreadsheet, Employees as mapped to Legal Entities, (Sept. 20, 2008) [LBEX-AM 5642400-2997].

[7064] *RSP Communications PLC v. Bidirici*, 649 F.Supp.2d 184, 212-213 (S.D.N.Y. 2009) ("[W]hile [the subsidiary] was solvent, Defendant's fiduciary duties required that [the subsidiary] be managed to the benefit of [the parent corporation].") (applying New York law).

[7065] *Id.* at 213 ("[A]lthough the parties disagree as to the timing of [the subsidiary's] insolvency, there is no dispute that Defendants' fiduciary obligations changed when [the subsidiary] became insolvent and the interests of [the subsidiary's] creditors became relevant at that time.") (applying New York law).

(1) LCPI's Background and Officers and Directors

LCPI is a wholly-owned subsidiary[7066] of LBI that Lehman used to book loans,[7067] including commercial loans, whole loans, real estate loans, and distressed debt purchases.[7068] Lehman also used LCPI to originate and trade secured and unsecured loans.[7069] LCPI had a board of directors comprised of three individuals at the time of the filing: Fred S. Orlan – elected to the Board on May 22, 2008; James P. Seery – elected to the Board on September 06, 2005; and Greg L. Smith – elected to the Board on August 25, 2005.[7070] Additionally, Greg Smith had served as the president of LCPI since January 24, 2008.[7071] Paolo Tonucci was elected treasurer on January 24, 2008.[7072] Ada Shek was the LEC controller for LCPI. Michael Montella assisted Shek in carrying out her duties in the weeks leading up to September 15, 2008.[7073]

[7066] Lehman, LCPI World Records Report (Sept. 15, 2008) [LBEX-LL 027825].

[7067] Examiner's Interview of Fred Orlan, Interview Summary, Sept. 21, 2009, at p. 3; Examiner's Interview of James Seery, Nov. 12, 2009, at p. 4.

[7068] Examiner's Interview of Joselito Rivera, Oct. 13, 2009, at p. 5; Examiner's Interview of James Seery, Nov. 12, 2009, at p. 4.

[7069] Lehman, LCPI World Records Report (Sept. 15, 2008) [LBEX-LL 027825]; Debtor's Motion Pursuant to Sections 105(a), 363(b), 363(c) and 541(d) of the Bankruptcy Code and Bankruptcy Rule 6004 for Authority to (A) Continue to Utilize Its Agency Bank Account, (B) Terminate Agency Relationships, and (C) Elevate Loan Participations, Docket No. 3, *In re Lehman Commercial Paper, Inc.*, Case No. 08-13900 (Bankr. S.D.N.Y. Oct. 6, 2008), at p. 3.

[7070] Lehman, LCPI World Records Report (Sept. 15, 2008) [LBEX-LL 027825].

[7071] *Id.*

[7072] *Id*.

[7073] Examiner's Interview of Ada Shek, Nov. 24, 2009 at p. 2; Examiner's Interview of Michael Montella, Oct. 26, 2009, at 2, 9.

LCPI relied on designated Lehman employees who were split among Lehman's various operating groups.[7074] Lehman's records indicate that there were approximately 120 Lehman employees who performed functions for LCPI.[7075] LCPI funded its operations through repurchase agreements, bank credit facilities, and borrowings from LBHI,[7076] but it was not a stand-alone entity.[7077]

LCPI's directors and officers owed duties both to its parent and to creditors when it became insolvent. The Examiner found sufficient evidence to support a finding that LCPI was balance sheet insolvent during the interval of May 31, 2008 through August 28, 2008, on which date it received a $900 million capital infusion from LBI that rendered it borderline solvent.[7078] In examining whether there is a colorable claim that LCPI's directors or officers breached their fiduciary duties, the Examiner considered: (1) whether the LCPI directors and officers breached their fiduciary duties to the creditors by authorizing transfers made by LCPI during its period of insolvency and (2) whether the LCPI directors and officers fulfilled their duty to monitor.

[7074] A&M, spreadsheet of employees mapped to legal entities (Sept. 20, 2008) [LBEX-AM 5642400]; e-mail from Paul Gregg, Lehman, to Peter Keavey, Lehman (Sept. 16, 2008) (employees allocated to LBCS discussing transfer of LBI employees to Barclays and noting "that's us") [LBEX-DOCID 3571486]; Examiner's Interview of Jonathan Williams, Aug. 5, 2009, at p. 4.

[7075] A&M, spreadsheet of employees mapped to legal entities (Sept. 20, 2008) [LBEX-AM 5642400]

[7076] Lehman, LCPI World Records Report (Sept. 15, 2008) [LBEX-LL 027825].

[7077] Examiner's Interview of Fred Orlan, Sept. 21, 2009, at p. 3; Examiner's Interview of James Seery, Nov. 24, 2009 at p. at 4.

[7078] E-mail from Anu Jacob to Kristie Wong, Lehman, *et al*. (August 28, 2008) [LBEX-SIPA 005564]; See Section III.B.3.c of this Report for an analysis of the solvency of the LBHI Affiliates.

(a) Duty of Care

In accord with his duties set forth by the Examiner Order, the Examiner investigated whether LCPI's officers and directors breached their duty of care by failing to maintain LCPI's solvency. Under New York law, the duty of care requires that directors act as "ordinarily prudent persons 'would do in similar circumstances being in possession . . . of the knowledge and information they possessed or could have possessed by diligent attention to their duties.'"[7079]

As early as September 2007, LCPI bordered on insolvency.[7080] From April 2008 through July 2008, LCPI was actually balance sheet insolvent.[7081] During that time period, LCPI made numerous transfers, the most significant of which was its June 19, 2008 transfer of $5.4 billion to LBHI, which LBHI in turn transferred to JPMorgan to cover LBHI's risk-based margin.[7082] The Examiner has been advised in interviews that trades involving LBI and LBHI Affiliates always net settled cash.[7083] Nevertheless, the

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[7079] *Macnish-Lenox, LLC v. Simpson*, No. 26021/04, 2007 WL 3086028 (N.Y.Sup. Oct. 23, 2007) (quoting *Syracuse Tel. v. Channel 9, Syracuse*, 273 N.Y.S.2d 16, 27 (N.Y. Sup. 1966)).

[7080] See Section III.B.3.c of this Report for an analysis of the solvency of the LBHI Affiliates.

[7081] *Id.*

[7082] E-mail from Craig Jones, Lehman, to John Feraca, Lehman (June 19, 2008) [LBEX-AM 001775] (Jones informed Feraca: "Today we moved several unencumbered assets (Sasco, Spruce, Pine, Fenway) to LCPI's DTC box at Chase to generate an additional $5.4 billion of NFE. This will help us absorb the increase in intra-day margining that Chase wants us to implement").

[7083] See Duff & Phelps' Interview of William Burke, Oct. 28, 2009 (trades between LBI and affiliates were "always settled," the settlement amount would be "net of margin;" and due to LBI's capital requirements, there would be no benefit to not settling trades). Essentially, LBI would have to keep an equivalent amount of assets on reserve for any unsettled trades; thus making it economically impractical. Duff & Phelps' Interview of Daniel J. Fleming, Oct. 21, 2009 (trades between LBSF and LBI were at "arm's length," as was the case with other intercompany trading activity both with and among LBI, LBHI, and LBHI Affiliates).

Examiner was advised that any cash transferred to an LBHI Affiliate would be swept into LBHI's accounts at each day's end.[7084]

Throughout 2008, LBI made various infusions of capital to LCPI in an attempt to reestablish LCPI's solvency.[7085] Despite the infusions, LCPI's solvency was not reestablished until August 2008. On August 28, 2008, LBI requested a capital infusion of $900 million from LBHI to LCPI to reestablish LCPI's solvency.[7086] Tonucci approved the payment,[7087] and LCPI became borderline solvent and apparently maintained this status at least through August 31, 2008.[7088] Therefore, LCPI creditors suffered no harm by reason of the earlier transfer of $5.4 billion dollars to LBHI on June 19, because the directors and officers of LCPI took the steps necessary to restore LCPI to solvency prior to LCPI's bankruptcy. For this reason, the LCPI directors and officers did not breach their duty of care to the extent that they authorized or permitted the June 19 transfer. Therefore, the Examiner concludes that the evidence does not support the existence of a colorable claim that LCPI's officers and directors breached their fiduciary duty of care by authorizing or permitting transfers made by LCPI during its period of insolvency.

[7084] See Section III.B.2.c of this Report for an analysis of LBHI's use of "cash sweeps."

[7085] See Sections III.B.3.c.3.a and III.B.3.e.8 of this Report, which address the mechanics of the LCPI capital infusions.

[7086] E-mail from Hui Wang, Lehman, to Helen Chu, Lehman, *et. al* (Aug 28, 2008) [LBEX-SIPA 003320-1].

[7087] E-mail from Kristie Wong, Lehman, to William T. Burke, Lehman, *et. al* (Aug. 28, 2008) [LBEX-SIPA 005564-66].

[7088] See Sections III.B.3.c.3.a and III.B.3.e.8 of this Report, which address the mechanics of the LCPI capital infusions. For a discussion of solvency of the LBHI Affiliates after August 31, 2008, see Section III.B.3.c of this Report.

(b) Duty to Monitor

The Examiner also analyzed whether the LCPI directors and officers breached their duty to monitor by allowing LCPI to fall into insolvency for a portion of 2008. Directors or officers of a New York corporation may be liable based on the actions of subordinates if they either fail to obtain material information or to make a reasonable inquiry into material matters.[7089]

Although LCPI was a separate corporate entity, Lehman did not operate it as a separate business but rather integrated LCPI's business affairs with LBHI's.[7090] Though not operated as a separate business, LCPI maintained its own corporate hierarchy. LCPI had a board of directors and over 50 officers including multiple managing directors, vice presidents, and senior vice presidents.[7091]

Primary responsibility in monitoring LCPI's financial condition and reporting that information to superiors fell to Shek, as LEC. Shek received assistance from Montella in the final weeks of Lehman.[7092] Shek was charged with monitoring and reporting many entities as their LEC, but she said her responsibility for LCPI was more

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[7089] *Higgins v. N.Y. Stock Exch., Inc.*, 806 N.Y.S.2d 339, 362 (N.Y. Sup. 2005).

[7090] Examiner's Interview of James Seery, Nov. 12, 2009 at p. 4.

[7091] Lehman, LCPI World Records Report (Sept. 15, 2008) [LBEX-LL 027825].

[7092] Examiner's Interview of Ada Shek, Nov. 24, 2009 at pp. 2, 4; Examiner's Interview of Michael Montella, Oct. 26, 2009, at pp. 2, 9.

onerous than with the other entities because LCPI had its own separate repo facility at JPMorgan and was involved in many intercompany repos and reverse repos.[7093]

Interviews with Lehman finance personnel revealed that LECs generally were charged with monitoring the solvency of LBI's subsidiaries and reporting capital shortfalls to superiors, who would then authorize infusions from LBI.[7094] However, Shek explained that LCPI's LECs only started to monitor capital levels vigorously in the April through July 2008 time period.[7095] While there were no overall guidelines other than the principle of avoiding negative equity, LECs were aware of the fact that an entity such as LCPI would be reviewed and questioned by regulators.[7096] While the directors and officers may in some instances have underestimated LCPI's equity needs and thus failed to adequately provide equity near the end of each month, management still observed and attempted to monitor the actions of LCPI and ultimately restored LCPI to solvency prior to the filing of Chapter 11 petitions. Therefore, the Examiner concludes that the evidence does not support the existence of a colorable claim against the LCPI's officers and directors for breaching their fiduciary duty to monitor in

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[7093] Examiner's Interview of Ada Shek, Nov. 24, 2009 at pp. 2, 4.

[7094] Examiner's Interview of Kristie Wong, Dec. 2, 2009, at p. 2; Examiner's Interview of Josalito Rivera, Oct. 13, 2009, at pp. 5-6. Wong, who was head LEC, also explained that the capital infusions LCPI received in May and July of 2008 were intended to allow it to post positive equity, but that the amount of capital necessary to do so was underestimated. Examiner's Interview of Kristie Wong, Dec. 2, 2009, at p. 3. Thus, LECs attempted to maintain positive equity in LCPI, but were occasionally unable to do so.

[7095] Examiner's Interview of Ada Shek, Nov. 24, 2009 at p. 7.

[7096] Examiner's Interview of Michael Montella, Oct. 26, 2009, at pp. 10-12; Examiner's Interview of Kristie Wong, Dec. 2, 2009, at p. 2.

connection with the financial condition of the Lehman enterprise prior to the commencement of the LBHI Chapter 11 case on September 15, 2008.

c) Breach of Fiduciary Duty for Aiding or Abetting Under Delaware Law

In accord with the fifth bullet of the Examiner Order, the Examiner analyzed whether there exist any colorable claims for aiding or abetting a breach of fiduciary duty by the LBHI Affiliates. Delaware law recognizes a cause of action for aiding and abetting a breach of fiduciary duty.[7097] There are four elements to this claim: (1) an underlying fiduciary duty; (2) breach of that duty by the fiduciary; (3) knowing participation in the breach by a non-fiduciary; and (4) damages.[7098] As set forth elsewhere in this Report in the section dealing with Repo 105,[7099] the Examiner concludes that the Repo 105 transactions give rise to colorable claims for breach of fiduciary duty on the part of certain LBHI officers for, among other things, causing or allowing Lehman to file misleading financial statements that misrepresented Lehman's treatment of repo transactions and omitted material information about Lehman's Repo 105 practice. The Examiner has determined that certain of LBSF's securities were involved in the Repo 105 transactions.[7100] Although the Examiner has uncovered

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[7097] *See, e.g.*, *Malpiede v. Townson*, 780 A.2d 1075, 1096 (Del. 2001). Some cases call an aiding and abetting breach of fiduciary duty claim a "civil conspiracy." However labeled, the elements are the same. *See Weinberger v. Rio Grande Indus., Inc.*, 519 A.2d 116, 131 (Del. Ch. 1986).

[7098] *Id.* For a more detailed discussion of the elements of an aiding and abetting breach of fiduciary duty claim, see Appendix 1, Legal Issues, at Section II.C.

[7099] See Section III.A.4 of this Report, which discusses Repo 105.

[7100] *Id.*

evidence that certain of the directors and officers of LBSF had knowledge of the purpose and effect of Repo 105 transactions, the Examiner has not discovered sufficient evidence that the directors and officers of LBSF themselves had any disclosure obligations vis-à-vis LBHI (which was the entity with public reporting obligations) or that they had knowledge that LBHI's public disclosures were materially misleading. Consequently, the Examiner concludes that the evidence uncovered during the course of his investigation does not support a finding that there are colorable claims against the LBSF directors or officers for aiding and abetting a breach of fiduciary duty for failure to disclose in connection with the financial condition of the Lehman enterprise prior to the commencement of the LBHI Chapter 11 case on September 15, 2008.

5. Examiner's Analysis of Lehman's Foreign Exchange Transactions (Second Bullet)[7101]

a) Summary

The Examiner was asked to report on "[a]ll voluntary and involuntary transfers to, and transactions with, affiliates, insiders and creditors of LBCC or its affiliates, in respect of foreign exchange transactions and other assets that were in the possession or control of LBHI Affiliates at any time commencing on September 15, 2008 through the day that each LBHI Affiliate commenced its Chapter 11 case."[7102] The Examiner identified and investigated post-petition cash transfers in respect of foreign exchange

[7101] This Section of the Report includes data extracted from Lehman's source systems, including, for example, GCCM, GSSR, and RISC.
[7102] Examiner Order at 3, second bullet.

("FX") transactions. This Section of the Report provides an overview of Lehman's foreign exchange business and describes the impact of LBHI's bankruptcy filing upon the settlement of such transactions. The Examiner analyzed cash transfers into and out of LBCC bank accounts in connection with foreign exchange transactions that either settled, in full, in part, or that failed to settle. The Examiner concludes that timing and operational disruption impacted the settlement of such transactions.

b) Foreign Exchange at Lehman

This Section of the Report addresses the relevant transfers and transactions in respect of FX and begins with an overview of Lehman's FX business. Lehman's FX business was a global operation, organized around centers in Tokyo, Hong Kong, London and New York, and, at the time of Lehman's bankruptcy filing in September 2008, was developing a presence in Singapore.[7103] Lehman was a significant participant in the global FX market.[7104] Lehman engaged primarily in FX transactions on the interbank market, which involved trading with other large financial institutions either for Lehman's own account or on behalf of its customers.[7105] However, Lehman also conducted FX transactions with counterparties that were not financial institutions.

[7103] Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 2; Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 2.

[7104] Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 2.

[7105] Bank for International Settlements, Triennial Central Bank Survey: Foreign exchange and derivatives market activity in 2007 (December 2007), available at http://www.bis.org/publ/rpfxf07t.pdf.

Lehman's FX transactions were initiated either through telephone orders or through various e-commerce systems.[7106]

Lehman Foreign Exchange Products. A typical FX transaction involves two counterparties exchanging one currency for another.[7107] The trade date is the date on which the parties agree to the terms of the transaction including the exchange rate, the type and amount of the currencies and the value date.[7108] The value date (or settlement date) is the date on which counterparties actually exchange the two currencies (*i.e.*, settle the transaction).[7109]

Lehman's FX business focused primarily on spots, forwards and options.[7110] Spots and forwards are trades in which counterparties exchange currencies in a single transaction rather than as part of a series of exchanges.[7111] In a spot transaction, a specific amount of currency is exchanged at an agreed-upon price for delivery and

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[7106] Most of Lehman's FX transactions were initiated through telephone orders. However, as part of a major strategic initiative, Lehman also developed a FX e-commerce business, which allowed clients to place orders using different electronic systems. These systems enabled Lehman's clients to access the interbank market and various other FX markets, including: (1) Electronic Communication Networks (ECNs), which allowed users to execute transactions with multiple banks; (2) Single Bank Platforms, which allowed users to trade with a single bank; and (3) Order Management Systems, which routed client orders to other markets based on pre-defined algorithms. Lehman accessed client trade information and advertised to clients through its e-commerce business.

[7107] *See* Lehman, Lehman Brothers Foreign Exchange Training Manual, at p. 2 [LBEX-LL 3356480].

[7108] *See generally* Lehman, Lehman Brothers Foreign Exchange Training Manual [LBEX-LL 3356480].

[7109] *See id.* at p. 4.

[7110] Lehman was also involved in other FX transactions, such as structured notes, which comprised a small percentage of Lehman's FX business. Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 3.

[7111] *See* Lehman, Lehman Brothers Foreign Exchange Training Manual, at p. 34 [LBEX-LL 3356480].

settlement within a two-day period.[7112] In a forward transaction, counterparties agree to exchange a specific amount of currency at a pre-determined rate on some future date, ranging between three days and several years from the trade date.[7113] Options are derivative instruments giving holders the right, but not the obligation, to buy or sell the underlying currency at a future date at a pre-determined exchange-rate.[7114]

Lehman's FX business also included FX swaps, which involve the exchange and re-exchange of two currencies on two different value dates.[7115] FX swaps consist of various combinations of spots and forwards.[7116] Because Lehman's FX trading group only viewed the spots and forwards underlying these transactions, it did not distinguish between swaps and the spots and forwards related to such swaps.[7117]

Lehman's FX business did not include interest rate swaps or currency futures.[7118] Lehman's derivatives group engaged in interest rate swaps, which are agreements between two parties where one stream of payments is exchanged for another based on a specified principal amount.[7119] Although interest rate swaps may involve payments in different currencies, Lehman did not characterize interest rate swaps as FX transactions

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[7112] *See id.*

[7113] *See id.* at p. 40. Lehman also transacted in a subset of forwards called non-deliverable forwards, which are contracts wherein no currencies are exchanged. Instead, the settlement amount reflects the difference between the contract price and the prevailing currency exchange rate. Examiner's Interview of Robert Eby, Jan. 6, 2010, at p. 2.

[7114] *See* Lehman, Lehman Brothers Foreign Exchange Training Manual, at p. 96 [LBEX-LL 3356480].

[7115] *See id.* at p. 71.

[7116] *See id.*

[7117] Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 3.

[7118] *Id.*; Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at pp. 2-3.

[7119] Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 3.

because interest rate swaps primarily involved interest rate risk rather than foreign exchange risk.[7120] As such, interest rate swaps were not handled by Lehman's FX trading group.

Lehman entities also transacted in currency futures, which are regulated exchange-traded products that reflect the difference in the price of an underlying currency on the trade date and on the settlement date.[7121] A future is generally settled in the underlying currency and does not reflect an exchange of currencies.[7122] Thus, Lehman did not consider currency futures to be FX transactions.[7123] The Examiner's analysis of Lehman's FX transactions thus excludes both interest rate swaps and currency futures.

Lehman Entities that Offered Foreign Exchange Products. As part of its global FX operations, Lehman conducted FX transactions primarily through LBI and LBCC.[7124] As a broker/dealer, LBI was subject to regulation by the New York Stock Exchange, and conducted only spot and forward transactions, not options transactions.[7125] LBCC was an unregulated entity that conducted spot, forward and options transactions.[7126]

[7120] *Id.*

[7121] *See* Federal Reserve Bank of New York: All about the Foreign Exchange Market in the United States by Sam Cross (1998), at p. 59, a*vailable at* http://www.newyorkfed.org/education/addpub/usfxm/chap6.pdf.

[7122] *Id.*

[7123] *Id.* However, Lehman used currency futures for hedging purposes in connection with FX transactions. *Id*.

[7124] *Id.* at pp. 3-5.

[7125] *Id.*

[7126] *Id.*

Other Lehman entities that engaged in FX transactions included LBIE, LBSF, LBJ LBBAG, LBF, LB Asia and LBCS.[7127] These entities conducted spot, forward and options transactions incidental to their general business transactions or to accommodate their clients' FX trading needs.[7128] LBHI also conducted spot and forward transactions for hedging purposes.[7129]

Lehman's FX business had a multi-entity structure, meaning that more than one Lehman entity was typically involved in a particular FX transaction.[7130] Under this arrangement, the receipt and payment of funds was documented through intercompany accounting.[7131] For instance, because LBCC only maintained U.S. dollar bank accounts, LBI received payments of foreign currencies from third parties on LBCC's behalf.[7132] LBCC made the corresponding U.S. dollar payments to third parties.[7133] Upon the receipt of funds by LBI for the benefit of LBCC, an intercompany payable was recorded on LBI's books and a corresponding intercompany receivable was recorded on LBCC's books.[7134] Consolidated journal entries for cash and intercompany activity in connection

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[7127] Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 3.; RISC Monthly Statements [LBEX-LL 3357479 - LBEX-LL 3357496].

[7128] Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at pp. 3-5.

[7129] *Id.*

[7130] *Id.*

[7131] *Id.*

[7132] *Id.*

[7133] *Id.*

[7134] *Id.* Typically, multi-entity FX transactions involved intercompany payables and receivables, rather than the transfer of funds. However, FX transactions involving LBJ required a transfer of funds because of legal and/or regulatory requirements. Examiner's Interview of Robert Eby, Jan. 06, 2010, at p. 5.

with FX transactions were recorded in Lehman's general ledger on a daily basis.[7135] Journal entries related to customer accounts payable and accounts receivable were recorded in Lehman's general ledger on a monthly basis.[7136] Journal entries were not recorded for individual transactions.[7137]

Although intercompany entries documented the amount owed by LBI to LBCC, the funds were not immediately transferred to LBCC.[7138] Instead, when the intercompany receivable from LBI to LBCC became substantial, LBCC typically requested that LBI transfer funds to pay down the receivable.[7139] LBI then evaluated its own liquidity needs to determine whether such payment should be made, and upon the approval of an appropriate administrator, made such payment to LBCC.[7140]

Lehman's Foreign Exchange Trading Services. Generally, Lehman offered the following services in connection with FX transactions: execution, confirmation and settlement.[7141] Execution is the process by which an order to buy or sell a currency on specific terms is consummated on a foreign exchange market.[7142] Confirmation is the process by which an organization acts as an intermediary, reviews transaction terms

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[7135] GCCM Custom Report [LBEX-LL 3371357- LBEX-LL 3396034].
[7136] Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 7.
[7137] *Id*. at p. 6.
[7138] *Id.* at p. 4. LBCC was funded primarily by receipts from third parties. If LBCC's account had a shortfall at the end of the day, LBHI provided the necessary funding to cover the shortfall. E-mail from Lauren Sheridan, Lehman to Ken Halperin, Duff and Phelps, *et al.* (Jan. 25, 2010).
[7139] Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at pp. 3-4.
[7140] *Id.*
[7141] Examiner's Interview of Francois Chu-Fong, Dec. 18, 2009, at p. 2.
[7142] *Id*.

and assumes the role of a buyer and seller for transactions in order to reconcile orders between transacting parties.[7143] Settlement is the mutual delivery of currencies to the parties to the transaction pursuant to the agreed-upon terms.[7144]

Lehman conducted FX transactions both as direct trades at the request of its clients and as part of its FX prime brokerage business.[7145] In a FX direct trade, the client executed foreign exchange transactions exclusively with Lehman.[7146] Lehman also managed the confirmation and settlement functions in connection with the transaction and allocated the client's funds to a designated account.[7147]

The FX prime brokerage business provided clients with the opportunity to consolidate their portfolio in a single institution and leverage that institution's credit rating to trade currencies.[7148] Lehman either (1) served as the prime broker, confirming and settling FX transactions that clients executed with other financial institutions; or (2) executed FX transactions with clients that used the prime brokerage services of other financial institutions.[7149]

In its capacity as prime broker, Lehman handled the confirmation and settlement functions in connection with FX transactions that Lehman's clients executed with third

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[7143] Examiner's Interview of Robert Eby, Jan. 6, 2010, at pp. 2-3.
[7144] *Id*. at p. 3.
[7145] Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 2.
[7146] *Id*. at p. 2.
[7147] Examiner's Interview of Robert Eby, Jan. 6, 2010, at pp. 2-3.
[7148] Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 2.
[7149] Examiner's Interview of Robert Eby, Jan. 6, 2010, at pp. 3-4.

parties.[7150] In order to perform its confirmation and settlement functions, Lehman, rather than the client, became the counterparty with the executing third party. At the same time, Lehman entered into an offsetting transaction with its client, for the purpose of delivering the settlement amount to the client.[7151]

Alternatively, where clients used the prime brokerage services of other financial institutions, Lehman executed FX transactions with its clients and notified the clients' prime broker of such transactions.[7152] The clients' prime broker then performed the confirmation and settlement functions in connection with such transactions.[7153]

Settlement of Lehman's Foreign Exchange Transactions. Lehman settled a significant portion of its foreign exchange transactions through CLS.[7154] Lehman was a user member and shareholder of CLS, and relied on Citibank, as its settlement member, to settle its FX transactions.[7155] CLS was created to, among other things, eliminate settlement risk associated with dual currency payment instructions related to foreign exchange transactions.[7156] CLS simultaneously settles two payments related to an FX

[7150] Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 2.

[7151] Examiner's Interview of Robert Eby, Jan. 6, 2010, at p. 4.

[7152] *Id*.

[7153] *Id*.

[7154] Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 3. See Sections III.A.5.c.1.a and III.A.5.c.1.f of this Report, which discuss Lehman's relationship with Citibank as it pertains to the settlement of FX transactions through CLS.

[7155] *Id.*

[7156] *See* CLS, http://www.cls-group.com/ForYou/CLSCorporates/Pages/default.aspx (last visited Jan. 28, 2010).

transaction, eliminating the risk that one party to an FX transaction pays out the currency it sold but does not receive the currency it bought (*i.e.*, the settlement risk).[7157]

CLS did not provide Lehman with statements listing individual transactions that settled through CLS.[7158] Instead, CLS provided the net amount owed to all counterparties for each currency, and Lehman paid its total obligation rather than making piecemeal payments associated with individual transactions.[7159]

Transactions in currencies that were not eligible for CLS settlement, or with counterparties that were not directly or indirectly affiliated with CLS, were settled by direct payments between the parties to the transaction.[7160] Unlike transactions settled through CLS, transactions settled by direct payments posed a certain degree of settlement risk because the exchange of currency was not simultaneous.[7161] Lehman's risk management team managed such risk by requiring collateral to be held or by setting certain settlement risk limits based on a credit review of the transaction counterparties.[7162]

[7157] *See id*.

[7158] Examiner's Interview of Robert Eby, Jan. 6, 2010, at p. 6.

[7159] *Id.* at p. 6. On or about September 15, 2008, LBHI transferred a total amount of $500 million to LBI in connection with FX transactions that settled through CLS. Lehman's FX transactions conducted through CLS were either settled or unwound during the Stub Period. Unlike transactions settled outside of CLS, transactions settled through CLS did not result in parties making payments without receiving corresponding payments in return. *Id*.

[7160] Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 3.

[7161] *Id.*

[7162] *Id.*

Lehman's FX transactions scheduled to settle by direct payments outside of CLS could have failed for a variety of reasons. For example, a party could have failed to pay or to receive the funds in connection with the transaction. Alternatively, payment instructions could be documented incorrectly.[7163] Because the payment of funds in connection with FX transactions was an automated process that was independent of the receipt of funds, Lehman could deliver funds to a counterparty without receiving currencies in exchange.[7164] Lehman's Operational Control Group managed the reconciliation system that documented such fails, while the FX Operations Group reviewed and resolved such fails.[7165]

Lehman's Risk Management with Regard to Foreign Exchange Transactions. FX transactions involve several discrete risks, including settlement risk (the risk that the opposing party may not deliver the appropriate amount of currency) and market risk (the risk that the currencies traded may lose value based on market fluctuations).[7166] To manage settlement risk, Lehman reviewed its clients' credit-worthiness and set settlement limits based on such credit reviews.[7167] Lehman monitored client transactions

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[7163] Examiner's Interview of Robert Eby, Jan. 6, 2010, at p. 3.
[7164] *Id.*
[7165] *Id.*
[7166] *See* Foreign Exchange Committee, Federal Reserve Bank of New York, Foreign, *Guidelines for Foreign Exchange Trading Activities* (May, 2008), at pp. 18-21, *available at* http://www.newyorkfed.org/fxc/annualreports/ar2007/fxar07re.pdf.
[7167] Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 3.

to ensure compliance with such limits.[7168] Lehman also required certain clients to post collateral in connection with FX transactions.[7169] Settlement risk was managed by the LBHI risk management group, both regionally and globally.[7170]

With respect to market risk, Lehman established risk limits to keep potential losses within acceptable risk tolerance levels.[7171] To mitigate such risk, LBCC monitored trader activity and its overall risk exposure to ensure that the risk limits were not exceeded.[7172] LBCC took additional steps to reduce its market risk, including hedging its foreign currency exposure.[7173]

c) Foreign Exchange Transactions During the Stub Period

In order to identify all transfers to, and transactions with, affiliates, insiders and creditors of LBCC or its affiliates, in respect of FX transactions during the Stub Period, the Examiner reviewed RISC[7174] system statement and bank account statement data for LBHI Affiliates, and reconciled such data to identify cash transfers related to the settlement of FX transactions.

[7168] Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at pp. 5-6.
[7169] Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 3.
[7170] Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at pp. 5-6.
[7171] *Id.*
[7172] *Id.*
[7173] *Id.*
[7174] RISC stands for Real-time Information Systems for Commodities.

The Examiner also reviewed LBI's payments and receipts of foreign currency to the extent these transfers related to certain FX transactions involving LBHI Affiliates.[7175] The Examiner's analysis excludes certain trading activity that took place during the Stub Period, which may have involved trade executions, but did not result in transfers of cash in settlement of FX transactions.

The Examiner focused his analysis of Lehman's Stub Period FX transactions on transfers of cash into and out of LBCC's bank accounts.[7176] On the morning of September 15, 2008, LBCC's bank account balance was $0.00.[7177] The Examiner has determined that, as a result of the LBHI bankruptcy, three primary sources of funding that LBCC relied upon to settle FX transactions were compromised: (1) receipts from counterparties; (2) payments from LBI to reduce LBCC's intercompany receivable; and (3) cash transfers from LBHI to cover LBCC's shortfalls. Consequently, LBCC did not have sufficient funds on September 15, 2008 to settle all of its FX obligations.[7178]

[7175] In working together with the LBI SIPA Trustee, the Examiner learned that LBI did not receive bank account statements, but rather received electronic transaction data that was electronically reconciled with LBI's books and records. Consequently, the LBI Trustee was unable to provide the Examiner with general data related to LBI's FX transactions, including transactions that settled through CLS. Instead, the Examiner received and reviewed LBI's payments and receipts in connection with specific FX transactions relevant to the investigation. E-mail from Sarah L. Cave, Hughes Hubbard and Reed, to Heather D. McArn, Jenner & Block (Nov. 24, 2009).

[7176] RISC data indicates that FX transactions involving LBCS and LBSF were scheduled to settle during the Stub Period. However, the Examiner's financial advisors determined that bank statement data for these entities contained no payments or receipts associated with the settlement of FX transactions.

[7177] With respect to unregulated entities such as LBCC, it was part of Lehman's cash management protocol to fund every bank account to $0.00 at the end of each day. Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 2.

[7178] *Id.* at pp. 4-5.

The Examiner sets forth below a series of tables illustrating the amounts LBCC committed to pay in settlement of FX transactions and the actual payments made to its counterparties, as well as the amounts LBCC expected to receive in settlement of FX transactions and its actual receipts.

The Examiner's financial advisors determined, as illustrated in the table below, that LBCC committed to pay approximately $2.1 billion in settlement of non-CLS transactions during the Stub Period.[7179] However, LBCC ultimately paid only approximately $400 million in connection with these transactions.[7180]

[7179] These settlements were scheduled to occur during the period from Sept. 15 through Sept. 19, 2008. GCCM Data Extraction [LBEX-BARGCM 010374 - LBEX-BARGCM 010395].
[7180] Debtor Bank Statement Data [LBEX-AM 5642100 - LBEX-AM 5642389].

Scheduled and Actual Stub Period Payments by LBCC to FX Counterparties (a)[7181]

Date	Total Amt. Due (b)	Total Amt. Paid (c)	% Paid of Amt. Due	Total Unpaid Amt.
9/15/2008	$1,184,160,821	$258,485,069	21.8%	$925,675,752
9/16/2008	$126,503,789	$50,562,787	40.0%	$75,941,003
9/17/2008	$600,812,093	$36,039,788	6.0%	$564,772,305
9/18/2008	$50,650,176	$38,150,176	75.3%	$12,500,000
9/19/2008	$175,591,322	$8,866,815	5.0%	$166,724,507
Totals	**$2,137,718,201**	**$392,104,635**	**18.3%**	**$1,745,613,567**

Notes:
(a) Based on payment request date and does not necessarily correlate to payment clearance date.
(b) Source: GCCM Data Extraction [LBEX-BARGCM 010374 - LBEX-BARGCM 010395].
(c) Source: Debtor Bank Statement Data [LBEX-AM 5642100 - LBEX-AM 5642389].

As noted in the table above, approximately 18% of the total amount LBCC owed to its counterparties during the Stub Period was paid to such counterparties in settlement of FX transactions. An analysis of individual transactions indicates that certain counterparties were paid in full; others, such as The Walt Disney Company ("Walt Disney Co."), received partial payment; and other counterparties were not paid any of the amounts owed to them. The table below presents all LBCC counterparties

[7181] LBCC made no wire transfer requests to Citibank in connection with FX transactions after Sept. 19, 2008.

identified by the Examiner's financial advisors that were owed amounts of $1 million or more during the Stub Period, and indicates what percentage of the amount owed was paid to such counterparties.

LBCC Stub Period Payments to FX Counterparties (a)

Counterparty (b)	**Total Amt. Due** (c)	***% Paid*** (d)	**Counterparty** (b)	**Total Amt. Due** (c)	***% Paid*** (d)
Ppl's Bank of China/Safe	$ 473,000,000	*0.0%*	JPMC Bank UK	$ 8,110,000	*100.0%*
LBIE - I/C	232,723,911	*32.0%*	Std Chartered Bank, Ldn	7,638,750	*18.8%*
Ford Global Treasury	194,130,388	*32.3%*	RBS Ldn/Man Inv Ltd.	7,595,608	*100.0%*
J. Aron & Co.	154,402,344	*1.0%*	Lehman Brothers Japan	7,540,327	*0.0%*
Walt Disney Co.	120,978,393	*12.3%*	AIG Intl Inc	6,707,111	*0.0%*
UBS AG	90,403,104	*5.9%*	Calyon	6,701,900	*100.0%*
Commerzbank AG Ffurt	88,324,250	*0.0%*	LBCC - A/C Joint Trading	6,524,412	*0.0%*
JPMC NY/FC Stone	75,000,000	*0.0%*	HSBC Bank PLC UK	6,283,510	*100.0%*
LB Aisa Holdings Ltd (019)	64,288,000	*0.0%*	BNP Paribas SA Paris	4,506,627	*42.2%*
LB Finance SA	47,000,000	*40.4%*	Citibank NA London	4,388,500	*100.0%*
Morgan Stanley Cptlgrp	47,121,477	*11.2%*	LB Comm. Corp. Aisa Ltd.	4,296,432	*100.0%*
Deutsche Bank AG Ldn	37,512,061	*14.9%*	Fimat Altern. Strategies	3,113,942	*100.0%*
Barclays Bank PLC	33,637,712	*11.4%*	LB Comm. Corp. Asia	3,034,417	*34.3%*
Bank Julius Baer Und Co.	30,117,000	*0.4%*	Deutsche Bank Ldn - DE	2,986,100	*100.0%*
Citibank Ldn/Julius Baer	26,965,762	*100.0%*	RBS London	2,765,656	*100.0%*
Citibank NA NY	24,848,830	*100.0%*	Citigroup Treasury	1,801,550	*100.0%*
ABN Amro/Chicago	24,040,670	*0.0%*	LBIE	1,759,486	*100.0%*
Cr. Suisse First Boston	23,200,000	*8.6%*	BAE Systems PLC	1,756,726	*100.0%*
Barclays Ldn/Rubicon	22,586,146	*0.4%*	Banca Delle Marche Ancona	1,694,580	*100.0%*
State St Bank & Trust/GS	22,237,045	*4.9%*	LB Special Financing	1,659,620	*100.0%*
ABN Amro Bank NV	20,000,000	*0.0%*	Lux. Trading Finance	1,611,000	*100.0%*
Cr. Suisse Ldn/GS Emerg.	17,134,762	*24.7%*	JPMC Bank NY	1,484,348	*100.0%*
Merrill Lynch Ldn	15,657,500	*46.2%*	Zurcher Kantonalbank	1,467,208	*0.0%*
HSBC Bank Ldn/GS	13,830,398	*26.3%*	Merril Lynch Intl/GS	1,447,643	*100.0%*
Merrill Lynch Captl Srvc	13,057,000	*23.4%*	BWA/the Wm. & Flora	1,412,037	*0.0%*
LB SEC Asia Ltd (130)	12,294,605	*0.0%*	BWA - Railpen C1A	1,358,025	*0.0%*
Phillip Morris Finance SA	11,120,000	*100.0%*	BWA - Railpen C1Z	1,296,296	*0.0%*
RBS Ldn/Lily Pond Capital	10,845,771	*0.0%*	BWA - Brgwater Pure A	1,239,637	*100.0%*
Bank of America NY	10,657,675	*6.2%*	DBS Bank Ltd	1,204,469	*100.0%*
Non-GCCM (e)	10,634,396	*100.0%*	BWA - Teamster A1A	1,149,691	*0.0%*
JPMC Bank Singapore	10,000,000	*0.0%*	BWA / TFL Pension Fund	1,149,012	*0.0%*
Merril Lynch Int Bank Ldn	10,000,000	*0.0%*	ABN Amro/GS	1,121,439	*100.0%*
ABN Amro/Mitsubishi	9,834,300	*64.8%*	Amercian Express Bank Ltd Ldn	1,000,000	*100.0%*
Intermobiliare Sim Spa	8,952,000	*100.0%*	Other Counterparties < $1 million	14,643,141	*77.2%*
LBCC vs. LBFAPL	8,733,500	*100.0%*	**Total**	**$ 2,137,718,201**	***18.3%***

Notes:

(a) This table only reflects counterparties that were owed amounts of $1 million or above.

(b) Source: RISC Monthly Statements [LBEX-LL 3357412 - LBEX-LL 3357674], [LBEX-LL 3371070 - LBEX-LL 3371355], [LBEX-LL 3396213 - LBEX-LL 3396252].

(c) Source: GCCM Data Extraction [LBEX-BARGCM 010374 - LBEX-BARGCM 010395].

(d) Source: Debtor Bank Statement Data [LBEX-AM 5642100 - LBEX-AM 5642389].

(e) Transaction amounts were not found in GCCM or in the RISC database.

The Examiner's financial advisors determined that during the Stub Period, LBCC expected to receive approximately $2.9 billion in payments from counterparties,

primarily in connection with FX transactions. However, it received only approximately $400 million.[7182] The table below compares these amounts.

Scheduled and Actual LBCC Stub Period Receipts From FX Counterparties (a)

Date	Total Amt. Due (c)	Total Amt. Received (d)	% Received of Amt. Due	Total Amt. Not Received
9/15/2008	$931,977,932	$154,022,750	16.5%	$780,955,182
9/16/2008	$1,390,249,519	$15,928,250	1.1%	$1,374,321,269
9/17/2008	$104,620,891	$593,416	0.6%	$104,027,475
9/18/2008	$154,732,044	$3,682,220	2.3%	$154,049,824
9/19/2008	$50,851,891	$-	0.0%	$50,851,891
Non-GCCM (b)	$235,545,263	$235,545,263	100.0%	$-
Totals	**$2,867,977,539**	**$409,771,889**	**14.3%**	**$2,464,205,640**

Notes:
(a) Based on wire date of expected receipt and does not necessarily correlate to date of actual receipt.
(b) Request date not available for these receipts.
(c) Source: GCCM Data Extraction [LBEX-BARGCM 004179 - LBEX-BARGCM 004215].
(d) Source: Debtor Bank Statement Data [LBEX-AM 5642100 - LBEX-AM 5642389].

The table below presents all LBCC FX counterparties identified by the Examiner's financial advisors that owed amounts of $1 million or more to LBCC during the Stub Period, and indicates what percentage of the amount owed was received by LBCC.

[7182] The Examiner's analysis of LBCC bank statements and RISC system data suggests that approximately $235 million of this amount was unrelated to the settlement of FX transactions.

LBCC Stub Period Receipts from FX Counterparties (a)

Counterparty (b)	**Total Amt Due** (c)	***% Received*** (d)	**Counterparty** (b)	**Total Amt Due** (c)	***% Received*** (d)
LB Aisa Holdings Ltd (019)	$ 1,418,356,045	*0.0%*	LB Comm. Corp. Asia	$ 13,205,115	*0.0%*
Non-GCCM (e)	235,545,263	*100.0%*	AIG Intl Inc, FX for LBCC	12,000,000	*100.0%*
LBIE - I/C	177,340,208	*57.8%*	Bank Julius Baer Und Co.	10,050,000	*13.4%*
Calyon	87,541,093	*0.0%*	Barclays/Ellington - 3442	9,860,000	*0.0%*
LB Finance SA	82,068,662	*0.0%*	LB SEC Asia Ltd (130)	9,265,497	*0.0%*
Barclays Ldn/Rubicon	74,242,355	*0.0%*	ABN Amro/Mitsubishi	7,565,474	*0.0%*
LB Special Financing	73,400,192	*0.0%*	Citibank NA London	7,507,750	*40.6%*
Barclays Bank PLC	59,147,237	*0.0%*	BWA - Pure Alpha - A2a	7,392,435	*0.0%*
Bear Stearns FOREX	58,744,908	*0.0%*	Ersel Sim SPA	7,000,000	*0.0%*
Caceis Bank Lux/CAAM	57,679,466	*0.0%*	Credit Suisse First Boston	5,934,272	*61.0%*
UBS AG	53,993,415	*1.2%*	RBS Ldn/Man Inv Ltd.	5,921,395	*0.0%*
Morgan Stanley Cptlgrp	38,901,801	*0.0%*	J. Aron & Co.	5,879,603	*0.0%*
HSBC Bank PLC UK	35,776,250	*0.0%*	RBS Ldn/Peregrine	5,484,988	*0.0%*
JPMC Bank UK	32,016,027	*0.0%*	Bayerische Hypo - und Vereins	4,800,000	*0.0%*
Unidentified (f)	26,144,050	*38.2%*	Citigroup Treasury	4,086,550	*0.0%*
Deutsche Bank AG Ldn	25,184,734	*0.0%*	BA BPATC, Pure Alpha	3,099,190	*0.0%*
Commerzbank AG Ffurt	24,874,500	*0.0%*	Citibank Ldn/Elk River	2,589,950	*0.0%*
Bank of America NY	23,324,375	*0.0%*	BWA - Pure Alpha - Euro	2,385,792	*0.0%*
La Caixa Madrid	21,885,000	*100.0%*	Dresdner Bank AG, Ffurt	2,238,593	*0.0%*
HSBC Bank Ldn/GS	21,227,721	*0.0%*	BWA-Exel Pensions C1A	1,889,081	*0.0%*
ABN Amro/Chicago	20,532,392	*0.0%*	RBS London	1,846,179	*0.0%*
Merrill Lynch Ldn	19,922,450	*0.0%*	Deutsche Bank Ldn - DE	1,572,000	*0.0%*
Bank of New York NY	17,731,728	*0.0%*	Barclays Bank Ldn/DeShaw	1,366,400	*0.0%*
State St Bank & Trust/GS	15,199,324	*0.0%*	JPMC NY /Koch Global	1,169,799	*0.0%*
TD Bank - Toronto	15,000,000	*100.0%*	Other Counterparties < $1 million	18,088,281	*23.1%*
			Total	**$ 2,867,977,539**	***14.3%***

Notes:

(a) This table only reflects counterparties that owed LBCC amounts of $1 million or above.

(b) Source: RISC Monthly Statements [LBEX-LL 3357412 - LBEX-LL 3357674], [LBEX-LL 3371070 - LBEX-LL 3371355], [LBEX-LL 3396213 - LBEX-LL 3396252].

(c) Source: GCCM Data Extraction [LBEX-BARGCM 004179 - LBEX-BARGCM 004215].

(d) Source: Debtor Bank Statement Data [LBEX-AM 5642100 - LBEX-AM 5642389].

(e) Transaction amounts were not found in GCCM or in the RISC database.

(f) The Examiner was unable to identify these counterparties through RISC statements.

The Examiner notes that approximately $1.7 billion of the approximately $2.5 billion shortfall in LBCC receipts from counterparties during the Stub Period was due to the nonpayment of funds by other Lehman entities. This amount accounts for approximately 96% of the unpaid amount LBCC owed to its counterparties in connection with FX transactions.

The Examiner further notes that Citibank, the paying agent for LBCC in connection with FX transactions, was also a counterparty in connection with certain

LBCC Stub Period FX transactions. During this time, Citibank cleared 100% of the approximately $59 million LBCC owed to various Citibank entities. However, various Citibank entities paid only 21% of the approximately $14 million they owed to LBCC.[7183]

The Walt Disney Company Transaction. A noteworthy series of FX transactions, which did not completely settle as a result of the LBHI bankruptcy, took place between Lehman and Walt Disney Co.[7184] In fact, Walt Disney Co. moved for the Examiner's appointment, in part, to investigate the circumstances related to the incomplete settlement of these transactions.[7185]

Walt Disney Co. entered into an ISDA[7186] master agreement ("the Master Agreement") with LBCC on May 8, 1998 for the purpose of conducting currency exchange transactions.[7187] LBHI guaranteed the obligations of LBCC to Walt Disney Co. in connection with such transactions.[7188] Because LBCC did not maintain foreign

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[7183] The tables contained in Appendix 24 provide a full recitation of the information summarized in this Section: specifically, the expected and actual payments and receipts in connection with individual LBCC FX transactions.

[7184] This series of transactions consisted of twenty forward contracts. Nineteen of these forward contracts were executed between June 12 and August 13, 2008. The settlement date for such contracts was September 15, 2008. An additional forward contract was executed on July 24, 2008. The settlement date for this contract was September 16, 2008. The Examiner's analysis suggests that a number of these forward contracts were executed as part of FX swap transactions.

[7185] *See* Motion of the Walt Disney Company for Appointment of Examiner pursuant to Section 1104(c)(2) of the Bankruptcy Code ("Examiner Motion"), at p. 6 (¶ 14), Docket No. 1143, *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Oct. 20, 2008).

[7186] International Swaps and Derivatives Association, Inc.

[7187] ISDA Master Agreement [LBEX-AM 047043 - LBEX-AM 047059] (referring to the LBHI guaranty).

[7188] *See* ISDA Master Agreement at p. 22 [LBEX-AM 047043].

currency bank accounts, LBI served as an agent for LBCC for the receipt of foreign currencies.[7189]

During the period from September 11 through September 16, 2008, pursuant to the Master Agreement, Walt Disney Co. wired foreign currencies in various amounts into LBI Citibank foreign currency accounts for the benefit of LBCC.[7190] According to the Examiner Motion, LBCC was required to pay Walt Disney Co. approximately $107 million in U.S. dollars on the same day.[7191] Instead, LBCC paid Walt Disney Co. approximately $15 million on October 2, 2008.[7192] No other payments were made to Walt Disney Co. in connection with these transactions. The net unpaid amount owed to Walt Disney Co. is approximately $92 million.[7193]

The Examiner has endeavored to further understand the impact of the bankruptcy on Lehman's FX payments to counterparties, including Walt Disney Co. Generally, there were three steps involved in the payment of funds by Lehman to

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[7189] Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 3.

[7190] *See* schedule listing Walt Disney Co.'s foreign currency payments to Lehman in connection with these transactions [LBEX-AM 047073 - LBEX-AM 047074]. The foreign currency amounts are as follows: 20,000,000.00 Australian dollars; 20,000,000.00 Canadian dollars; 20,472,986.04 Euros; 17,061,453.56 British pounds sterling; 20,475,000.00 Singapore dollars; and 162,402,000.00 Japanese yen. In addition, Walt Disney Co. instructed UBS to wire 4,302,101.92 Euros, 2,968,668.80 British pounds sterling, 1,118,000.00 Singapore dollars, and 162,402,000.00 Japanese yen to LBCC. However, UBS did not consummate these transactions. *Id.*

[7191] *See* Examiner Motion, at p. 2 (¶ 4), Docket No. 1143, *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Oct. 20, 2008).

[7192] This payment was made in connection with the forward contract executed on June 12, 2008, selling Singapore dollars against U.S. dollars. Debtor Bank Statement Data [LBEX-AM 5642207]; Walt Disney Co. September 2008 RISC Statement [LBEX-LL 3354476].

[7193] The determination of the exact amount owed to Walt Disney Co. is a factual question, dependent, in part, upon the appropriate currency exchange rate used to determine the value of currencies not delivered by Walt Disney Co. to Lehman pursuant to the forward contracts discussed above.

counterparties in these transactions: (1) the RISC system created a payment message, notifying GCCM that a payment was due to a counterparty; (2) GCCM released payment instructions to the paying bank (Citibank, in the case of LBCC) to send funds to the counterparty; and (3) the bank transferred the appropriate funds (*i.e.* cleared the payment) to the counterparty's designated bank account.

In addition to LBCC not having sufficient funds in its accounts to settle its FX obligations as a result of the bankruptcy filing, the timing, implementation and conclusion of the three step process outlined above was disrupted. The Examiner sets forth below examples of the impact that the bankruptcy and resulting operational disruption had on the settlement process of FX transactions with Lehman counterparties.

The following table summarizes the creation times for RISC payment messages and the release times for GCCM payment instructions to Citibank in connection with LBCC's payments to counterparties to settle FX transactions in amounts of $10 million or more during the Stub Period, as identified by the Examiner's financial advisors. The table also indicates whether Citibank in fact cleared payment.

LBCC Requests to Citibank for Individual Payments $10 Million or Above to FX Counterparties

Party (a)	Amount (USD) (b)	RISC Payment Message Date (b)	RISC Created Payment Message (EST) (b)	GCCM Released Payment Instruction to Citi (EST) (b)	Result (c)
Walt Disney Co.	(33,364,108)	09/15/08	12:27 AM	12:33 PM	Not Paid
Walt Disney Co.	(19,218,700)	09/15/08	12:27 AM	12:33 PM	Not Paid
Walt Disney Co.	(19,537,241)	09/15/08	12:27 AM	12:33 PM	Not Paid
Walt Disney Co.	(32,453,441)	09/15/08	12:27 AM	12:33 PM	Not Paid
Walt Disney Co.	(14,891,429)	09/15/08	12:27 AM	12:33 PM	Paid 10/2/2008
Ford Global Treasury	(62,733,340)	09/15/08	12:36 AM	12:43 PM	Paid 9/15/2008
Cr. Suisse First Boston	(12,900,000)	09/15/08	6:03 AM	6:08 AM	Not Paid
LBIE - I/C	(11,035,656)	09/15/08	6:03 AM	6:08 AM	Not Paid
LBIE - I/C	(12,995,937)	09/15/08	6:03 AM	6:08 AM	Not Paid
LBIE - I/C	(11,903,565)	09/15/08	6:03 AM	6:08 AM	Not Paid
LB Finance SA	(20,000,000)	09/15/08	6:03 AM	6:09 AM	Not Paid
LBIE - I/C	(20,637,643)	09/15/08	6:03 AM	6:09 AM	Not Paid
LB Finance SA	(10,000,000)	09/15/08	6:03 AM	6:09 AM	Not Paid
JPMC Bank Singapore	(10,000,000)	09/15/08	6:03 AM	6:09 AM	Not Paid
JPMC NY / FC Stone	(75,000,000)	09/15/08	6:03 AM	6:09 AM	Not Paid
J. Aron & Co.	(150,860,219)	09/15/08	6:03 AM	6:09 AM	Not Paid
Citibank Ldn / Julius Baer	(26,965,762)	09/15/08	6:03 AM	6:10 AM	Paid 9/29/2008
LB Aisa Holdings Ltd (019)	(24,179,500)	09/15/08	6:03 AM	6:10 AM	Not Paid
LB Aisa Holdings Ltd (019)	(40,108,500)	09/15/08	6:03 AM	6:10 AM	Not Paid
Bank Julius Baer Und Co.	(30,000,000)	09/15/08	6:03 AM	6:11 AM	Not Paid
Merril Lynch Int Bank Ldn	(10,000,000)	09/15/08	6:03 AM	6:11 AM	Not Paid
ABN Amro Bank NV	(20,000,000)	09/15/08	6:03 AM	6:11 AM	Not Paid
UBS AG	(27,086,689)	09/15/08	6:03 AM	6:12 AM	Not Paid
Commerzbank AG Ffurt	(36,218,000)	09/15/08	9:22 AM	9:28 AM	Not Paid
Commerzbank AG Ffurt	(52,106,250)	09/15/08	9:22 AM	9:28 AM	Not Paid
LBIE - I/C	(64,994,000)	09/15/08	9:45 AM	9:50 AM	Paid 9/15/2008
Deutsche Bank AG Ldn	(11,651,680)	09/15/08	10:49 AM	10:55 AM	Not Paid
UBS AG	(20,337,500)	09/15/08	10:49 AM	10:55 AM	Not Paid
UBS AG	(37,650,000)	09/15/08	10:49 AM	10:55 AM	Not Paid
LBIE - I/C	(33,715,000)	09/15/08	1:31 PM	1:35 PM	Not Paid
Morgan Stanley Cptlgrp	(25,000,000)	09/15/08	5:36 PM	6:19 PM	Not Paid
Barclays Bank PLC	(12,500,000)	09/16/08	6:04 AM	10:15 AM	Not Paid
LB SEC Asia Ltd (130)	(12,294,605)	09/16/08	6:04 AM	10:15 AM	Not Paid
LB Finance SA	(10,000,000)	09/16/08	6:04 AM	10:15 AM	Paid 9/17/2008
Barclays Bank PLC	(17,300,000)	09/16/08	6:04 AM	10:16 AM	Not Paid
Deutsche Bank AG Ldn	(20,281,250)	09/16/08	10:19 AM	10:54 AM	Not Paid
Ppl's Bank of China/Safe	(473,000,000)	09/17/08	6:05 AM	10:35 AM	Not Paid
Phillip Morris Finance SA	(10,000,000)	09/17/08	9:42 AM	12:00 PM	Paid 9/29/2008
Citibank NA NY	(24,848,830)	09/18/08	6:02 AM	9:15 AM	Paid 9/19/2008
Barclays Ldn/Rubicon	(10,000,000)	09/18/08	9:15 AM	6:02 AM	Not Paid
Bank of America NY	(10,000,000)	09/19/08	6:08 AM	10:12 AM	Not Paid
RBS Ldn / Lily Pond Capital	(10,845,771)	09/19/08	6:08 AM	10:12 AM	Not Paid
Ford Global Treasury	(131,397,048)	09/19/08	6:08 AM	10:12 AM	Not Paid

Notes:

(a) Source: RISC Monthly Statements [LBEX-LL 3357412 - LBEX-LL 3357674], [LBEX-LL 3371070 - LBEX-LL 3371355], [LBEX-LL 3396213 - LBEX-LL 3396252].

(b) Source: GCCM Data Extraction [LBEX-BARGCM 010374 - LBEX-BARGCM 010395].

(c) Source: Debtor Bank Statement Data [LBEX-AM 5642100 - LBEX-AM 5642389].

The timing set forth in the table above reveals certain anomalies. Specifically, the time difference between the creation of payment messages in RISC and the generation of payment instructions in GCCM, for scheduled payments by LBCC to various counterparties on September 15, 2008, ranged from five minutes to 12 hours. Prior to September 15, 2008, on the other hand, the time difference between the creation of the payment message in RISC and the release of the GCCM payment instruction to Citibank was typically less than 20 minutes.[7194]

The payment instructions from LBCC to Citibank on September 15, 2008 provide an illustration: RISC payment messages in connection with five scheduled payments from LBCC to Walt Disney Co. (ranging in amount from $14,891,429 to $33,364,108) were created at 12:27 a.m. EST. Corresponding GCCM payment instructions were released approximately 12 hours later at 12:33 p.m.[7195] Four of the five payments associated with these payment instructions did not clear. The fifth payment in the amount of $14,891,429 cleared on October 2, 2008.

In contrast, a RISC payment message in connection with a scheduled payment of $64,994,000 from LBCC to LBIE was created at 9:45 a.m. EST (approximately nine hours after the creation of the Walt Disney Co. payment messages). The corresponding

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[7194] Citibank then typically cleared the payment on the same business day. Examiner's Interview of Robert Eby, Jan. 6, 2010, at p. 6.

[7195] LBCC instructed Citibank to make an additional payment to Walt Disney Co. in the amount of $1,513,474 on Sept. 16, 2008, but that payment did not clear. In any event, Walt Disney Co. did not pay LBCC the foreign currency funds related to this transaction.

GCCM payment instructions were released approximately five minutes later at 9:50 a.m. This payment cleared on September 15, 2008.[7196]

A RISC payment message for the payment of $62,733,340[7197] to Ford Global Treasury Inc. ("Ford") was created at 12:36 a.m. EST (approximately nine minutes after the creation of the Walt Disney Co. payment messages). The corresponding GCCM payment instructions were released approximately 12 hours later at 12:43 p.m. EST. This payment also cleared on September 15, 2008.[7198]

The RISC payment messages (and associated GCCM payment instructions) for the three transactions of $10 million or more listed below were generated one to three days after the payment messages and instructions for LBCC's payment to Walt Disney Co. These payments, which cleared during the period between September 17 and September 29, 2008, were as follows: (1) a payment of $10 million to LB Finance SA on September 17, 2008; (2) a payment of $10 million to Phillip Morris SA on September 29, 2008; and (3) a payment of $24,848,830 to Citibank (NY) on September 19, 2008. The

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[7196] Similarly, a RISC payment message in connection with a payment of $26,965,762 to Citibank (London) was created at 6:03 a.m. EST (more than five hours after the creation of the Walt Disney Co. payment messages), and a GCCM payment instruction was released seven minutes later at 6:10 a.m. EST on September 15, 2008. This payment cleared on September 29, 2008.

[7197] An additional payment to Ford in the amount of $131,397,048 was requested on September 19, 2008, but did not clear. Ford Sept. 2008 Monthly RISC Statement [LBEX-LL 3261020 - LBEX-LL 3261033].

[7198] It should be noted that the five GCCM instructions for payment to Walt Disney Co. corresponded to the amounts of five foreign currencies paid by Walt Disney Co. to Lehman. Ford, on the other hand, paid various amounts in six foreign currencies to Lehman. However, LBCC's payment to Ford was made via one wire transfer. This netting of payments was typical of Lehman's arrangements with certain FX counterparties. Examiner's Interview of Robert Eby, Jan. 6, 2010, at p. 6.

Examiner further notes that 36 scheduled payments in amounts of $10 million or more to LBCC's counterparties during the Stub Period did not clear.

To further understand the priority in which payments made in connection with the transactions discussed above were cleared, the Examiner requested that Citibank provide an explanation of its policies and procedures in connection with the settlement of LBCC's FX transactions on and after September 15, 2008. According to Citibank, prior to September 15, in the ordinary course of business, Citibank would clear LBCC's FX payments to counterparties according to a FIFO (first-in, first-out) priority.[7199] According to Citibank, however, the payment clearing time did not necessarily match the GCCM payment instruction time discussed above because, under certain circumstances, scheduled payments to counterparties were held and not immediately paid.[7200] Citibank offered various reasons why a payment may have been held: (1) formatting errors in the payment instruction, (2) insufficient funds, (3) debit no-post restrictions or (4) sanction checks (e.g., the Office of Foreign Assets & Controls requires banks to hold payments going to Cuba or Iraq).[7201] These payments were directed to different queues in Citibank's systems and held there until they were cleared or cancelled.[7202]

[7199] Citigroup's Written Responses to Examiner's Inquiry (Jan. 12, 2010), at p. 2.
[7200] *Id.*
[7201] *Id.*
[7202] *Id.*

Citibank provided an overview of how the payment process for LBCC's accounts changed upon the LBHI bankruptcy filing. On the morning of September 15, 2008, Citibank placed all of Lehman's accounts on "debit no-post" and "crisis management" status.[7203] As a result, Citibank temporarily stopped processing all payments from LBCC's accounts.[7204] Citibank resumed the payment process for LBCC's accounts later in the afternoon on September 15, clearing the largest payments that could be made with available funds.[7205] Citibank recalled that payments that did not clear on that day because of insufficient funds were placed in a queue and cleared if the necessary funds became available.[7206]

According to Citibank, payments from LBCC's accounts continued without interruption from the late afternoon of September 15 through September 21, 2008.[7207] During this time, the separately queued LBCC payments that had not cleared on September 15 were processed simultaneously with LBCC's new payment instructions.[7208] Citibank explained that it may have processed new payments before processing payments that had been pending since September 15 (because new payments may have cleared in between attempts to clear pending payments).[7209]

[7203] *Id.*
[7204] *Id.*
[7205] *Id.*
[7206] *Id.* at pp. 2-3.
[7207] *Id.* at p. 3.
[7208] *Id.*
[7209] *Id.*

Subsequently, on September 22 after an additional round of Lehman Affiliate bankruptcy filings, Citibank again imposed payment restrictions on Lehman's bank accounts. These restrictions were lifted on September 29, 2008.[7210] Citibank informed the Examiner that it did not receive any instructions from Lehman regarding the prioritization of LBCC's FX payments to counterparties.[7211]

As discussed above, as a result of LBHI's bankruptcy, LBCC did not have sufficient funds in its account to meet all of its obligations to its FX counterparties and operational disruption at both Lehman and Citibank impacted whether and in what order counterparties were paid.

6. Examiner's Review of Intercompany Transactions Within Thirty Days of LBHI's Bankruptcy Filing (Seventh Bullet)

a) Summary

This Section of the Report provides an overview of the intercompany accounts and transfers among LBHI and some of its direct and indirect subsidiaries, including LBIE, LBSF, and LBCS during the thirty-day period preceding the commencement of the Chapter 11 cases by each debtor on September 15, 2008 or thereafter or such longer period as the Examiner deemed relevant to the investigation.[7212] The Examiner was not asked to investigate the existence of potentially colorable claims, but rather to provide a

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[7210] *Id.*

[7211] *Id.* at p. 2.

[7212] Examiner Order at p. 4, seventh bullet.

narrative relating to accounts and transfers among LBHI and various other Lehman entities of interest in the thirty days prior to LBHI's bankruptcy.

The Examiner found that certain Lehman entities of interest, particularly LBHI, LBIE, and LBSF, engaged in substantial intercompany funding and quasi-funding activity, as captured in Lehman's cash management system, GCCM, in the six weeks prior to LBHI's bankruptcy. Notably, LBHI transferred a net amount of almost $22 billion to or on behalf of LBIE during that six-week period, including a net amount of at least $4 billion in the last week prior to LBHI's bankruptcy.

b) Discussion

As an initial matter, the Examiner notes that other Sections of this Report address intercompany transfers relating to noteworthy events prior to, and during, this period. For example, the Examiner discussed collateral pledged to JPMorgan in August and September 2008 and the intercompany transfers from LCPI to LBHI preceding that pledge. Similarly, the Examiner addresses insider preferences and discusses transfers between LBHI and certain LBHI Affiliates between June 1 and September 15, 2008.[7213]

To avoid duplication between this and other Sections of the Report, the Examiner analyzed intercompany "funding" and "quasi-funding"[7214] activity between LBHI and

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[7213] See Appendix No. 22: Duff & Phelps, Preferences Against LBHI and Other Lehman Entities (Feb. 1, 2010).

[7214] For purposes of this discussion, the term "funding" refers to the movement of cash between bank accounts owned by the Lehman entities of interest. "Quasi-funding" refers to activity where the Lehman entities of interest engaged in transfers and transactions with third parties on behalf of another Lehman

certain debtors in the days leading up to LBHI's bankruptcy on September 15, 2008.[7215] The Examiner's financial advisors obtained from Barclays a report containing all intercompany activity recorded in GCCM, including activity for August 1 through September 15, 2008. The Examiner notes, however, that the data contains limited information (and in some cases no information) relating to some entities, including LBI. Moreover, as discussed in several Sections of this Report, money was transferred between and among Lehman entities in ways not captured by GCCM (or contained in the following analysis).

The Examiner analyzed such data for August 1, 2008 to September 12, 2008,[7216,] and for comparison purposes, the corresponding time period in 2007, from GCCM.[7217] It would have been impractical, in terms of time and resources, to identify and review every means by which Lehman engaged in intercompany funding and quasi-funding activity.[7218] Before turning to the intercompany funding and quasi-funding analysis,

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entity of interest, thereby generating intercompany adjustments to the payable and receivable accounts between them.

[7215] The Examiner did not investigate activity involving LCPI because its main bank account was tied to the MTS trading system, which was not integrated into GCCM. See Section III.B.3.e.8 of this Report, which discusses LCPI's funding activities.

[7216] The Examiner extended the look-back period to August 1 in order to capture a full accounting cycle.

[7217] The Examiner selected the corresponding 2007 time period as a useful benchmark for comparison. While Lehman did have adverse economic events that year, such as closing BNC Mortgage in August 2007, Lehman posted positive net revenues in every quarter that year. Lehman Brothers Holdings, Inc., Fiscal Year 2007 Report (Form 10-K) (Jan. 29, 2008), at p. 135 n.16.

[7218] While GCCM captured Lehman's quasi-funding activity, the Examiner understands that GCCM did ***not*** capture a considerable amount of Lehman's intercompany funding activity. Examiner's Interview of Daniel J. Fleming, Dec. 17, 2009, at p. 8. See Section III.B.3.e.8 of this Report, which discusses alternate mechanisms of intercompany funding-related transfers.

however, a brief overview of GCCM is necessary to provide context.[7219] GCCM captured two types of intercompany activity: (1) activity originating ***outside*** of GCCM by way of external feeder systems and (2) activity originating ***inside*** GCCM by way of internal GCCM payment functions.

With respect to activity originating outside of GCCM, four external feeder systems are relevant to this analysis. Treasury Workstation (Summit) ("TWS") was a suite of applications that controlled Lehman's unsecured funding. TWSLON, a feeder system analogous to TWS, was employed for Lehman's European operations. ASAP was a feeder system for payments and settlements related to fixed income and equity derivative transactions, in addition to consolidating the cash flows generated by those derivatives. Finally, Prime Transaction Manager ("PTM") was a system for hedge fund-related prime brokerage activity.

As for activity originating inside of GCCM, two internal GCCM payment functions are relevant to this analysis. MANPMT was used to denote certain transactions posted manually to the GCCM system. FUNDING was an internal function that Lehman employed to initiate cash transactions, i.e., intercompany transfers between the bank accounts of the Lehman parties of interest. For purposes of clarity, the Examiner notes that "funding" transfers, that is, transfers involving the

[7219] Lehman Brothers, Global Cash and Collateral Management Platform Initiative on Lehman Live [LBEX-LL 3356455] (hereinafter "GCCM Platform Initiative").

movement of cash between bank accounts of the Lehman entities of interest, was captured by GCCM from the internal FUNDING function.[7220]

c) Analysis

The Examiner conducted a two-fold analysis of intercompany funding and quasi-funding data captured in GCCM for the various Lehman entities of interest. First, the Examiner analyzed that data on a macro level by examining the net intercompany account activity for the entire 2007 and 2008 periods of analysis. From this analysis, the Examiner sought to understand each of the entity's roles in intercompany funding and quasi-funding activity relative to the other Lehman entities of interest. The Examiner then reviewed that data on a daily basis to identify any particularly notable intercompany activity occurring in the days immediately prior to LBHI's bankruptcy.

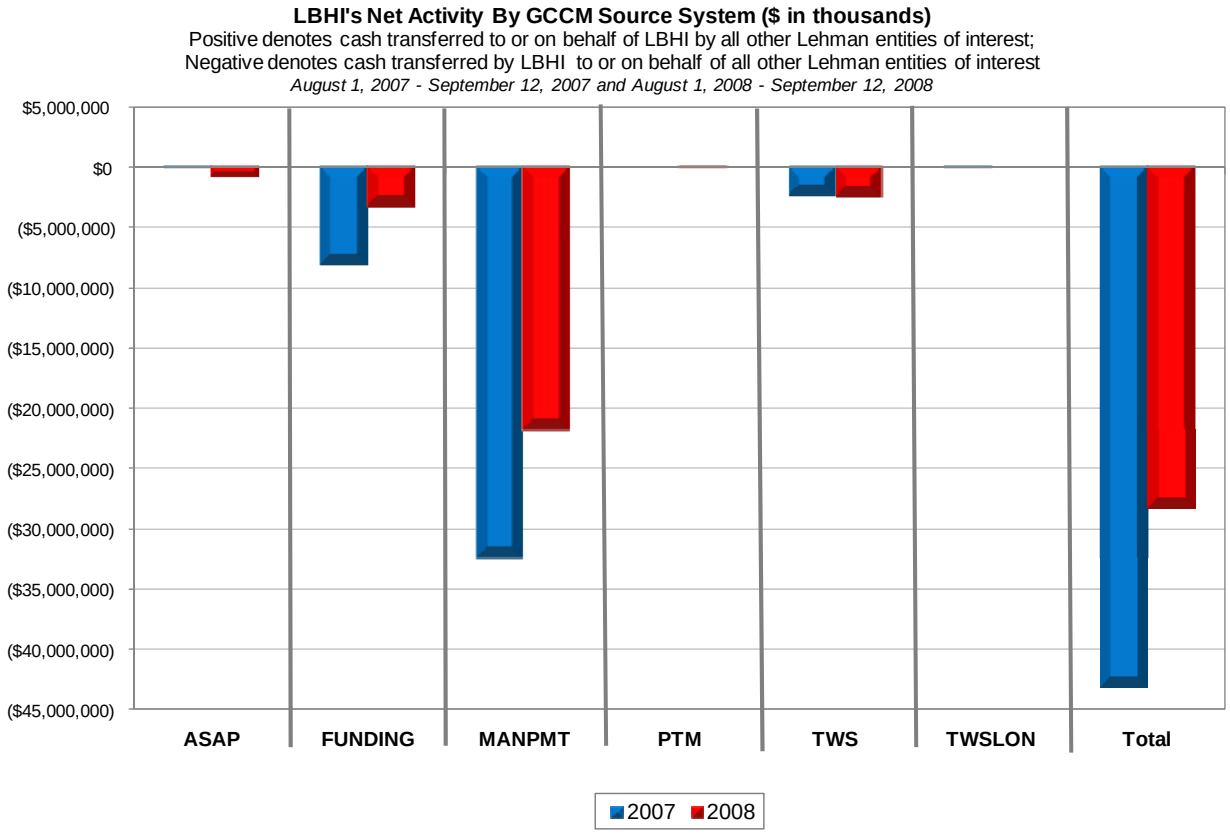
d) Analysis of Overall Net Intercompany Data for the 2007 and 2008 Periods of Analysis

(1) LBHI

The Examiner observed that LBHI transferred a net amount of approximately $43 billion to or on behalf of certain other Lehman entities of interest in the 2007 period of analysis, and a net amount of approximately $28 billion to or on behalf of certain other Lehman entities of interest in the 2008 period of analysis. This activity included net funding transfers of about $8.1 billion and about $3.2 billion in the respective 2007 and 2008 periods of analysis, as well as net quasi-funding transfers of about $35 billion and

[7220] As discussed below, "funding" activity was also captured to some extent from MANPMT and TWS.

about $25 billion in the respective 2007 and 2008 periods of analysis. This activity is presented in the chart below, with negative activity depicting net outflows of cash from LBHI to or on behalf of other Lehman entities of interest with respect to the GCCM source systems of interest:



In the 2007 and 2008 time periods of analysis, quasi-funding activity captured in GCCM from the MANPMT source code comprised the vast majority of net transfers (approximately $32.4 billion and approximately $21.8 billion in 2007 and 2008,

respectively).[7221] LBHI transferred virtually all of that cash to or on behalf of LBIE in both years. As for funding activity captured in GCCM from the FUNDING source code, the Examiner observed that LBHI transferred net amounts of approximately $8.1 billion and approximately $3.2 billion to various Lehman entities of interest in the respective 2007 and 2008 periods of analysis. LBIE and LBSF were the primary recipients of these net transfers in the 2007 period of analysis. In that period, LBHI transferred a net amount of approximately $4.0 billion to LBIE and approximately $4.4 billion to LBSF. In the 2008 period of analysis, LBHI transferred a net amount of approximately $3.9 billion to LBIE.[7222]

These data show that LBHI transferred substantial cash to various Lehman entities of interest (funding) and made substantial payments on behalf of various Lehman entities of interest (quasi-funding), particularly LBIE. These data are consistent with the Examiner's understanding that LBHI acted as "central banker" for the Lehman entities and that LBIE, in particular, required significant funding and quasi-funding during the period immediately prior to the bankruptcy filing as a result of unwinding prime brokerage services.[7223] The Examiner understands that there is disagreement as to

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[7221] The Examiner notes the possibility that MANPMT could have captured some funding-type transfers. In view of time and resource limitations, the Examiner did not attempt to quantify the amount of these funding-type transfers.

[7222] The LBHI transfers in 2008 were partially offset by transfers from LBSF to LBHI (roughly $0.6 billion).

[7223] Lehman Brothers, Liquidity of Lehman Brothers (Draft) (Oct. 7, 2008), at p. 16 [LBHI_SEC07940_844701] (presentation slide entitled "Broker Dealer Liquidity Positions" explaining that "[d]uring the week of September 8, LBIE lost $11.0 billion primarily as a result of [a] $4.2 billion decrease

whether substantial sums of cash flowed from LBIE to one or more Lehman entities in the days leading up to LBHI's bankruptcy.[7224] The Examiner has not investigated this issue, and this analysis is not necessarily meant to answer that question. The Examiner understands that there were ways to move money between entities not captured by the data contained in this analysis.

(2) LBIE

The Examiner observed that various Lehman entities of interest transferred a net amount of approximately $36.4 billion and $24.4 billion to or on behalf of LBIE in the respective 2007 and 2008 periods of analysis. That activity included net funding transfers of about $4.0 billion and about $3.9 billion in the respective 2007 and 2008 periods of analysis, as well as net quasi-funding transfers of approximately $32.4 billion and approximately $20.5 billion in the respective 2007 and 2008 periods of analysis. This activity is set forth in the chart below:

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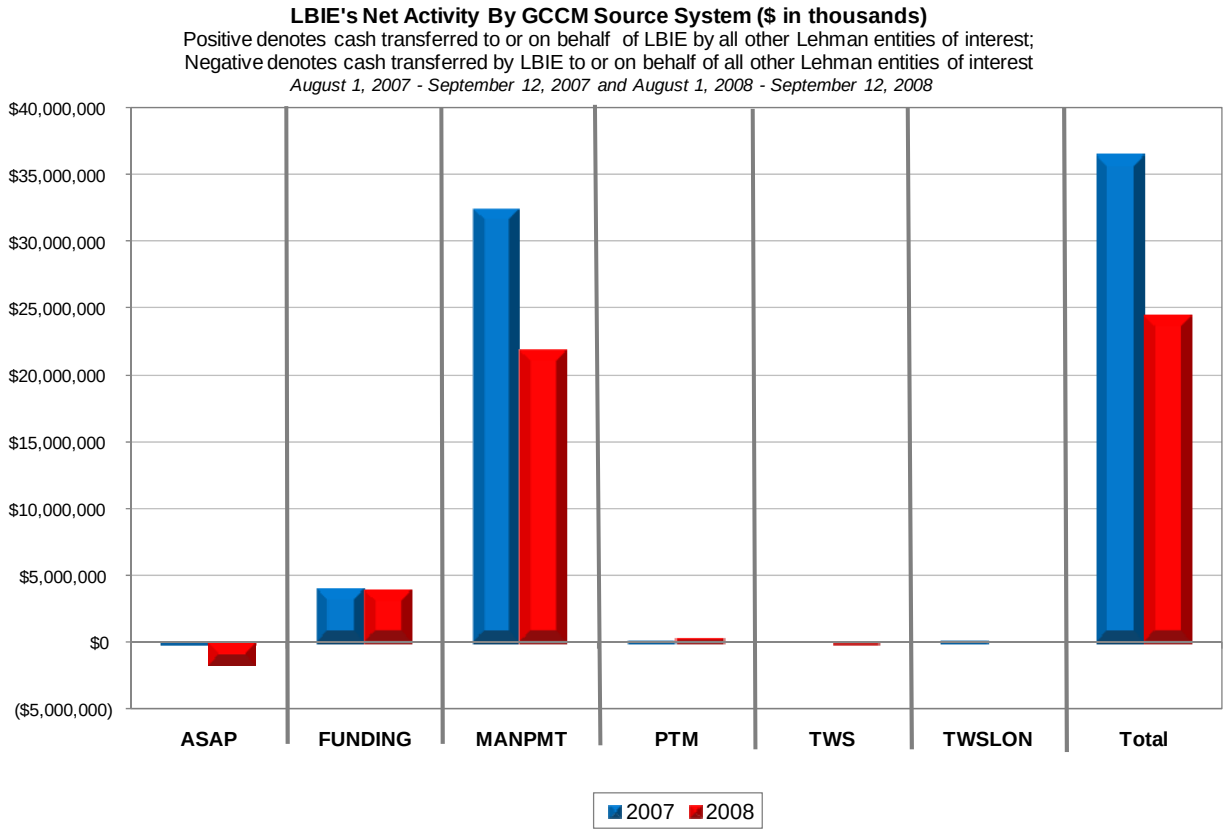
in operational cash cushion of its prime broker business (although this cushion is meant to protect its prime broker business, it is commingled with and included in LBIE liquidity)").

[7224] Carrick Mollenkamp, et. al, *Outcry Grows Over Transfer of U.K. Funds By Lehman*, WALL ST. J., Sept. 22, 2008, at C1; *see also* Cassell Bryan-Low, *Lehman's Legacy: Lehman Europe Claims Begin to Come In*, WALL ST. J., Sept. 25, 2009, at C3.



With respect to quasi-funding transfers, MANPMT activity comprised nearly all of these transfers, including net amounts of about $32.4 billion in the 2007 period of analysis and about $21.8 billion in the 2008 period of analysis. As discussed above, LBHI transferred virtually all of these amounts to or on behalf of LBIE. GCCM also captured notable quasi-funding activity from its ASAP source code in the 2008 period of analysis. In that period, LBIE transferred approximately $1.7 billion on behalf of LBSF. As for funding activity captured in GCCM from the FUNDING source code, the Examiner observed that LBHI transferred net amounts to LBIE of approximately $4.0

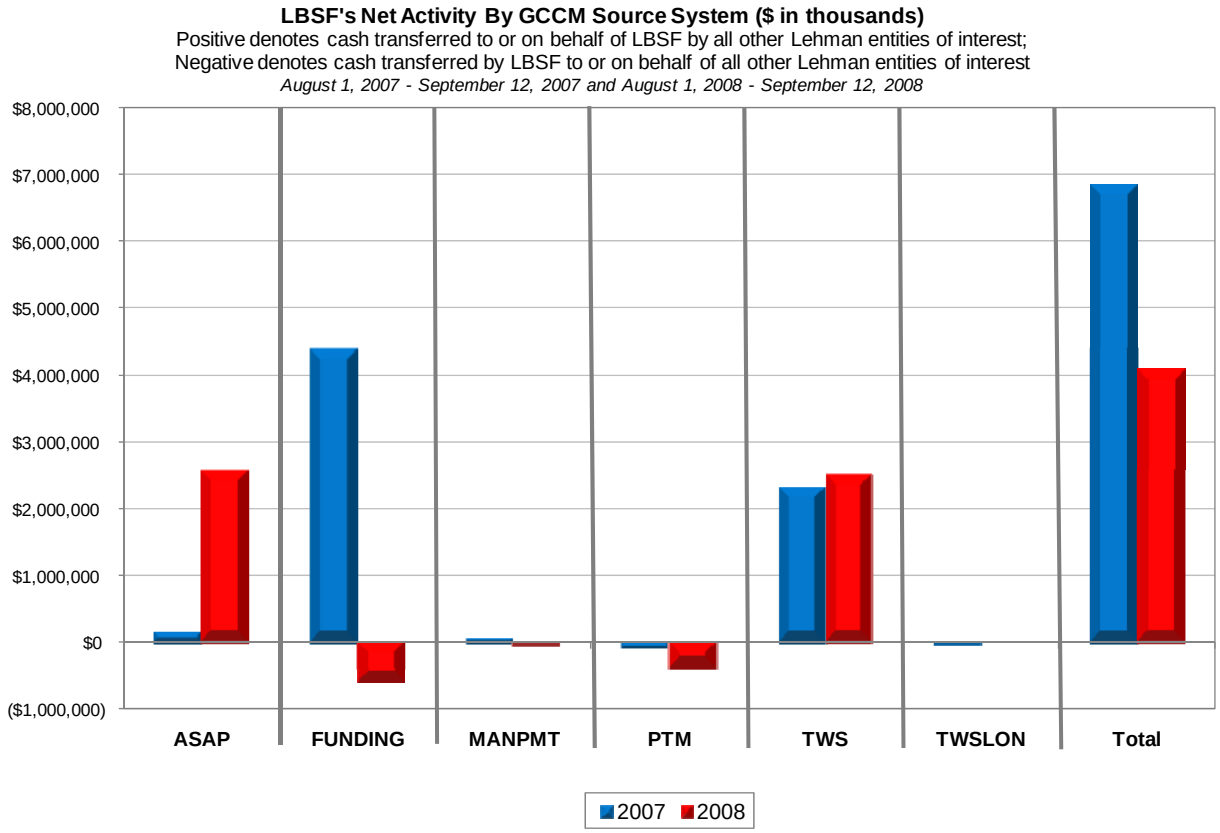
billion and approximately $3.9 billion in the respective 2007 and 2008 periods of analysis.

The foregoing data show that LBIE was the recipient of substantial funding and quasi-funding from various Lehman entities of interest, particularly LBHI. These data are consistent with the Examiner's understanding that LBIE required significant funding and quasi-funding during the period of this analysis as a result of unwinding prime brokerage services.[7225]

(3) LBSF

The Examiner observed that various Lehman entities of interest transferred net amounts of approximately $6.8 billion and approximately $4.0 billion to or on behalf of LBSF in the respective 2007 and 2008 periods of analysis. That activity included net funding transfers of nearly $4.4 billion into LBSF in the 2007 period of analysis and net funding transfers out of LBSF of nearly $600 million in the 2008 period of analysis. That activity also included net quasi-funding transfers of roughly $2.5 billion and roughly $4.7 billion to or on behalf of LBSF in the respective 2007 and 2008 periods of analysis. This activity is provided in the chart below:

[7225] Lehman Brothers, Liquidity of Lehman Brothers (Oct. 7, 2008), at p. 16 [LBHI_SEC07940_944701].



With respect to TWS-related quasi-funding transfers, LBHI was the sole transferor in both the 2007 and 2008 periods of analysis. LBHI transferred net amounts of roughly $2.3 billion and roughly $2.5 billion, respectively, to or on behalf of LBSF.[7226] GCCM also captured notable quasi-funding activity, nearly $2.6 billion, from its ASAP source code in the 2008 period of analysis. In that period, LBIE and LBHI transferred net amounts of roughly $1.7 billion and roughly $750 million, respectively, on LBSF's behalf. As for funding activity captured in GCCM from the FUNDING source code, the Examiner observed that LBHI was the entity primarily associated with such net

[7226] The Examiner notes the possibility that TWS could have captured some funding-type transfers. In view of time and resource limitations, the Examiner did not attempt to quantify the amount of these funding-type transfers.

transfers. In the 2007 period of analysis, LBHI transferred a net amount of approximately $4.4 billion to LBSF, while in the 2008 period of analysis LBSF transferred approximately $600 million to LBHI.

These data show that LBSF was the recipient of substantial net funding and net quasi-funding from various Lehman entities of interest. The data showing LBSF's ASAP activity is consistent with the Examiner's understanding of LBSF's derivatives trading activities during the period of analysis. In addition, the data showing LBHI's involvement in FUNDING activity with LBSF are consistent with the Examiner's understanding that LBHI acted as "central banker" for the Lehman entities.

e) Analysis of Net Daily Intercompany Data for the 2007 and 2008 Periods of Analysis

With few exceptions, the net daily intercompany data for the relevant periods in 2007 and 2008 revealed little notable activity in the last six weeks prior to September 15, 2008.[7227] In many cases, an entity's level of net daily activity in 2008 generally mirrored the same level of net activity in the preceding year. Moreover, in many cases, the Examiner observed that the net daily activity in the last two to three weeks prior to September 15, 2008 was either (1) minimal or nonexistent, or (2) consistent with prior weeks, suggesting the absence of notable activity.

[7227] The net daily data for the relevant periods in 2007 and 2008 are set forth in Appendix No. 25, Intercompany Transactions Occurring Within Thirty Days Before Bankruptcy (Feb. 1, 2010).

At the same time, the Examiner found several instances in which the net daily activity may be of particular note. First, in reviewing LBHI's MANPMT activity with LBIE, the Examiner observed that in the 2008 period of analysis, LBHI transferred a net amount of roughly $12 billion to or on behalf of LBIE in the last two weeks prior to LBHI's bankruptcy, and a net amount of almost $9 billion in the last week alone. The total activity for these two weeks comprised over half of the net activity for the entire 2008 period. At the same time, in examining LBHI's FUNDING activity with LBIE, the Examiner observed that in the 2008 period of analysis, LBHI transferred a net amount of roughly $4 billion to LBIE in the last week prior to LBHI's bankruptcy. As noted above, there is disagreement as to whether substantial sums of cash flowed from LBIE to one or more Lehman entities in the days leading up to LBHI's bankruptcy.[7228]

Second, in further reviewing LBHI's FUNDING activity, the Examiner also observed in the 2008 period of analysis that LBHI made sizeable net transfers of cash to LBSF and LBCS in the last week prior to LBHI's bankruptcy. Those cash transfers included net amounts of approximately $2.7 billion to LBSF and nearly $250 million to LBCS. Including the $4 billion in net transfers to LBIE discussed above, LBHI transferred a net amount of over $7 billion in cash during that last week in 2008.

[7228] Carrick Mollenkamp, *et. al, Outcry Grows Over Transfer of U.K. Funds By Lehman*, WALL ST. J., Sept. 22, 2008, at C1; *see also* Cassell Bryan-Low, *Lehman's Legacy: Lehman Europe Claims Begin to Come In*, WALL ST. J., Sept. 25, 2009, at C3.

Finally, in analyzing LBHI's ASAP activity with LBSF, the Examiner observed that in the 2008 period of analysis, LBHI transferred a net amount of roughly $650 million on behalf of LBSF on September 11, almost immediately prior to LBHI's bankruptcy. The Examiner found this single net transfer particularly notable in view of the fact that it comprised almost 90% of the activity for the entire six-week period.

7. Examiner's Analysis of Lehman's Debt to Freddie Mac

The Federal Housing Finance Agency ("FHFA"), Conservator for the Federal Home Loan Mortgage Corporation ("Freddie Mac"), requested the Examiner's assistance in investigating certain transactions between Freddie Mac and LBHI.[7229] Pursuant to the eighth bullet of paragraph 2 of the Examiner Order, the Examiner's investigation extends to "transactions . . . among the debtors and the pre-chapter 11 lenders and/or financial participants."[7230] In this Section, the Examiner reports on his investigation concerning unsecured loans from Freddie Mac to LBHI in 2008 that LBHI did not repay.

[7229] *See* Letter from Alfred M. Pollard, FHFA, to Anton R. Valukas, Jenner & Block, re: In re Lehman Brothers Holdings, Inc., *et al*. (Feb. 23, 2009), at p. 2. As Conservator for Freddie Mac, FHFA holds "all rights, titles, powers, and privileges" of Freddie Mac. 12 U.S.C. § 4617(b)(2). Further, FHFA has the authority to avoid certain fraudulent transactions related to Freddie Mac. *See id*. § 4617(b)(15). FHFA claims superpriority to the proceeds of such transactions. *See id.* § 4617(b)(15)(D). The Examiner makes no legal conclusions as to FHFA's priority.

[7230] Further, the Examiner Order provides that "[t]he Examiner shall cooperate fully with any governmental agencies." Order Directing Appointment of an Examiner Pursuant to Section 1104(c)(2) of the Bankruptcy Code, at p. 6 (¶ 8), Docket No. 2569, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Jan. 16, 2009).

Beginning in early 2008, Freddie Mac engaged in a series of privately negotiated short-term funding transactions with LBHI, typically advancing between $1 billion and $1.2 billion for approximately one month at a time.[7231] Steven Engel, Lehman's Global Head of Funding, described LBHI's transactions with Freddie Mac as "plain vanilla:" Engel or another trader from Lehman's funding desk would speak with a broker, typically Tullett Prebon, which would indicate that Freddie Mac was looking to lend money and ask whether Lehman was interested in borrowing that money.[7232] Lehman borrowed from Freddie Mac to take advantage of an attractive rate, and it would seek to roll the transaction when the rate was favorable.[7233]

On August 19, 2008, Freddie Mac transferred $450 million to LBHI and on August 20, 2008, Freddie Mac transferred $750 million to LBHI.[7234] Both transfers were due to be repaid on the morning of September 15 – the day LBHI filed for bankruptcy –

[7231] Letter from David A. Felt, FHFA, to Anton R. Valukas, Jenner & Block, re: In re: Lehman Brothers Holdings, Inc., *et al.* (Apr. 17, 2009), at p. 2 & Attach. 2; Examiner's Interview of Steven J. Engel, Oct. 30, 2009, at p. 4. Although FHFA and Lehman sometimes described these transactions as "fed funds" transactions, Steven Engel, Lehman's Global Head of Funding, explained that these transactions, though made through a fed funds broker, were not strictly fed funds transactions because LBHI was not a bank. Examiner's Interview of Steven J. Engel, Oct. 30, 2009, at pp. 7-8.

[7232] Examiner's Interview of Steven J. Engel, Oct. 30, 2009, at p. 4.

[7233] *Id*. Engel never spoke with Freddie Mac directly about these transactions. *Id*. Richard Fuld interacted with Richard Syron, CEO of Freddie Mac, as a banking client, but Fuld had no recollection of discussing these transactions with Syron. Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at p. 14. According to FHFA, Syron also did not recall speaking with Fuld concerning these transactions. Letter from David A. Felt, FHFA, to Anton R. Valukas, Jenner & Block, re: In re: Lehman Brothers Holdings, Inc., *et al.* (Apr. 17, 2009), at p. 4. Although it appears that a call was scheduled among Lehman's Paolo Tonucci and others with Freddie Mac on August 1, 2008 "to discuss liquidity," e-mail from Daniel Malone, Lehman, to Paolo Tonucci, Lehman, *et al*. (July 31, 2008) [LBHI_SEC07940_53324], Tonucci could not recall whether the call took place, Examiner's Interview of Paolo Tonucci, Sept. 16, 2009, at p. 28.

[7234] *See* e-mail from Kevin Farmer, Tullett Prebon, to David Forsyth, Lehman, *et al*. (Aug. 19, 2008) [LBEX-DOCID 450084]; e-mail from Kevin Farmer, Tullett Prebon, to David Forsyth, Lehman, *et al*. (Aug. 20, 2008) [LBEX-DOCID 450083].

but never were. The trades were executed through Tullett Prebon, at an interest rate of 2.55%, and the funds were initially placed into an LBHI account at Citibank.[7235] This Citibank account was the cash account to which LBHI typically issued payment instructions.[7236] Thus, the funds from Freddie Mac were not segregated from other LBHI funds and, upon receipt, they were managed as part of LBHI's liquidity pool.[7237]

Because Freddie Mac was due to be repaid on the morning of Monday, September 15, preparations for repayment should have occurred on Friday, September 12.[7238] There is conflicting evidence as to whether preparations for repayment took place on September 12. Engel explained that in order to prepare for repayment LBHI would have had to invest part of its liquidity pool Friday night in a product that would repay by Monday morning. He did not think that such preparations were made on September 12.[7239] In a letter dated October 16, 2008, Lehman's counsel stated that LBHI did not issue wire instructions to repay Freddie Mac on September 15.[7240] However, Alvarez & Marsal has indicated that "[t]he payment request to repay this loan was systematically

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[7235] E-mail from Kevin Farmer, Tullett Prebon, to David Forsyth, Lehman, *et al*. (Aug. 19, 2008) [LBEX-DOCID 450084]; e-mail from Kevin Farmer, Tullett Prebon, to David Forsyth, Lehman, *et al*. (Aug. 20, 2008) [LBEX-DOCID 450083]; Examiner's Interview of Steven J. Engel, Oct. 30, 2009, at p. 5.
[7236] Examiner's Interview of Steven J. Engel, Oct. 30, 2009, at p. 5.
[7237] *Id*. at pp. 5-6.
[7238] *Id*. at p. 6.
[7239] *Id.*
[7240] Letter from Diane Harvey, Weil, Gotshal & Manges, to Karen Wagner, Davis, Polk & Wardwell, re: Federal Home Loan Mortgage Corporation Funds Transfers (Oct. 16, 2008), at p. 2 (attached to Declaration of George Kielman in Supp. of Mot. of Federal Home Loan Mortgage Corp. for Leave to Conduct Rule 2004 Discovery, Docket No. 1181, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Oct. 22, 2008)).

generated and waiting to be released to the bank on Monday, 9/15/08."[7241] Moreover, some documentation over the course of the weekend indicated that Lehman planned to repay Freddie Mac on September 15.[7242]

Despite the magnitude of Lehman's transactions with Freddie Mac, the transactions were not governed by a formal written agreement.[7243] Rather, LBHI documented the transactions with "screenshots" from its accounting system.[7244] In addition, the broker Tullett Prebon would sometimes send Lehman e-mails confirming the transactions and their basic terms.[7245] Freddie Mac also maintained minimal trading

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[7241] E-mail from Lauren Sheridan, Alvarez & Marsal, to Jerome L. Epstein, Jenner & Block, *et al*. (Oct. 20, 2009). These wire instructions were issued by TWS (Treasury Workstation), an application used by LBHI to manage its treasury functions. *See* e-mail from Lauren Sheridan, Alvarez & Marsal, to Heather D. McArn, Jenner & Block, *et al*. (Dec. 2, 2009); TWS Freddie Mac Payment Details [LBEX-AM 5640797]; *see also supra* Section III.B.2.c (discussing TWS).

[7242] *See* e-mail from Tamir Shafer, Lehman, to Daniel J. Fleming, Lehman, *et al*. (Sept. 13, 2008) [LBEX-DOCID 051810], attaching Spreadsheet [LBEX-DOCID 059347] (showing repayment to Freddie Mac scheduled for 9:00 a.m.); e-mail from Tamir Shafer, Lehman, to Christopher Tsuboi, FRBNY, *et al*. (Sept. 14, 2008) [LBEX-AM 049457], attaching Spreadsheet [LBEX-AM 049458] (showing repayment to Freddie Mac scheduled for 5:30 p.m.).

[7243] *See* e-mail from Lauren Sheridan, Alvarez & Marsal, to Heather D. McArn, Jenner & Block, *et al*. (Oct. 18, 2009); Examiner's Interview of Steven J. Engel, Oct. 30, 2009, at p. 5. The Estate does not dispute the existence of these transactions. Although Freddie Mac was not included on Lehman's initial list of its largest unsecured creditors, *see* Voluntary Petition, at Sched. 1, Docket No. 1, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 15, 2008), it was later listed on Schedule F as a creditor holding an unsecured claim; that claim was listed as not contingent, not unliquidated, and not disputed, *see* Schedules, at p. 235, Docket No. 3078, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Mar. 12, 2009). According to Alvarez & Marsal, Freddie Mac's exclusion from the initial list was inadvertent. *See* e-mail from Lauren Sheridan, Alvarez & Marsal, to Jerome L. Epstein, Jenner & Block, *et al*. (Oct. 20, 2009).

[7244] *See* e-mail from Lauren Sheridan, Alvarez & Marsal, to Heather D. McArn, Jenner & Block, *et al.* (Oct. 18, 2009); Facsimile from Scott Alvey, Lehman, to Howard Comet, Weil, Gotshal & Manges (Oct. 30, 2008), at p. 2 [LBEX-SE 000001] (screenshot of August 20, 2008 transaction); Lehman, Screenshot of Aug. 19, 2008 Transaction [LBEX-AM 5640789].

[7245] *See, e.g.*, e-mail from Kevin Farmer, Tullett Prebon, to David Forsyth, Lehman, *et al.* (June 25, 2008) [LBEX-WGM 648915]; Examiner's Interview of Steven J. Engel, Oct. 30, 2009, at p. 5.

records of these transactions.[7246] Engel could not speak to whether such minimal documentation was typical from Lehman's perspective, as Lehman did not engage in similar transactions with other entities.[7247]

Although the Examiner is aware of multiple possible reasons that Freddie Mac was not repaid on September 15,[7248] the critical fact is that LBHI had filed for bankruptcy protection early on the morning of September 15 and thus did not have to make the payment.[7249] The Examiner is not aware of any basis to treat the Freddie Mac claim as anything other than an unsecured claim that is not contingent, not unliquidated, and

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[7246] Letter from David A. Felt, FHFA, to Anton R. Valukas, Jenner & Block, re: In re: Lehman Brothers Holdings, Inc., *et al.* (Apr. 17, 2009), at Attach. 4-5.

[7247] Examiner's Interview of Steven J. Engel, Oct. 30, 2009, at p. 5.

[7248] LBHI could not make wire transfers on September 15 because banks shut down its cash accounts. *See supra* Section III.B.2. In October 2008, however, Lehman's counsel offered a different reason for the nonpayment – that LBHI's Citibank account did not have sufficient funds to repay Freddie Mac on September 15. Letter from Diane Harvey, Weil, Gotshal & Manges, to Karen Wagner, Davis, Polk & Wardwell, re: Federal Home Loan Mortgage Corporation Funds Transfers (Oct. 16, 2008), at pp. 1-2 (attached to Declaration of George Kielman in Supp. of Mot. of Federal Home Loan Mortgage Corp. for Leave to Conduct Rule 2004 Discovery, Docket No. 1181, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Oct. 22, 2008)). Alvarez & Marsal, in turn, explained that "[t]he loan was not repaid because of the bankruptcy filing." E-mail from Lauren Sheridan, Alvarez & Marsal, to Jerome L. Epstein, Jenner & Block, *et al*. (Oct. 20, 2009); Examiner's Interview of Steven J. Engel, Oct. 30, 2009, at p. 7.

[7249] It is true that a substantial amount of funds were withdrawn from LBHI's Citibank account on Friday, September 12, to meet JPMorgan's September 11 request for $5 billion cash collateral. *See supra* Section III.A.5.b.1.k. For a discussion of an avoidance analysis concerning Lehman's transactions with JPMorgan, *see supra* Section III.B.3.g.5.a. LBHI also appears to have transferred $500 million from its Citibank account to LBI late on Sunday, September 14. E-mail from Julius Silbiger, Citigroup, to Thomas Obermaier, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00104189] (stating that the $500 million had moved by 9:42 p.m. that evening); e-mail from Roger Barnes, Citigroup, to Naresh N. Kumar, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00104189] (explaining that Citichecking opened at 9 p.m. that evening so the transfer could be made then); e-mail from Thomas Fontana, Citigroup, to Christopher M. Foskett, Citigroup, *et al*. (Sept. 14, 2008) [CITI-LBHI-EXAM 00101129] (approving the transfer). An account statement, however, lists the transfer date as September 15. Lehman Brothers Inc. Account Report (Oct. 1, 2008), at p. 1033 [CITI-LBI 00024142] (account statement confirming that the transaction transferred $500 million from Lehman Brothers Holdings Main Open Account 4061-5202 to Lehman Brothers Inc. account 3054-4658). See Sections III.C.5.c..1.d.iii and III.B.3.g.5.b for further discussion of this transfer.

not disputed – as indicated on the Debtor's Schedule F (Creditors Holding Unsecured Nonpriority Claims).

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	Chapter 11 Case No.
LEHMAN BROTHERS HOLDINGS INC., *et al.*,	:	08-13555 (JMP)
	:	(Jointly Administered)
Debtors.	:	

REPORT OF EXAMINER ANTON R. VALUKAS

Section III.C: Barclays Transaction

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C. Do Colorable Claims Arise From Transfers of LBHI Affiliate Assets to Barclays, or From the Lehman ALI Transaction?

1. Executive Summary

a) Purpose of Investigation

(1) Barclays Sale Transaction

By Order dated September 20, 2008, the Court approved, among other things, the sale of assets of LBHI, LBI and LB 745 to Barclays. The Court did not authorize the transfer of non-debtor assets to Barclays.

After the September 22, 2008 closing of the sale transaction, certain creditors asserted that assets of LBHI affiliates (other than LBI and LB 745) may have been transferred to Barclays in connection with the sale transaction.[7250]

The Court directed the Examiner to investigate:

> Whether assets of any LBHI Affiliates (other than Lehman Brothers, Inc.) were transferred to Barclays Capital Inc. as a result of the sale to Barclays Capital Inc. that was approved by order of the Bankruptcy Court entered September 20, 2008, and whether consequences to any LBHI Affiliate as a result of the consummation of the transaction created colorable causes of action that inure to the benefit of the creditors of such LBHI subsidiary or affiliate.[7251]

[7250] *See*, *e.g.*, Motion of The Walt Disney Company for Appointment of Examiner Pursuant to Section 1104(c)(2) of the Bankruptcy Code, at p. 4 (¶ 10), Docket No. 1143, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Oct. 20, 2008); Motion of the Bank of New York Mellon Trust Company, N.A. as Indenture Trustee, for Order Pursuant to Bankruptcy Rule 2004 Directing Examination of, and Production of, Documents by Lehman Brothers Holdings Inc., Lehman Brothers, Inc., Lehman Brothers Commodity Services Inc. and Barclays Capital Inc., Docket No. 1766, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Nov. 26, 2008).

[7251] Examiner Order, at p. 4 (sixth bullet).

The Examiner Order defines "LBHI Affiliate(s)" to include "LBCC [and] any other entity that currently is an LBHI chapter 11 debtor subsidiary or affiliate."[7252] As of the date of the entry of the Examiner Order, those entities were:

- Lehman Brothers Commodity Services Inc.
- Lehman Brothers Commercial Corporation
- Lehman Commercial Paper Inc.
- Lehman Brothers OTC Derivatives Inc.
- Lehman Brothers Finance S.A.
- LB 745 LLC
- BNC Mortgage LLC
- Lehman Brothers Special Financing Inc.
- Lehman Brothers Derivative Products Inc.
- Lehman Brothers Financial Products Inc.
- Fundo de Investimento Multimercado Credito Privado Navigator Investimento No Exterior
- Lehman Scottish Finance L.P.
- PAMI Statler Arms LLC
- East Dover Limited
- Luxembourg Residential Properties Loan Finance S.A.R.L.
- CES Aviation LLC
- CES Aviation V LLC
- CES Aviation IX LLC

Additional affiliates of LBHI filed Chapter 11 petitions after the entry of the Examiner Order.[7253] In addition, other affiliates of LBHI commenced foreign insolvency proceedings.[7254] Because the definition of "LBHI Affiliates" in the Examiner Order includes neither entities that filed bankruptcy petitions after the entry of the Examiner

[7252] Examiner Order, at p. 3 (first bullet).

[7253] Those entities include Structured Asset Securities Corporation, LB Rose Ranch LLC, LB 2080 Kalakaua Owners LLC, Merit LLC, LB Somerset LLC and LB Preferred Somerset LLC.

[7254] Those entities include LBIE, LBJ and LBAHL.

Order nor entities that commenced foreign insolvency proceedings, those entities were not within the scope of the Examiner's investigation.

(2) Lehman ALI Transaction

On September 19, 2008, shortly before the commencement of the SIPA proceeding for LBI, LBI transferred ownership of 25 subsidiaries (and their direct and indirect subsidiaries) to Lehman ALI Inc. ("Lehman ALI"), pursuant to a PIK Note and Security Agreement,[7255] an Assignment of Intellectual Property[7256] and a Transfer Agreement.[7257]

The Court directed the Examiner to investigate: "The transfer of the capital stock of certain subsidiaries of LBI on or about September 19, 2008 to Lehman ALI Inc."[7258]

b) Summary of Conclusions

(1) Barclays Transaction

The Examiner investigated whether assets of any LBHI Affiliates were transferred to Barclays in connection with the sale transaction. The Examiner also investigated certain aspects of the negotiation and consummation of the sale transaction. The Examiner concludes that there is sufficient evidence to support a finding that limited assets of three LBHI Affiliates were transferred to Barclays in

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[7255] PIK Note & Security Agreement between Lehman ALI Inc. and Lehman Brothers Inc. (Sept. 19, 2008).
[7256] Intellectual Property Assignment Agreement among Lehman Bros. Holdings Inc., Lehman Brothers Inc., LB 745 LLC and Barclays Capital Inc. (Sept. 19, 2008) ("Intellectual Property Assignment").
[7257] Transfer Agreement among Lehman Brothers, Inc., LBI Group Inc., and Lehman ALI Inc. (Sept. 19, 2008) [LBEX-WGM 000227].
[7258] Examiner Order, at p. 4 (ninth bullet).

connection with the sale transaction,[7259] namely: (1) information identifying LBCS's customers, the products those customers traded and prices for those products; and (2) office equipment owned by LBCS, LBSF and LCPI. The Examiner thus concludes that colorable claims exist against Barclays arising from those transfers. The Examiner also concludes, however, that the value of those assets may not be material, particularly in the context of the Debtors' Chapter 11 cases. Specifically, the office equipment transferred had a total net book value of less than $10 million (and an actual value that was likely much less), and the customer information was of questionable value. The Examiner also concludes that there is no evidence to support a finding that any securities transferred to Barclays in connection with the sale transaction were owned by LBHI Affiliates.

The Examiner concludes that the evidence does not support the existence of a colorable claim that directors and officers of the LBHI Affiliates breached their fiduciary duties in connection with the transfer to Barclays of the limited assets referenced above.[7260]

To assist the parties and the Court, the Examiner sets forth below the facts he has developed relating to the sale transaction. However, in light of the pending litigation between the Debtors, the SIPA Trustee and the Official Committee of Unsecured Creditors ("Creditors Committee"), on the one hand, and Barclays on the other, relating

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[7259] *See* Sections III.B.3.b & III.B.3.c of this Report.

[7260] *See* Section III.C.5.b.3 of this Report.

to the sale transaction, including the extensive discovery still underway, the Examiner has not reached any conclusions regarding whether LBHI or LBI have colorable claims arising from the acts and events relating to the sale transaction.[7261] The Examiner sets forth below the facts relating to the sale transaction.[7262] If the Court were to grant relief in connection with the motions and claims being brought by the Debtors, the SIPA Trustee or the Creditors Committee, however, the Examiner notes that such relief could inure in part to the benefit of creditors of the LBHI Affiliates.

(2) Lehman ALI Transaction

The Examiner analyzed documents and data and interviewed witnesses in order to develop an understanding of the Lehman ALI transaction and whether colorable claims arise from that transaction. The Examiner concludes that the Lehman ALI transaction was the product of a good faith, well-grounded business judgment, and that the evidence does not support the existence of a colorable claim (other than claims arising from rights provided for in the PIK Note & Security Agreement itself) from the Lehman ALI transaction.[7263]

2. Facts

a) Lehman Businesses and Assets

At the time LBHI filed its Chapter 11 bankruptcy petition on September 15, 2008, the Lehman organization consisted of thousands of entities that collectively supported

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[7261] *See* Section III.C.6 of this Report.

[7262] *See id.*

[7263] *See* Section III.C.3.c of this Report.

its three primary business lines: Capital Markets, Investment Banking and Investment Management.[7264]

Lehman's Capital Markets division included secondary trading, financing, mortgage origination and securitization, prime brokerage and research activities in fixed income and equity products. Lehman served as an agent, market-maker and intermediary in the marketplace to facilitate these transactions on behalf of its clients. The products that Lehman offered in connection with this business included a variety of cash, derivative, secured financing, structured instrument and investment products. The Capital Markets division also engaged in investing for principals and proprietary trading activities, including real estate, private equity and other long-term investments.[7265]

Lehman's Investment Banking division advised corporate, institutional and government clients with respect to mergers, acquisitions and other financial matters. This division also raised capital for these clients by underwriting public and private debt offerings and equity instruments. Lehman maintained investment banking hubs in North America, Europe, the Middle East, Latin America and the Asia Pacific region.[7266]

[7264] Examiner's Interview of Thomas E. Hommel, Apr. 29, 2009, at p. 3; Lehman Brothers Holdings Inc., Annual Report for 2007 as of Nov. 30, 2007 (Form 10-K) (filed on Jan. 29, 2008), at p. 3 ("LBHI 2007 10-K").
[7265] LBHI 2007 10-K, at p. 4.
[7266] *Id.* at p. 7.

Lehman's Investment Management Division provided strategic investment advice and services to institutional and high net worth clients.[7267] Specifically, it offered asset management, private equity, wealth advisory and trust execution services.[7268]

Lehman functioned as an integrated company, and in general structured and managed its businesses along different product lines within the three divisions.[7269] Lehman and its subsidiaries typically presented themselves to the public as "Lehman" or "Lehman Brothers."[7270] Customers typically had a relationship with LBI, but Lehman employees would book certain trades to the legal entity within Lehman that corresponded to the product being traded, or that satisfied tax, financing or regulatory considerations.[7271] Multiple Lehman entities often were used to structure particular types of transactions.[7272] As a result, customers whose relationships were with LBI would, in fact, often have their business transacted through other Lehman entities. Those customers generally did not rely on the credit rating of those Lehman entities;

[7267] *Id.* at p. 8.

[7268] *Id.* at pp. 8-9.

[7269] Examiner's Interview of Peter A. Tennyson, Oct. 13, 2009, at pp. 2-3; Examiner's Interview of Peter A. Tennyson, Dec. 2, 2009, at p. 2; Examiner's Interview of Clifford Feibus, Mar. 12, 2009, at p. 2; Examiner's Interview of Thomas E. Hommel, Apr. 29, 2009, at p. 5.

[7270] *Cf.* Examiner's Interview of James P. Seery, Jr., Nov. 12, 2009, at p. 4; Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 4.

[7271] Examiner's Interview of James P. Seery, Jr., Jan. 14, 2010, at p. 2; Examiner's Interview of Peter A. Tennyson, Dec. 2, 2009, at p. 2.

[7272] *See, e.g.,* Lehman, Confidential Memorandum re $660,000,000 Main Street Natural Gas, Inc., Gas Project Revenue Bonds Series 2008B (Jan. 14, 2008) [LBEX-AM 137776], attached to e-mail from Evette Saldana, Lehman, to Commitment Committee, Lehman (Jan. 11, 2008) [LBEX-AM 137775].

indeed, those customers sometimes were not even aware that Lehman entities other than LBI were involved in their transactions.[7273]

LBHI and LBI generally directed and managed the operations of the entire organization. These entities (and LBI in particular) hired, employed and compensated most Lehman employees.[7274] In certain cases, employees' compensation was booked as an expense at the legal entities for which they performed services.[7275] Those employees, however, generally regarded themselves as employees of LBI, rather than as employees of the subsidiary for which they performed functions.[7276] Most entities shared at least some common officers and directors.[7277]

[7273] Examiner's Interview of James P. Seery, Jr., Jan. 14, 2010, at p. 2; Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 4. LBDP and LBFP, discussed in Section III.C.2.a.f, are exceptions to these general propositions.

[7274] Examiner's Interview of Tracy Binkley, Dec. 22, 2009; s*ee*, *e.g.*, letter from Christopher O'Meara, Lehman, to John DeRosa, Lehman, re: employment offer (Nov. 10, 2006), at p. 2 [LBEX-AM 023144]; e-mail from Kaushik Amin, Lehman, to Herbert H. McDade, III, Lehman (Sept. 19, 2008) [LBHI_SEC07940_656489].

[7275] Examiner's Interview of Clifford Feibus, Mar. 12, 2009, at p. 5.

[7276] E-mail from Paul Gregg, Lehman, to Peter Keavey, Lehman (Sept. 16, 2008) [LBEX-DOCID 3571486] (employees allocated to LBCS discussing transfer of LBI employees to Barclays and noting "that's us"); Examiner's Interview of Jonathan D. Williams, Aug. 5, 2009, at p. 4.

[7277] *See*, *e.g.*, Lehman, LBCS World Records Report (Sept. 15, 2008) [LBEX-LL 027844]; Lehman, LBCC World Records Report (Sept. 15, 2008) [LBEX-LL 027848]; Lehman, LBSF World Records Report (Sept. 15, 2008) [LBEX-LL 027833]; Lehman, LBFP World Records Report (Sept. 15, 2008) [LBEX-LL 027860]; Lehman, LBDP World Records Report (Sept. 15, 2008) [LBEX-LL 027856]; Lehman, LBF World Records Report (Sept. 12, 2008) [LBEX-LL 027785]; Lehman, BNC World Records Report (Sept. 15, 2008) [LBEX-LL 027795]; Lehman, LB745 World Records Report (Sept. 15, 2008) [LBEX-LL 027840]; Lehman, CES World Records Report (Sept. 15, 2008) [LBEX-LL 027772]; Lehman, CES V World Records Report (Sept. 15, 2008) [LBEX-LL 027775]; Lehman, CES IX World Records Report (Sept. 15, 2008) [LBEX-LL 027779]; Lehman, PAMI Statler World Records Report (Sept. 15, 2008) [LBEX-LL 027790]; Lehman, East Dover World Records Report (Sept. 15, 2008) [LBEX-LL 027782]; Lehman, Navigator World Records Report (Sept. 15, 2008) [LBEX-LL 3668315]; Lehman, Scottish Finance World Records Report (Sept. 15, 2008) [LBEX-LL 027788]; Lehman, LOTC World Records Report (Sept. 15, 2008) [LBEX-LL 027852]. No World Records Report was available for Luxembourg LLC.

As a consequence of the functional approach that Lehman took to the operation of its day-to-day business, there was significant overlap between and among the operations of the various Lehman entities. Nevertheless, the Lehman entities did observe basic corporate formalities, such as maintaining corporate record books and separate financial statements. Legal entities typically were assigned a legal entity controller who was responsible for reviewing and verifying their financial statements, and monitoring their regulatory financial requirements, if any.[7278] When entities required authorization from their directors to take certain actions, such authorization generally was provided through unanimous consent resolutions rather than board meetings.[7279]

In order to conduct his investigation of the operations and assets of the LBHI Affiliates, and of the possible transfer of assets to Barclays, the Examiner divided the businesses of LBHI Affiliates into two broad categories: (a) operating companies; and (b) single purpose entities.[7280]

[7278] Examiner's Interview of Clifford Feibus, Mar. 12, 2009, at p. 2.

[7279] Examiner's Interview of James P. Seery, Jr., Nov. 12, 2009, at p. 4; Examiner's Interview of Fred S. Orlan, Sept. 21, 2009, at p. 3; Examiner's Interview of Satu S. Parikh, Aug. 26, 2009, at p. 7.

[7280] Lehman's subsidiary and affiliate entities generally were organized into one of three tiers based on the type and value of assets that they held. Lehman, Description of Lehman Subsidiary Tier Categories [LBEX-LL 001750]. Tier I entities generally held the most significant assets while Tier II and Tier III entities typically held much less substantial assets. Examiner's Interview of Ada Shek, Nov. 24, 2009, at p. 2; Examiner's Interview of Tracy C. Tanaka, Oct. 21, 2009, at p. 2. Most of Lehman's single purpose entities were in Tiers II or III, while the operating companies were typically Tier I.

(1) LBHI Affiliate Operating Companies

Several LBHI Affiliates were operating companies that regularly traded with Lehman customers and counterparties, including commodities, derivatives and foreign exchange trading transactions. With the exception of LBCS, however, these entities generally were used by Lehman to book transactions related to customers of LBI.[7281] Lehman personnel asserted that customers did not rely on the credit ratings of these entities, with the exception of LBDP and LBFP, as discussed below.[7282]

(a) LBCS

Lehman Brothers Commodity Services, Inc. ("LBCS") housed Lehman's commodity trading business,[7283] which was focused on natural gas, oil and power trading. LBCS also traded a variety of other commodities and commodities derivatives for Lehman, including products related to sulfur dioxide, carbon dioxide and nitrogen oxide emissions allowances,[7284] coal,[7285] metals and mining,[7286] chemicals,[7287] ethanol,

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[7281] Examiner's Interview of James P. Seery, Jr., Jan. 14, 2010, at p. 2. For background on Lehman's commodities operations generally, see Lehman, Global Commodities August 2008 YTD Performance [LBEX-DOCID 680728]; Lehman, Commodities Weekly Metrics As Of 9/4/08 [LBEX-DOCID 680596].

[7282] Examiner's Interview of James P. Seery, Jr., Jan. 14, 2010, at p. 2; Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 4.

[7283] *See* Lehman, LBCS World Records Report (Sept. 15, 2008) [LBEX-LL 027844]; Examiner's Interview of Satu S. Parikh, Aug. 26, 2009, at p. 8.

[7284] *See, e.g.,* e-mail from James Macintosh, Lehman, to Maximilian Coreth, Lehman (Aug. 25, 2008) [LBEX-DOCID 3628450]; e-mail from RGGI Auction Manager, World Energy, to James Macintosh, Lehman (Aug. 25, 2008) [LBEX-DOCID 3563294]; e-mail from James Macintosh, Lehman, to Adam Robinson, Lehman (Aug. 28, 2008) [LBEX-DOCID 3510886]; e-mail from James Macintosh, Lehman, to Robert Forgrave, CIBC (Sept. 15, 2008) [LBEX-DOCID 3567571].

[7285] *See, e.g.,* e-mail from James Macintosh, Lehman, to Maximilian Coreth, Lehman (Aug. 25, 2008) [LBEX-DOCID 3567361].

[7286] *See, e.g.,* Lehman, Commodities Priority List [LBEX-DOCID 3567397].

exotics (including index, single and multi-asset commodity derivatives and structured notes), agricultural products and uranium and nuclear products.[7288]

Although LBCS originally had focused on trading energy derivatives, at the time of Lehman's bankruptcy, it was in the process of building a physical trading presence and had acquired Houston-based Eagle Energy Partners as part of that growth strategy.[7289] LBCS also engaged in a limited number of proprietary trading activities for Lehman.[7290]

The sophisticated parties with whom LBCS traded typically requested parent guarantees (from LBHI) when dealing with LBCS.[7291]

As of LBHI's bankruptcy filing, Lehman's records indicate that approximately 100 people who were employed by LBI performed functions for LBCS.[7292] LBCS's primary operations were centralized on the seventh floor of Lehman's New York headquarters.[7293]

[7287] *See, e.g.,* e-mail from Lawrence Jollon, Lehman, to Laurence Jollan, Lehman (Sept. 14, 2008) [LBEX-DOCID 3601573].

[7288] *See, e.g.,* Max Coreth, North America Gas & Power Trading Power - New York [LBEX-DOCID 3458961], attached to e-mail from Paul Gregg, Lehman, to Satu S. Parikh, Lehman (Sept. 16, 2008) [LBEX-DOCID 3460953].

[7289] Examiner's Interview of Satu S. Parikh, Aug. 26, 2009, at pp. 6-7; Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 8.

[7290] Examiner's Interview of Satu S. Parikh, Aug. 26, 2009, at p. 9.

[7291] *Id.* at p. 8.

[7292] A&M, Spreadsheet of Employees Mapped to Legal Entities (Sept. 20, 2008) [LBEX-AM 5642400]; a*ccord* Examiner's Interview of David M. Perlman, July 10, 2009.

[7293] Examiner's Interview of Satu S. Parikh, Aug. 26, 2009, at p. 8.

LBCS's commodity trading business was separate and distinct from LBI's commodities business, which primarily executed domestic futures and options exchange-cleared trades for LBI's customer base.[7294] LBI also cleared all domestic futures and exchange-traded options contracts for other Lehman entities.[7295]

(b) LBCC

Lehman Brothers Commercial Corporation ("LBCC") was the entity that Lehman used to book the majority of its foreign exchange ("FX") trades, including currency and FX options, spots and forwards.[7296] LBCC also entered into swaps (particularly interest rate swaps) to hedge its transactions.[7297]

LBCC engaged solely in over-the-counter ("OTC") transactions.[7298] It did not service a significant retail customer base, and instead typically dealt with sophisticated institutional clients and hedge funds.[7299] LBCC also was involved in the interbank market, which meant that it engaged in OTC transactions with entities such as JPMorgan and Goldman Sachs.[7300]

[7294] Examiner's Interview of Satu S. Parikh, Jan. 4, 2010.

[7295] Examiner's Interview of Satu S. Parikh, Aug. 26, 2009, at p. 9.

[7296] Lehman, LBCC World Records Report (Sept. 15, 2008) [LBEX-LL 027848]; Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 7.

[7297] Examiner's Interview of Peter A. Tennyson, Oct. 13, 2009, at p. 2; Examiner's Interview of Francois Chu-Fong, Dec. 18, 2009, at p. 2.

[7298] Examiner's Interview of Peter A. Tennyson, Oct. 13, 2009, at p. 2.

[7299] *Id.* at p. 3.

[7300] *Id.* at p. 3.

LBCC was used to book three primary types of FX transactions: spots, forwards and options.[7301] Spot FX transactions consist of an agreement to exchange one currency for another within one to two business days.[7302] A forward FX transaction is one in which counterparties agree to exchange currencies more than three days after the agreement date.[7303] FX options are derivative instruments that give holders the right (though not the obligation) to buy or sell the underlying currency at a future date for a pre-determined price.[7304]

Although LBCC was used to book most of Lehman's FX and currency trades, it was not the only entity that engaged in these types of activities. Many other entities engaged in such trades as well because hedge accounting rules often required that the hedge involve the same legal entity as the position being hedged.[7305] Thus, LBSF also traded heavily in interest rate swaps; LBIE was engaged in FX trading through its role as the UK broker-dealer; and LBI engaged in spot FX transactions with Street counterparties such as other commercial banks.[7306] LBI also handled some "vanilla" FX trades for highly rated or institutional counterparties,[7307] while trades with counterparties that presented some credit risk, including PIM customers, typically were

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[7301] Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 2.
[7302] Examiner's Interview of Francois Chu-Fong, Dec. 18, 2009, at p. 2.
[7303] *Id*.
[7304] *Id.*
[7305] Examiner's Interview of Peter A. Tennyson, Oct. 13, 2009, at pp. 2-3.
[7306] Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 3.
[7307] Examiner's Interview of Jonathan D. Williams, Aug. 5, 2009, at p. 3.

booked at LBCC.[7308] LBI did not engage in FX options transactions, because its ability to do so was constrained by regulatory requirements.[7309] Rather, LBI booked FX options transactions even for highly-rated counterparties at LBCC.[7310]

Some of LBCC's FX trades were done back-to-back with other Lehman entities.[7311] If an existing customer already had an account with a Lehman entity, the customer could engage in the FX trade with that entity, and LBCC would enter into a back-to-back FX trade with the Lehman entity where the customer maintained the account.[7312] This also worked in the opposite direction if LBCC was the entity where the customer had a relationship.[7313] Generally speaking, however, the primary Lehman interface for most clients was LBI.[7314]

LBCC was wholly-owned and fully guaranteed by LBHI.[7315] LBCC had a few dedicated traders, and used LBHI and LBI employees to support its broader

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[7308] Examiner's Interview of Peter A. Tennyson, Dec. 2, 2009, at p. 3; Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at pp. 3, 5.

[7309] Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at pp. 3, 5; Examiner's Interview of Francois Chu-Fong, Dec. 18, 2009, at p. 3; Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 3; Examiner's Interview of Robert Eby, Jan. 6, 2010, at p. 4. For further discussion of Lehman's FX business, see Section III.B.5.

[7310] Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 3; Examiner's Interview of Francois Chu-Fong, Dec. 18, 2009, at p. 3; Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 3; Examiner's Interview of Robert Eby, Jan. 6, 2010, at p. 4.

[7311] Examiner's Interview of Peter A. Tennyson, Dec. 2, 2009, at p. 3; Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 2.

[7312] Examiner's Interview of Jonathan D. Williams, Aug. 5, 2009, at p. 3; Examiner's Interview of Peter A. Tennyson, Dec. 2, 2009, at p. 3.

[7313] Examiner's Interview of Peter A. Tennyson, Dec. 2, 2009, at p. 3.

[7314] Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 4.

[7315] Lehman, LBCC World Records Report (Sept. 15, 2008) [LBEX-LL 027848]; Amended Corporate Ownership Statement Pursuant to Federal Rule of Bankruptcy Procedure 1007(a)(1) and Local Rule of

infrastructure requirements.[7316] Generally, Lehman employees did not think of LBCC as a distinct entity.[7317] LBCC was thinly capitalized and could not have survived without LBHI.[7318]

(c) LCPI

Lehman Commercial Paper, Inc. ("LCPI") was used by Lehman to book and hold loans,[7319] including commercial loans,[7320] whole loans, real estate loans and distressed debt purchases.[7321] It also originated and traded secured and unsecured loans.[7322] In a typical origination transaction, LBHI or LBI would underwrite the loan, a different Lehman entity would fund it, and the loan would be recorded at LCPI.[7323] This was done in part to obviate the need for regulated entities, such as LBI, to record capital

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Bankruptcy Procedure 1007-3, Docket No. 8, *In re Lehman Bros. Commercial Corp.*, No. 08-13901 (Bankr. S.D.N.Y. Oct. 23, 2008); Lehman Unanimous Written Consent to the Executive Committee of the Board of Directors of Lehman Brothers Holdings Inc. (June 9, 2008) [LBEX-AM 003415].

[7316] Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 5.

[7317] Examiner's Interview of Jonathan D. Williams, Aug. 5, 2009, at p. 2; Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 6.

[7318] Examiner's Interview of Jonathan D. Williams, Aug. 5, 2009, at p. 2; Examiner's Interview of Peter A. Tennyson, Oct. 13, 2009, at p. 3; Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 5.

[7319] Examiner's Interview of Fred S. Orlan, Sept. 21, 2009, at p. 3; Examiner's Interview of James P. Seery, Jr., Nov. 12, 2009, at p. 4.

[7320] Examiner's Interview of Joselito M. Rivera, Oct. 13, 2009, at p. 5.

[7321] Examiner's Interview of James P. Seery, Jr., Nov. 12, 2009, at p. 4.

[7322] Lehman, LCPI World Records Report (Sept. 15, 2008) [LBEX-LL-027825]; Debtors' Motion Pursuant to Sections 105(a), 363(b), 363(c) and 541(d) of the Bankruptcy Code and Bankruptcy Rule 6004 for Authority to (A) Continue to Utilize Its Agency Bank Account, (B) Terminate Agency Relationships, and (C) Elevate Loan Participations, at p. 3, Docket No. 3, *In re Lehman Commercial Paper, Inc.*, No. 08-13900 (Bankr. S.D.N.Y. Oct. 6, 2008).

[7323] Examiner's Interview of James P. Seery, Jr., Nov. 12, 2009, at p. 4.

charges pertaining to the loan.[7324] LCPI also extended warehouse loans that were secured by mortgage loans and other assets.[7325]

In addition, LCPI was involved in the administration, syndication and trading of commercial loans.[7326] In the primary loan market, LCPI served as a lender, syndication agent and administrative agent for commercial loans, and also bought and sold loans that other financial institutions originated.[7327] Its portfolio of loans included both fully funded loans and unfunded loans (loans as to which it had future funding obligations).[7328]

When LCPI acted as an administrative agent, it served as an intermediary between lenders and borrowers and performed functions such as monitoring loans, collecting advances from lending syndicate members and transferring these funds to borrowers, and collecting payments of principal and interest from borrowers and

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[7324] *Id*.

[7325] Lehman, LCPI World Records Report (Sept. 15, 2008) [LBEX-LL-027825]. The process of "warehousing" loans consisted of extending "warehouse" lines of credit to finance the operations of mortgage originators in exchange for the right to sell securities backed by a pool of mortgages. Examiner's Interview of Madelyn Antoncic, Feb. 25, 2009, at p. 4.

[7326] Lehman, LCPI World Records Report (Sept. 15, 2008) [LBEX-LL-027825]; Debtors' Motion Pursuant to Sections 105(a), 363(b), 363(c) and 541(d) of the Bankruptcy Code and Bankruptcy Rule 6004 for Authority to (A) Continue to Utilize Its Agency Bank Account, (B) Terminate Agency Relationships, and (C) Elevate Loan Participations, at p. 3, Docket No. 3, *In re Lehman Commercial Paper, Inc.*, No. 08-13900 (Bankr. S.D.N.Y. Oct. 6, 2008).

[7327] Debtors' Motion Pursuant to Sections 105(a), 363(b) and 541(d) of the Bankruptcy Code and Bankruptcy Rule 6004 for Authority to (A) Continue to Utilize Its Agency Bank Account, (B) Terminate Agency Relationships, and (C) Elevate Loan Participations, at pp. 3-4, Docket No. 3, *In re Lehman Commercial Paper, Inc.*, No. 08-13900 (Bankr. S.D.N.Y. Oct. 6, 2008).

[7328] *Id.* at p. 4.

distributing the funds to syndicate members.[7329] LCPI sometimes had no economic interest in a particular loan, while in other transactions it served both as lender and as an administrative agent.[7330] LCPI received a fee for its services as an administrative agent.[7331]

When LCPI acted as a syndication agent, it originated commercial loans and sold interests in them to third parties.[7332] These third parties pledged to fund a portion of the lenders' future obligations in exchange for a proportionate share of the proceeds from repayment of the loans.[7333] In a typical syndication transaction, LCPI would sell a participation. The participant would in turn receive the right to receive principal and interest payments from the loan. The participant would assume an obligation to fund a proportional unfunded amount of the loan.[7334] The participant did not become a lender of record, however, and there was no direct contractual relationship between the borrower and the participant in these transactions.[7335] LCPI also would buy participations in loans that other financial institutions originated and sell sub-participations of its share to third parties.[7336]

[7329] *Id.*
[7330] *Id.*
[7331] *Id.*
[7332] *Id.*
[7333] *Id.*
[7334] *Id.*
[7335] *Id.* at pp. 4-5.
[7336] *Id.* at p. 5.

LCPI was the primary entity through which Lehman engaged in securitizations.[7337] LCPI maintained a repo facility at JPMorgan, and was actively involved in intercompany repo and reverse repo financing.[7338]

Early in its history, LCPI had been engaged in issuing commercial paper, but notwithstanding its name, was no longer active in that business line at the time of bankruptcy.[7339]

Lehman's records indicate that approximately 120 LBI and LBHI employees performed functions for LCPI.[7340] LCPI funded its operations through repo agreements, bank credit facilities and borrowings from LBHI.[7341] LCPI could not function as a stand-alone entity.[7342]

(d) LBSF

Lehman Brothers Special Financing, Inc. ("LBSF") was used by Lehman as its primary vehicle for trading in derivatives,[7343] and was fully guaranteed by LBHI.[7344]

[7337] Examiner's Interview of Ada Shek, Nov. 24, 2009, at p. 4.

[7338] *Id.*

[7339] Examiner's Interview of Joselito M. Rivera, Oct. 13, 2009, at p. 5; Examiner's Interview of James P. Seery, Jr., Nov. 12, 2009, at p. 4.

[7340] A&M, Spreadsheet of Employees Mapped to Legal Entities (Sept. 20, 2008) [LBEX-AM 5642400].

[7341] Lehman, LCPI, World Records Report (Sept. 15, 2008) [LBEX-LL-027825]; Examiner's Interview of Kristie Y. Wong, Dec. 2, 2009, at p. 1.

[7342] Examiner's Interview of Fred S. Orlan, Sept. 21, 2009, at p. 3.

[7343] Examiner's Interview of Kristie Y. Wong, Dec. 2, 2009; Examiner's Interview of Ada Shek, Nov. 24, 2009, at p. 10; Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 6.

[7344] Lehman, LBSF World Records Report (Sept. 15, 2008) [LBEX-LL-027825]; Lehman, Unanimous Written Consent of the Executive Committee of the Board of Directors of Lehman Brothers Holdings Inc. (June 9, 2008) [LBEX-AM 003415].

LBSF was used to book transactions for products including interest rate swaps,[7345] interest rate and equity derivatives,[7346] mortgage-backed securities,[7347] currency derivatives,[7348] credit default swaps,[7349] total return swaps,[7350] collateralized debt obligations[7351] (including structured finance collateralized debt obligations and corporate-backed synthetic collateralized debt obligations)[7352] and municipal bonds and derivatives.[7353]

Although LBSF was Lehman's primary swap trading entity, other entities also were used to book swaps for, among other things, hedging purposes.[7354] LBSF also was used as a swap counterparty for trades originating at other Lehman entities.[7355] If a client maintained a relationship with a different Lehman entity, but wanted to execute a

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[7345] Examiner's Interview of Jonathan D. Williams, Aug. 5, 2009, at p. 3; Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 4; Examiner's Interview of Peter A. Tennyson, Dec. 2, 2009, at p. 2.

[7346] *See*, *e.g.*, memorandum from Ajay Nagpal, Lehman, to Allyson Carine, Lehman (Nov. 4, 2004) [LBEX-DOCID 3525376]; memorandum from Janet Hurley, Lehman, *et al.,* to Transaction Management Group, *et al.*, Lehman (July 21, 2006) [LBEX-DOCID 3568131].

[7347] *See*, *e.g.*, letter from Lehman Brothers Special Financing Inc. to Credit Industriel et Commercial (Nov. 16, 2006) [LBEX-DOCID 3678372].

[7348] E-mail from Jessica Laut, Lehman, to Kathleen Kalaher, Lehman, *et al.* (Aug. 28, 2008) [LBEX-DOCID 3620744].

[7349] Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 6.

[7350] E-mail from Jonathan Lai, Lehman, to John Gatsos, Lehman, *et al.* (Sept. 15, 2008) [LBEX-DOCID 3621679].

[7351] E-mail from Terrence Glomski, Lehman, to Stephen Lukow, Lehman (Sept. 15, 2008) [LBEX-DOCID 3620796].

[7352] *See*, *e.g.*, Lehman, CDO Entity List [LBEX-DOCID 3501971].

[7353] *See*, *e.g.*, memorandum from Gerald Rizzieri, Lehman, *et al.*, to Matthew Looney, re: Lehman, Closing Memorandum (Aug. 25, 2008) [LBEX-DOCID 3517551]; e-mail from Patrick Scott, Lehman, to Gerald Rizzieri, Lehman, *et al.* (Aug. 27, 2008) [LBEX-DOCID 3547534]; Lehman, Municipal Derivatives Business and Market Risk Overview, at p. 4 (Sept. 2008).

[7354] Examiner's Interview of Peter A. Tennyson, Dec. 2, 2009, at p. 2.

[7355] Examiner's Interview of Satu S. Parikh, Aug. 26, 2009, at p. 10.

trade in a product that LBSF typically booked, LBSF would often make the trade back-to-back with the other Lehman entity.[7356]

LBSF had a dedicated trading desk that was used to trade and manage the products described above.[7357] However, LBSF did not have its own sales force.[7358] LBSF could not have survived as a stand-alone entity.[7359]

(e) LOTC

Lehman Brothers OTC Derivatives, Inc. ("LOTC") was an over-the-counter ("OTC") derivatives dealer regulated by the SEC.[7360] It faced customers in the United States, and was subject to lower capital requirements than a full-service broker-dealer such as LBI.[7361] By limiting its activities to eligible OTC derivative products and risk mitigating transactions, LOTC was permitted to calculate its regulatory capital requirement using VaR models.[7362] The reduced capital requirements allowed Lehman to offer lower prices on these transactions than a traditional broker-dealer with more substantial capital requirements, such as LBI, could offer. LOTC was subject to regular

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[7356] *Id.*
[7357] Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 6.
[7358] *Id* at p. 6.
[7359] Examiner's Interview of Kaushik Amin, Sept. 17, 2009, at p.10.
[7360] Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 9.
[7361] *Id.*
[7362] Lehman Brothers Company Overview, Third Quarter 2007, at p. 4 [LBEX-LL 2165164].

reporting requirements, strict internal controls, and annual review by the SEC.[7363] LOTC was wholly-owned and fully guaranteed by LBHI.[7364]

(f) LBDP and LBFP

Lehman Brothers Derivative Products, Inc. ("LBDP") and Lehman Brothers Financial Products, Inc. ("LBFP") were AAA-rated derivatives trading entities.[7365] The AAA-ratings were important because some OTC derivatives trading counterparties required a AAA counterparty credit rating in order to do business with Lehman.[7366]

To maintain their AAA ratings, LBDP and LBFP were subject to numerous requirements, including year-end audits, regular issuance of financial statements and monitoring by on-site auditors.[7367] Both had to comply with certain operating guidelines, which Lehman shared with rating agencies and auditors.[7368] They also were required to submit verifications to the rating agencies confirming their compliance with operating and capital requirements.[7369]

[7363] *Id.*

[7364] Lehman, LOTC World Records Report (Sept. 15, 2008) [LBEX-LL-027825]; Corporate Ownership Statement Pursuant to Federal Rule of Bankruptcy Procedure 1007(a)(1) and Local Rule of Bankruptcy Procedure 1007-3, Docket No. 2, *In re Lehman Bros. OTC Derivatives, Inc.*, No. 08-13893 (Bankr. S.D.N.Y. Oct. 3, 2008); Lehman, Unanimous Written Consent of the Executive Committee of the Board of Directors of Lehman Brothers Holdings Inc. (June 9, 2008) [LBEX-AM 003415]. Further details about LOTC's business are found at Section III.C.2.a.1.c of this Report.

[7365] Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 4; Lehman, LBFP World Records Report (Sept. 15, 2008), [LBEX-LL 027860]; LBDP World Records Report (Sept. 15, 2008) [LBEX-LL 027856].

[7366] Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 4; Examiner's Interview of Murtaza Bhalloo, Sept. 14, 2009.

[7367] Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 4; Examiner's Interview of Clifford Feibus, Mar. 12, 2009, at pp. 4-5.

[7368] Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 4.

[7369] *Id.*

LBFP and LBDP monitored their capital levels daily to ensure that they fully complied with the formulas used to calculate their capital requirements.[7370] The formulas established minimum capital requirements based on the credit ratings of LBFP's and LBDP's counterparties and their exposures to those counterparties.[7371] As the market began to decline in the months leading up to LBHI's bankruptcy, these capital requirements increased, but LBFP and LBDP still retained their AAA ratings until their actual bankruptcy filings.[7372]

Both LBDP and LBFP were used to engage in swap and derivative transactions.[7373] They were used primarily for interest rate swaps, and neither entity was involved in credit default swaps.[7374] The entities' counterparty trades were mirrored and supported with margin and collateral from LBSF.[7375] The LBDP and LBFP capital structures were very expensive to maintain, however, so Lehman traders were discouraged from booking trades through them.[7376]

Although LBFP and LBDP were used to trade similar products, they were designed to operate differently upon the occurrence of certain triggering events.

[7370] *Id.*
[7371] *Id.*
[7372] *Id.*
[7373] *Id.* at p. 5; Lehman, LBFP World Records Report (Sept. 15, 2008) [LBEX-LL 027860].
[7374] Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 5.
[7375] *Id.*; e-mail from Mahavir Saida, Lehman, to John E. Martinelli, Lehman, *et al.* (Sept. 15, 2008) [LBEX-DOCID 3620842].
[7376] Examiner's Interview of Kristie Y. Wong, Dec. 2, 2009, at p. 5.

LBFP was a bankruptcy remote vehicle[7377] and was created as a continuation structure, which meant that if certain triggering events occurred (such as its holding company filing for bankruptcy), a contingent manager would step in and continue to trade LBFP's positions.[7378]

In contrast, LBDP was organized as a termination structure[7379] that had a "hard termination feature."[7380] Under this arrangement, all of LBDP's swaps terminated automatically if certain triggering events occurred.[7381] LBDP's termination events included: (1) a downgrade in LBDP's rating; (2) LBSF's failure to deliver or procure delivery of required collateral; (3) LBDP's failure to maintain designated capital requirements; and (4) bankruptcy of LBHI or LBSF.[7382]

Neither LBFP nor LBDP could have survived without LBHI or LBI because they had no independent ability to raise funds.[7383]

[7377] Lehman, LBFP World Records Report (Sept. 15, 2008) [LBEX-LL 027860]; e-mail from Seth L. Konheim, Lehman, to Alexander Pevzner, Lehman, *et al.* (Sept. 18, 2008) [LBEX-DOCID 3620957].

[7378] Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 6; Lehman, LBFP Operating Guidelines [LBEX-BARLEG 0001886].

[7379] Lehman, LBDP World Records Report (Sept. 15, 2008) [LBEX-LL 027856]; Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 5.

[7380] E-mail from Gerald Rizzieri, Lehman, to Brian Finnegan, Lehman (Sept. 17, 2008) [LBEX-DOCID 3592595].

[7381] Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 5; Lehman, LBDP Operating Guidelines, Article Ten (July 16, 1998), at pp. 24-30 [LBEX-BARLEG 00001824].

[7382] Lehman, LBDP Operating Guidelines, Article Ten (July 16, 1998), at pp. 25-26 [LBEX-BARLEG 00001824].

[7383] Examiner's Interview of Murtaza Bhalloo, Sept. 14, 2009, at p. 4.

(g) LBF

Former debtor Lehman Brothers Finance, S.A. ("LBF") was a wholly-owned and fully guaranteed subsidiary of LBHI, and was the entity through which Lehman conducted a substantial portion of its equity derivatives business.[7384] Approximately 50 percent of Lehman's equity derivatives transactions were booked in LBF.[7385] In general, LBF was used to structure and trade global OTC equity derivatives,[7386] including equity derivatives involving complex disbursement formulas.[7387] Most of its counterparties were professional market participants.[7388]

LBF was organized in Switzerland, where it qualified to operate as an unregulated entity.[7389] To maintain this status, LBF restricted its activities to the following:

- execution of OTC derivatives (*i.e.*, options, forwards and swaps) on underlying assets or products;

[7384] Lehman, LBF World Records Report (Sept. 15, 2008) [LBEX-LL 027785]; Joint Declaration of Pascal Portmann and Christiana Suhr Brunner, as Representatives of PricewaterhouseCoopers AG, Zurich, as Bankruptcy Liquidator of Lehman Brothers Finance AG, in Liquidation, a/k/a Lehman Brothers Finance SA, in Liquidation, in Support of Chapter 15 Petition and Motion to Dismiss, at p. 3, Docket No. 10, *In re Lehman Bros. Finance*, No. 09-B-10583, and *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Feb. 10, 2009); Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 9; Examiner's Interview of Kleber Rodriguez, Dec. 19, 2009, at p. 4.

[7385] PricewaterhouseCoopers AG, Zurich, First Report of PricewaterhouseCoopers AG, Zurich, as appointed liquidators to the creditors of Lehman Brothers Finance S.A., Zurich, in liquidation (Sept. 25, 2009), at p. 2.

[7386] Lehman, LBF World Records Report (Sept. 15, 2008) [LBEX-LL 027785].

[7387] PricewaterhouseCoopers AG, Zurich, First Report of PricewaterhouseCoopers AG, Zurich, as appointed liquidators to the creditors of Lehman Brothers Finance S.A., Zurich, in liquidation (Sept. 25, 2009), at p. 2.

[7388] *Id.*

[7389] Lehman, LBF World Records Report (Sept. 15, 2008) [LBEX-LL027785].

- issuance of warrants and certificates;
- trading of securities and listed derivatives only to the extent that it was hedging risk on its derivatives portfolio; and
- securities borrowing and lending or repos only when done with other Lehman entities and when related to the settlement or financing of securities hedging positions.[7390]

LBF was not permitted to borrow Swiss securities, and any trading activity that did not fall into the categories enumerated above was strictly forbidden.[7391]

LBF was highly integrated into the rest of the Lehman organization and relied on employees from other groups to process and book most of its transactions.[7392] LBF relied on data processing systems used by other Lehman entities.[7393]

LBF filed for bankruptcy on October 3, 2008.[7394] It subsequently moved to dismiss its United States bankruptcy proceeding on February 10, 2009.[7395] LBF argued that it was involved in concurrent bankruptcy proceedings in Switzerland that should be recognized as foreign main proceedings under Chapter 15 of the Bankruptcy Code,

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[7390] *Id.*

[7391] *Id.*

[7392] PricewaterhouseCoopers AG, Zurich, First Report of PricewaterhouseCoopers AG, Zurich, as appointed liquidators to the creditors of Lehman Brothers Finance S.A., Zurich, in liquidation (Sept. 25, 2009), at p. 3.

[7393] *Id.*

[7394] Voluntary Petition, at p. 1, Docket No. 1, *Lehman Bros. Finance S.A.*, No. 08-13887 (Bankr. S.D.N.Y. Oct. 3, 2008).

[7395] Motion Pursuant to Section 305 of the Bankruptcy Code for an Order Dismissing Chapter 11 Case upon Recognition of Foreign Main Proceeding Under Chapter 15, Docket No. 2789, *In re Lehman Bros. Finance AG, In Liquidation, a/k/a Lehman Bros. Finance SA, In Liquidation*, No. 09-B-10583, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Feb. 10, 2009).

and that dismissal of the Chapter 11 proceeding was therefore appropriate.[7396] LBF asserted that the Chapter 11 proceeding had been filed on its behalf without appropriate board approval and that it had limited connections to the United States.[7397] On March 12, 2009, the Court recognized the Swiss proceedings as foreign main proceedings for purposes of Chapter 15 of the Bankruptcy Code, and dismissed LBF's Chapter 11 proceeding.[7398] As a result of the dismissal, the Examiner conducted no investigation of this entity.

(h) BNC

BNC Mortgage, Inc., the predecessor to BNC Mortgage LLC ("BNC"), originated subprime mortgages.[7399] BNC Mortgage, Inc. was converted to an LLC, which was organized in Delaware on March 1, 2007, in order to take advantage of certain state tax rules.[7400] Despite this change in corporate structure, BNC continued to originate subprime mortgage loans for a period of several months.[7401] As a result of the collapse

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[7396] *Id.*

[7397] *Id.*

[7398] Order Dismissing Chapter 11 Case of Lehman Brothers Finance AG a/k/a Lehman Brothers Finance SA (No. 08-13887) and Granting Related Relief, at p. 3, *In re Lehman Bros. Finance AG, In Liquidation, a/k/a Lehman Bros. Finance SA, In Liquidation*, Chapter 15 No. 09-10583, *In re Lehman Bros. Holdings Inc.*, No. 08-13555, at p. 3.

[7399] Examiner's Interview of Susan Harrison, Apr. 28, 2009, at p. 4; Examiner's Interview of Marie Jean Burruel, Apr. 28, 2009, at p. 4.

[7400] Lehman, BNC World Records Report (Sept. 15, 2008) [LBEX-LL 027795]; e-mail from Lauren Sheridan, A&M, to Heather D. McArn, Examiner's Counsel (Dec. 30, 2009).

[7401] Examiner's Interview of Susan Harrison, Apr. 28, 2009, at p. 4; Examiner's Interview of Marie Jean Burruel, Apr. 28, 2009, at p. 4 (describing the business of BNC Mortgage, Inc., which was a precursor to BNC Mortgage LLC).

of the market for sub-prime mortgages and related securitized products, Lehman shut down BNC's mortgage origination business in August of 2007.[7402]

(2) LBHI Affiliate Single Purpose Entities

The other LBHI Affiliates were single purpose entities used as holding companies for various real estate, physical and financial assets.

(a) LB 745

LB 745 LLC ("LB 745") was used to acquire and hold Lehman's headquarters building at 745 Seventh Avenue in Manhattan.[7403] According to Schedule 1(b) of the Clarification Letter, LB 745 also owned Lehman's Cranford, New Jersey facility.[7404]

(b) CES Aviation Entities

The CES Aviation entities were part of Lehman's "Corporate Executive Services" group.[7405] CES Aviation LLC ("CES") was used to acquire and hold a Gulfstream G IV jet[7406] for the use of Lehman's executives.[7407] CES Aviation V LLC ("CES V") was used to acquire and hold a Sikorsky S-76C+ helicopter[7408] for the use of Lehman's executives.[7409]

[7402] Examiner's Interview of Marie Jean Burruel, Apr. 28, 2009, at p. 10; Examiner's Interview of Martha Evans, May 22, 2009, at p. 14; LBHI 2007 10-K at p. 5.

[7403] Lehman, LB 745 World Records Report (Sept. 15, 2008) [LBEX-LL 027840].

[7404] Letter agreement among Lehman Brothers Holdings Inc., Lehman Brothers Inc., LB 745 LLC and Barclays Capital, Inc. (Sept. 20, 2008) ("Clarification letter"), at Schedule 1(b).

[7405] Examiner's Interview of Amy Lederer, Oct. 22, 2009, at p. 2.

[7406] Lehman, CES World Records Report (Sept. 15, 2008) [LBEX-LL 027772].

[7407] Examiner's Interview of Amy Lederer, Oct. 22, 2009, at p. 2; Debtors' Motion for Entry of an Order Pursuant to Section 363 of the Bankruptcy Code and Federal Rule of Bankruptcy Procedure 6004 Authorizing Lehman Brothers Holdings Inc. to Enter into a Sale and Purchase Agreement, at pp. 3-4, Docket No. 1033, *In re Lehman Bros. Holdings Inc.,* No. 08-13555 (Bankr. S.D.N.Y. Oct. 15, 2008).

[7408] Lehman, CES V World Records Report (Sept. 15, 2008) [LBEX-LL 027775]; Debtors' Motion Pursuant to Sections 105 and 363 of the Bankruptcy Code, Federal Rules of Bankruptcy Procedure 2002, 6004, and

CES Aviation IX LLC (CES IX) was used to acquire and hold a Falcon 50 jet[7410] for the use of Lehman's executives.[7411]

(c) PAMI Statler

PAMI Statler Arms LLC (PAMI Statler) was a holding company that owned and operated an apartment building located at 1127 Euclid Avenue in Cleveland, Ohio.[7412] PAMI Statler was a subsidiary of PAMI, the parent company for Lehman's real estate holding and asset management business.[7413]

(d) East Dover

East Dover Limited (East Dover) was an Irish company[7414] that leased aircraft to third parties.[7415] By 2008, however, East Dover no longer owned those operating assets, and instead held only an intercompany payable and third party receivables.[7416]

9014, and Rules 6004-1, 9006-1 and 9014-1 of the Local Bankruptcy Rules for Approval of the Sale of Debtors' Aircraft Pursuant to an Aircraft Sale and Purchase Agreement and Payment of Related Fees at p. 2, Docket No. 3003, *In re Lehman Bros. Holdings Inc.,* No. 08-13555 (Bankr. S.D.N.Y. Mar. 5, 2009).

[7409] Examiner's Interview of Amy Lederer, Oct. 22, 2009, at p. 2.

[7410] Lehman, CES IX World Records Report (Sept. 15, 2008) [LBEX-LL 027779]; CES IX Summary of Schedules, *In re Lehman Bros. Holdings Inc.,* No. 08-13907 (Bankr. S.D.N.Y.).

[7411] Examiner's Interview of Amy Lederer, Oct. 22, 2009, at p. 2; Debtors' Motion for Entry of an Order Pursuant to Sections 105 and 363 of the Bankruptcy Code, Federal Rules of Bankruptcy Procedure 2002, 6004 and 9014, and Rules 6004-1, 9006-1 and 9014-1 of the Local Bankruptcy Rules Approving the Sale of the Debtors' Aircraft Pursuant to an Aircraft Sale and Purchase Agreement, at p. 3, Docket No. 1464, *In re Lehman Bros. Holdings Inc.,* No. 08-13555 (Bankr. S.D.N.Y. Nov. 12, 2008).

[7412] Motion of Debtors Seeking Entry of an Order Pursuant to Section 1112(b) of the Bankruptcy Code Dismissing Chapter 11 Case of PAMI Statler, at pp. 3-4, Docket No. 3650, *In re Lehman Bros. Holdings Inc.,* No. 08-13555 (Bankr. S.D.N.Y. May 26, 2009).

[7413] Corporate Ownership Statement Pursuant to Federal Rule of Bankruptcy Procedure 1007(a)(1) and Local Rule of Bankruptcy Procedure 1007-3, Docket No. 2, *In re PAMI Statler Arms LLC*, No. 08-13664 (Bankr. S.D.N.Y. Sept. 23, 2008); Examiner's Interview of Joselito M. Rivera, Oct. 13, 2009, at p. 2.

[7414] Lehman, East Dover World Records Report (Sept. 15, 2008) [LBEX-LL 027782].

[7415] Lehman, East Dover World Records Report (Sept. 15, 2008) [LBEX-LL 027782]; Examiner's Interview of Ada Shek, Nov. 24, 2009, at p. 3; Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 9.

(e) Scottish Finance

Lehman Scottish Finance L.P. ("Scottish Finance") was a single-purpose entity used to invest and hold equity in Luxembourg Finance S.A.R.L. (an entity distinct from LBHI Affiliate Luxembourg Residential Properties Loan Finance S.A.R.L., described below).[7417] Luxembourg Finance S.A.R.L. was involved in the financing of an equity-linked note.[7418] In that transaction, Luxembourg Finance S.A.R.L. entered into an agreement with Relationship Funding Company ("RFC"), pursuant to which RFC issued notes linked to a basket of equity securities.[7419] RFC loaned the proceeds to Luxembourg Finance S.A.R.L., which then re-loaned the proceeds to LBIE and other Lehman affiliates.[7420]

(f) Luxembourg S.A.R.L.

Luxembourg Residential Properties Loan Finance S.A.R.L. ("Luxembourg S.A.R.L.") was a single-purpose entity that held loan assets as part of a financing and asset investment transaction.[7421] As of its bankruptcy filing, S.A.R.L. held

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[7416] Examiner's Interview of Ada Shek, Nov. 24, 2009, at p. 3.

[7417] Examiner's Interview of Joselito M. Rivera, Oct. 13, 2009, at p. 4; Examiner's Interview of Gerald Haupt, Nov. 12, 2009.

[7418] Examiner's Interview of Gerald Haupt, Nov. 12, 2009; Examiner's Interview of Joselito M. Rivera, Oct. 13, 2009, at p. 4.

[7419] Examiner's Interview of Gerald Haupt, Nov. 12, 2009, at p. 2; Loan Agreement between Luxembourg Finance S.A.R.L. and Relationship Funding Company (March 2, 2007), at pp. 4, 11 [LBEX-DOCID 1030326].

[7420] Loan Agreement between Luxembourg Finance S.A.R.L. and Relationship Funding Company (March 2, 2007), at pp. 1, 5, 11, 21 [LBEX-DOCID 1030326].

[7421] Examiner's Interview of Gerald Haupt, Oct. 13, 2009, at p. 2.

$596,884,125.52 in U.S. corporate loans,[7422] consisting of one tranche of loans from the multi-tranche Archstone loan transaction.[7423]

(g) Navigator

Fundo de Investimento Multimercado Credito Privado Navigator Investimento No Exterior ("Navigator") was a Brazilian company that traded agricultural notes and commodities derivatives[7424] for Lehman's Emerging Markets Group trading desk.[7425]

Navigator filed for bankruptcy on October 5, 2008.[7426] It subsequently moved to dismiss its bankruptcy case on February 4, 2009.[7427] Navigator alleged that it had filed bankruptcy because it held a substantial cash balance at the time of Lehman's collapse, and an "inaccurate notation" in Lehman's internal records indicated that it was headquartered in Delaware, not Brazil.[7428] Navigator argued that its inclusion in the United States bankruptcy proceedings inhibited its ability to wind down its Brazilian

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[7422] Luxembourg Residential Properties Loan Finance S.A.R.L. Summary of Schedules, at p. 13, *In re Lehman Bros. Holdings Inc.*, No. 09-10108 (Bankr. S.D.N.Y. Mar. 11, 2009).

[7423] Examiner's Interview of Gerald Haupt, Oct. 13, 2009, at p. 2; e-mail from Lauren Sheridan, Alvarez & Marsal, to Heather D. McArn, Examiner's Counsel (Dec. 30, 2009).

[7424] Examiner's Interview of Ada Shek, Nov. 24, 2009, at p. 9; Motion Seeking Entry of an Order Pursuant to Sections 1112(b) or 305 of the Bankruptcy Code Dismissing the Chapter 11 Case of Fundo de Investimento Multimercado Credito Privado Navigator Investimento No Exterior, at p. 3, Docket No. 9, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Feb. 4, 2009).

[7425] Lehman, Fundo de Investimento Multimercado Credito Privado Navigator Investimento No Exterior World Records Report (Sept. 15, 2008) at p. 1 [LBEX-LL 3660315].

[7426] Voluntary Petition, *In re Fundo de Investimento Multimercado Credito Privado Navigator Investimento No Exterior*, No. 08-13903 (Bankr. S.D.N.Y. Oct. 5, 2008).

[7427] Debtors' Motion Seeking Entry of an Order Pursuant to Sections 1112(b) or 305 of the Bankruptcy Code Dismissing the Chapter 11 Case of Fundo de Investimento Multimercado Credito Privado Navigator Investimento No Exterior, at p. 3, Docket No. 2726, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Feb. 4, 2009).

[7428] *Id.*

business, and dismissal was therefore appropriate.[7429] The Court dismissed Navigator's bankruptcy case on February 24, 2009.[7430] As a result, the Examiner conducted no investigation of this entity.

(3) Sale Transaction[7431]

After LBHI filed for bankruptcy, Lehman and Barclays reached an agreement for Barclays to buy certain assets of LBI, the broker/dealer. Certain creditors have alleged that Barclays may have received assets belonging to the LBHI Affiliates to which it was not entitled.

Shortly after LBHI filed its petition under Chapter 11 of the Bankruptcy Code on September 15, 2008, Lehman and Barclays began to negotiate the sale of LBI's business and assets to Barclays.

On September 17, Lehman and Barclays executed an Asset Purchase Agreement, which was dated as of September 16, 2008 (the "APA"). The APA provided for the sale to Barclays of the following assets, among others:

- the Lehman headquarters building that was located at 745 Seventh Avenue in New York City and Lehman's two New Jersey data centers;[7432]

[7429] Debtors' Motion Seeking Entry of an Order Pursuant to Sections 1112(b) or 305 of the Bankruptcy Code Dismissing the Chapter 11 Case of Fundo de Investimento Multimercado Credito Privado Navigator Investimento No Exterior, at pp. 4-8, Docket No. 2726, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Feb. 4, 2009).

[7430] Order Dismissing the Bankruptcy Case of Fundo de Investimento Multimercado Credito Privado Navigator Investimento No Exterior, at pp. 1-2, Docket No. 2913, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Feb. 24, 2009).

[7431] The Examiner sets forth here the facts pertinent to the analysis of potential LBHI Affiliate asset transfers that follows. A more detailed account of facts relating to the sale transaction is set forth below in Section III.C.6.

- the "business" of LBHI and LBI, which was defined to include "the U.S. and Canadian investment banking and capital markets business of Seller including the fixed income and equities cash trading, brokerage, dealing, trading and advisory businesses, investment banking operations and LBI's business as a futures commission merchant";[7433]

- "all of the assets of [LBHI and LBI] and [their] subsidiaries used in connection with the Business (excluding the Excluded Assets)";[7434]

- "50% of each position in the residential real estate mortgage securities";[7435]

- long positions with a book value of approximately $70 billion;[7436] and

- the "Furniture and Equipment."[7437]

On September 17, the Debtors filed the Sale Motion[7438] asking the Court to schedule a sale hearing and establish sale procedures.

On September 19, certain creditors filed responses and objections to the Sale Motion. Several creditors alleged that the terms of the APA were ambiguous enough to permit assets of Lehman's non-debtor subsidiaries to be included in the sale.[7439]

[7432] Asset Purchase Agreement among Lehman Brothers Holdings Inc., Lehman Brothers Inc., LB 745 LLC and Barclays Capital Inc. (Sept. 16, 2008) (the "APA"), at p. 6 (§ 1.1).

[7433] APA, at p. 2 (§ 1.1).

[7434] *Id.* at p. 6 (§ 1.1).

[7435] *Id.*

[7436] *Id.*

[7437] *Id.* The APA defines "Furniture and Equipment" to include: "all furniture, fixtures, furnishings, equipment, vehicles, leasehold improvements, and other tangible personal property owned or used by Seller and its Subsidiaries in the conduct of the Business, including, all desks, chairs, tables, Hardware, copiers, telephone lines and numbers, telecopy machines and other telecommunication equipment, cubicles and miscellaneous office furnishings and supplies." "Hardware" is defined to include: "any and all computer and computer-related hardware, networks, and peripherals, including, but not limited to, information and communications systems, computers, file servers, facsimile servers, scanners, color printers, laser printers, and networks." *Id.* at 4 (§ 1.1).

[7438] Debtors' Motion to (A) Schedule a Sale Hearing; (B) Establish Sales Procedures; (C) Approve a Break-Up Fee; and (D) Approve the Sale of the Purchased Assets and the Assumption and Assignment of Contracts Relating to the Purchased Assets, Docket No. 60, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 17, 2008) ("Sale Motion").

On September 19, the Court held a sale hearing to consider the proposed transaction with Barclays. At the hearing, the Debtors represented that no assets of non-debtor affiliates were being sold, including those belonging to LBCS.[7440]

On September 20, 2008, the Court entered the Sale Order approving the terms of the sale as embodied in the APA, the First Amendment thereto and an additional "clarifying" document.[7441]

On September 22, 2008, the parties executed a Clarification Letter, which was dated as of September 20, 2008. The Clarification Letter provided, among other things, that the "Purchased Assets" Barclays was buying included "none of the assets of Subsidiaries of LBHI (other than assets of LBI) except as otherwise specifically provided."[7442]

On Monday, September 22, the sale transaction closed. In connection with the sale, almost all of LBI's assets and employees were transferred to Barclays.

[7439] *See, e.g.*, Response of The Walt Disney Company to Debtors' Motion Dated September 17, 2008 for Sale Approval, at pp. 2-4, Docket No. 183, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 19, 2008); Limited Objection and Reservation of Rights of Ad Hoc Committee of Bondholders to Debtors' Motion to (A) Schedule a Sale Hearing; (B) Establish Sales Procedures; (C) Approve a Break-Up Fee; and (D) Approve the Sale of the Purchased Assets and the Assumption and Assignment of Contracts Relating to the Purchased Assets, at p. 3, Docket No. 161, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 19, 2008).

[7440] Transcript of hearing, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 19, 2008, at pp. 88-89, 226 (Fife).

[7441] Order Under 11 U.S.C. §§ 105(a), 363, and 365 and Federal Rules of Bankruptcy Procedure 2002, 6004 and 6006 Authorizing and Approving (A) the Sale of Purchased Assets Free and Clear of Liens and Other Interests and (B) Assumption and Assignment of Executory Contracts and Unexpired Leases, at pp. 1, 12, Docket No. 258, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 20, 2008).

[7442] Clarification Letter, at p. 1.

Barclays immediately took over Lehman's facilities at 745 Seventh Avenue.[7443] Because many of the LBHI Affiliates conducted their operations out of the 745 Seventh Avenue headquarters, when it took over the building, Barclays assumed possession of many of the fixed assets used in LBHI Affiliate business operations, such as furniture and computer and communications equipment.[7444] Given the integrated manner in which Lehman operated its business and the short period of time surrounding the sale, the Examiner has concluded that it would have been nearly impossible for Lehman or Barclays to identify which fixed assets belonged to which legal entities prior to the sale, and the Debtors did not attempt to do so until later.[7445]

As part of the sale transaction, Barclays acquired various intellectual property assets from Lehman.[7446] Though Lehman separated some hardware and software components for Nomura, and also segregated most of Neuberger Berman's intellectual property assets, all other technology assets were transferred to Barclays wholesale.[7447] The Examiner was advised that it would not have been feasible to isolate software components in the limited time available during the week between the sale negotiations

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[7443] Examiner's Interview of Thomas E. Hommel, Kelly L. Gargiulo, Lauren Sheridan, William B. Gordon, and Jeffrey Donaldson, Jan. 22, 2010.

[7444] *Id.*

[7445] *Id.*

[7446] APA at p. 8 (§ 1.1); *see also* Intellectual Property Assignment Agreement Among Lehman Brothers Holdings Inc., Lehman Brothers Inc., LB 745 LLC and Barclays Capital Inc. (Sept. 22, 2008), at p. 1.

[7447] Examiner's Interview of Thomas E. Hommel, Kelly L. Gargiulo, Lauren Sheridan, William B. Gordon and Jeffrey Donaldson, Jan. 22, 2010.

and the beginning of the transition.[7448] As a result, any intangible assets of the LBHI Affiliates that were housed in Lehman's consolidated computer systems and networks would have been swept up in the transfer.

There was no effort made to segregate employees allocated to LBHI Affiliates from the group to whom Barclays offered employment in the context of the sale. As part of its purchase of LBI's assets, Barclays was to purchase most of the businesses that comprised Lehman's Fixed Income Division ("FID"). Lehman human resources personnel compiled a list of all FID employees, identified a few who had already been given notice of termination pre-bankruptcy, as well as certain corporate officers, legal staff and human resources personnel who were essential to the wind down of the Debtors' business, and designated the remainder for transfer to Barclays.[7449] It would have been difficult (if not impossible) to identify and hold back employees allocated to the LBHI Affiliates during that time period, particularly given that most Lehman employees were actually employed by LBI and did not understand that they were employees of an LBHI Affiliate, even though they may have performed services for them.[7450]

[7448] *Id.; Accord* Examiner's Interview of Jeffrey Osterman, Jan. 28, 2010.

[7449] Examiner's Interview of Tracy Binkley, Dec. 22, 2009; e-mail from Tracy Binkley, Lehman, to Steven Berkenfeld, Lehman (Sept. 23, 2008) [BCI-EX-(S)-00005498].

[7450] Examiner's Interview of Tracy Binkley, Dec. 22, 2009; s*ee*, *e.g.*, letter from Christopher M. O'Meara, Lehman, to John DeRosa, Lehman, re: employment offer (Nov. 10, 2006), at p. 2 [LBEX-AM 023144]; e-mail from Kaushik Amin, Lehman, to Herbert H. McDade, III, Lehman (Sept. 19, 2008) [LBHI_SEC07940_656489]; e-mail from Paul Gregg, Lehman, to Peter Keavey, Lehman (Sept. 16, 2008) [LBEX-DOCID 3571486] (employees allocated to LBCS discussing transfer of LBI employees to Barclays

As a result, the Debtors were left with few legacy Lehman employees to assist in the wind down of their businesses, and only limited access to Lehman's books and computer systems in the immediate aftermath of LBHI's bankruptcy filing and the sale to Barclays.[7451] The Debtors' lack of access to computer systems and personnel made it very difficult to manage the wind down of the Debtors' remaining businesses, and they had little institutional knowledge upon which to draw.[7452]

Throughout the fall and winter of 2008, the Debtors pushed Barclays to grant additional access to legacy Lehman systems that Barclays had received in the sale, and several disputes arose concerning transition service obligations.[7453] The situation improved over time.

The Debtors and Barclays eventually engaged in discussions over who owned certain former assets of the Debtors.[7454] In the summer of 2009, the Debtors ultimately moved the Bankruptcy Court to authorize a repurchase of certain equipment and other

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and noting "that's us"); Examiner's Interview of Jonathan D. Williams, Aug. 5, 2009, at p. 4; transcript of deposition testimony of Bryan P. Marsal, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Dec. 22, 2009, at p. 32.

[7451] Examiner's Interview of Thomas E. Hommel, Kelly L. Gargiulo, Lauren Sheridan, William B. Gordon and Jeffrey Donaldson, Jan. 22, 2010.

[7452] *Id.*; transcript of deposition testimony of Bryan P. Marsal, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Dec. 22, 2009, at pp. 29-30.

[7453] Examiner's Interview of Thomas E. Hommel, Kelly L. Gargiulo, Lauren Sheridan, William B. Gordon and Jeffrey Donaldson, Jan. 22, 2010; transcript of deposition testimony of Bryan P. Marsal, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Dec. 22, 2009, at pp. 37-38; Alvarez & Marsal, Lehman Bros. Holdings Inc., Report to Unsecured Creditors Committee (Nov. 13, 2008), at pp. 29-31 [LBEX-AM 5641910].

[7454] Examiner's Interview of Thomas E. Hommel, Kelly L. Gargiulo, Lauren Sheridan, William B. Gordon and Jeffrey Donaldson, Jan. 22, 2010.

physical assets from Barclays to allow it to renegotiate its lease.[7455] That motion did not address any LBHI Affiliate Assets that may have been transferred to Barclays.[7456]

Though Barclays and the Debtors have engaged in discussions and negotiations to resolve asset ownership issues as between themselves, including in connection with transition services disputes and negotiations relating to the summer 2009 repurchase of furniture and equipment, the Examiner has investigated the assets of LBHI Affiliates pursuant to the Court's charge.

3. Whether Assets of LBHI Affiliates Were Transferred to Barclays

As indicated above, in the Examiner Order the Court directed the Examiner to investigate:

> Whether assets of any LBHI Affiliates (other than Lehman Brothers, Inc.) were transferred to Barclays Capital Inc. as a result of the sale to Barclays Capital Inc. that was approved by order of the Bankruptcy Court entered September 20, 2008, and whether consequences to any LBHI Affiliate as a result of the consummation of the transaction created colorable causes of action that inure to the benefit of the creditors of such LBHI subsidiary or affiliate.[7457]

As instructed by the Court, with respect to each LBHI Affiliate, the Examiner performed an investigation to determine the assets that each LBHI Affiliate owned prior to LBHI's bankruptcy filing, and examined whether there were indications that any of those assets were improperly transferred to Barclays in connection with the sale. The Examiner

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[7455] *See* Motion of Lehman Bros. Holdings Inc. Pursuant to Sections 105(a) and 363 of the Bankruptcy Code for Authorization to Purchase Certain Furniture, Fixtures and Equipment from Barclays Capital Inc., Docket No. 3774, *In re Lehman Bros. Holdings Inc.,* No. 08-13555 (Bankr. S.D.N.Y. June 4, 2009).

[7456] *Id*.

[7457] Examiner Order, at p. 4 (sixth bullet).

used the following methodologies to reach the factual conclusions set forth in this section of the Report.

a) Analysis of Securities Transferred to Barclays

Most of the assets LBI transferred to Barclays in connection with the sale were securities. Several LBHI Affiliates were involved in securities trading and financing activities. Consequently, a natural area of inquiry for the Examiner was to determine whether any of the securities transferred to Barclays were not owned by LBI, but rather by LBHI Affiliates.

Some LBHI Affiliates owned or held majority interests in subsidiaries that were not the subject of bankruptcy proceedings, but were engaged in substantial securities trading and financing activities ("LBHI Affiliate Subsidiaries"). Transfers of their securities to Barclays, if made, would have negatively impacted the value of the LBHI Affiliates' assets – namely a reduction in the value of their stock or other ownership interests in the LBHI Affiliate Subsidiaries. For purposes of this Section of the Report, therefore, the Examiner also investigated whether securities owned by any LBHI Affiliate Subsidiaries were transferred to Barclays.[7458]

In order to evaluate whether any securities owned by LBHI Affiliates or LBHI Affiliate Subsidiaries ("LBHI Affiliate Entities") had been transferred to Barclays, the

[7458] The Examiner's financial advisors identified LBHI Affiliate Subsidiaries based upon organization charts sourced from Lehman's World Records [LBEX-LL 3668280-314]. Based upon this review, the only LBHI Affiliate Subsidiary associated with a security transferred to Barclays was L.B. Pass-Through Securities, Inc., which was identified as an LCPI subsidiary.

Examiner's financial advisors first tested the integrity of the various Lehman systems used to track ownership and transfers of securities held by Lehman entities.[7459] The Examiner's financial advisors then used those systems to determine whether any securities owned by LBHI Affiliate Entities were transferred to Barclays. The Examiner investigated not only whether any securities reflected in the securities inventories of LBHI Affiliate Entities were transferred to Barclays, but also (where applicable) how securities were transferred from LBHI Affiliate Entities to LBI in order to determine whether LBI had the right to in turn transfer the securities to Barclays. As part of this inquiry, the Examiner also examined whether any securities transfers to LBI took place after September 12, 2008; after that date, it is questionable whether any LBHI Affiliate Entities should have continued to expect that LBI would be able to satisfy intercompany obligations arising from non-cash settled transfers of securities from an LBHI Affiliate Entity to LBI. The Examiner also conducted interviews, and consulted with parties in interest in the Debtors' cases, to confirm his findings.

(1) Securities Transferred to Barclays

Securities worth tens of billions of dollars were transferred to Barclays in connection with the sale transaction. However, those securities were not the same set of securities described in the APA and Sale Motion. The APA and Sale Motion described the transfer to Barclays of a relatively balanced book of "short" and "long" securities

[7459] As explained in the introduction to this Section, this Report does not address LBHI Affiliate Entities whose chapter 11 cases have been dismissed, and which are no longer pending before this Court.

positions in which Barclays did not hold a pre-existing interest. In contrast, most of the securities that ultimately were transferred to Barclays were securities that were the subject of the Replacement Transaction,[7460] and thus were securities over which Barclays already exerted control prior to the sale; those securities were listed on Schedule A to the final version of the Clarification Letter. LBI also was supposed to transfer to Barclays the securities listed on Schedule B to the Clarification Letter (the so-called "bag of hammers").[7461]

Documents and witness interviews show that Schedules A and B to the Clarification Letter were not prepared and finalized contemporaneously with the September 22, 2008 closing of the sale to Barclays. Instead, a number of days elapsed after the sale closing during which Barclays, the SIPA Trustee and the Debtors continued to negotiate and reconcile precisely which securities had been transferred to Barclays as part of the sale. As late as September 29, 2008, according to an e-mail from Paolo R. Tonucci, Schedules A and B included "what we believe to have been transferred to Barclays, and what we expect to transfer to Barclays in the forthcoming

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[7460] As described in Section III.C.6.f.1 of the Report, the Replacement Transaction was the September 18, 2009 pre-sale transaction pursuant to which Barclays replaced the FRBNY as the primary repo lender to LBI and stepped into the FRBNY's $45 billion repo lending position.

[7461] "Bag of hammers" was a phrase coined during the closing weekend to describe the basket of miscellaneous additional securities that were identified for transfer to Barclays. As explained in one interview, the miscellaneous securities were like a "bag of hammers" because although a single hammer might be a valuable tool, an entire bag of hammers would be clumsy and less desirable (and therefore less valuable) because a worker does not need an entire bag of hammers, and it would take significant time and effort for the worker to deal with all of the hammers. Examiner's Interview of James P. Seery, Jr., Nov. 12, 2009.

days," and Tonucci was "awaiting final confirmation" of that fact.[7462] Tonucci further stated that Schedule B included "those assets that have not yet been transferred but we expect to transfer, as well as assets transferred on Friday 19 September."[7463] Thus, the parties continued to refine which securities were included in Schedules A and B, and to effectuate the transfer of certain of those securities to Barclays, well after the closing date.

It appears that the parties finally settled upon the securities that were supposed to comprise Schedule A and Schedule B in early October. Schedule A consisted of 8,514 different CUSIP identifiers,[7464] and included a list of par amounts and brief descriptions.[7465] In total, $69.8 billion in par value is represented on Schedule A. Schedule B consisted of 3,917 CUSIP identifiers, and also included par amounts and brief descriptions.[7466] In total, $2.8 billion in par value is represented on Schedule B. The total number of unique CUSIPs presented on Schedule A was 7,913, and the total number of unique CUSIPs presented on Schedule B was 3,834. Of the CUSIPs appearing on Schedules A and B, 490 CUSIP identifiers appeared on both schedules. The aggregate number of "unique" CUSIP identifiers on Schedules A and B was 11,257

[7462] E-mail from Paolo R. Tonucci, Lehman, to David Murgio, Weil, *et al.* (Sept. 29, 2008) [WGM-00002540].

[7463] *Id.*

[7464] "CUSIP stands for Committee on Uniform Securities Identification Procedures. A CUSIP identifies most securities, including: stocks of all registered U.S. and Canadian companies, and U.S. government and municipal bonds. . . . The [CUSIP] number consists of nine characters (including letters and numbers) that uniquely identify a company or issuer and the type of security." *See* Securities and Exchange Commission, CUSIP Number, http://www.sec.gov/answers/cusip.htm (last visited Feb. 2, 2010).

[7465] Clarification Letter, at p. 1 (¶ 1(a)(ii)(A)) (providing for Schedule A).

[7466] *Id.* at p. 1 (¶ 1(a)(ii)(B)) (providing for Schedule B).

(the 11,747 total number of CUSIPs presented on Schedules A and B, less the 490 non-unique CUSIP identifiers appearing on both Schedules A and B).

A number of the securities listed on Schedule B apparently were never delivered to Barclays. On December 29, 2008, Barclays' counsel sent a letter to the SIPA Trustee indicating that under Section 1(a)(ii)(B) of the Clarification Letter, Barclays was expecting delivery in connection with the sale of not only the securities listed on Schedule B, but also "such securities and other assets held in LBI's 'clearance boxes' as of the time of Closing," which "are still in LBI's clearance boxes."[7467] Barclays' counsel stated that Barclays only was seeking such securities to the extent that there were no customer "long" positions associated with the CUSIPs, or to the extent that the security quantities in the clearance boxes exceeded the quantities of customer long positions.[7468]

Barclays confirmed to the Examiner shortly before the delivery of this Report that, as of January 22, 2010, the only Schedule B securities which had been delivered to Barclays were the securities delivered prior to and including September 30, 2008 ($1.035 billion on September 19, $269 million on September 29, and $161 million on September 30, all valued per Lehman's marks); that Barclays' position is that 814 CUSIPs listed on Schedule B either have not yet been delivered or were delivered in incorrect quantities; and that additional securities in the clearance boxes must still be delivered to Barclays

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[7467] Letter from Lindsee P. Granfield, Cleary Gottlieb, to James B. Kobak, Jr., Hughes Hubbard (Dec. 29, 2008), at p. 1 [LBEX-AM 5641781].
[7468] *Id.*

in connection with the sale.[7469] Because they were specifically identified in Schedule B, the Examiner's analysis of securities delivered (or to be delivered) to Barclays included the 814 CUSIPs on Schedule B which Barclays asserts either were not delivered or were delivered in incorrect quantities. The Examiner has not included in this analysis any additional securities that may be in LBI clearance boxes.[7470]

In December 2008, additional securities were transferred to Barclays in settlement of certain claims arising from the sale, pursuant to the settlement agreement among JPMorgan, Barclays and the SIPA Trustee approved by Court Order dated December 22, 2008.[7471] Those additional securities are identified in an attachment (Annex A to Settlement Agreement) to a December 5, 2008 letter from Barclays' counsel delivered to the Court in connection with the hearing on approval of the settlement.[7472] Annex A identified – by CUSIP, class of security, type of security and face value of remaining par amount of the debt securities and the number of shares of the equity securities – the securities transferred to Barclays under the settlement.[7473] In total, Annex A included 1,192 CUSIPs with a total par value of $19.9 billion.[7474] Of the 1,192

[7469] Schedule B Securities List [LBEX-BAR 000421], attached to e-mail from Jack G. Stern, Boies Schiller, to Vincent E. Lazar, Examiner's Counsel (Jan. 22, 2010).

[7470] Whether any additional securities in the LBI clearance boxes will be delivered is the subject of dispute between Barclays and the SIPA Trustee.

[7471] *See* Section III.D.8.c.

[7472] *See* Annex A to Settlement Agreement (Dec. 5, 2008) [BCI-EX-00077246], attached to letter from Lindsee P. Granfield, Cleary Gottlieb, to Honorable James M. Peck, S.D.N.Y. Bankr., *In re Lehman Bros. Inc.*, No. 08-01420 (Dec. 5. 2008) [BCI-EX-00077244].

[7473] *See* Annex A to Settlement Agreement (Dec. 5, 2008) [BCI-EX-00077246].

[7474] *Id.*

CUSIPs appearing on Annex A, 53 are not unique and also appeared on either Schedule A or B.

Schedule A, Schedule B and Annex A (together, the "Securities Lists") did not specify the owner of the securities transferred to Barclays. Multiple Lehman entities held interests in securities bearing the same CUSIP identifiers, and thus in many cases ownership of the securities transferred to Barclays could not be determined (or excluded) simply by reference to data in the Global Funding System ("GFS") described below. As an example, a total of $9.2 million par value of Sirius XM Radio Inc. CUSIP No. 82967N108 appeared in GFS in the securities inventories of LBI and LBHI Affiliates. $7.6 million (par value) of this CUSIP was transferred to Barclays as part of the sale. GFS indicates $8,612,319 (par value) in securities bearing this CUSIP identifier were held in LBI's securities inventory, $586,665 (par value) were held by LBSF and $3,788 (par value) were held by LOTC. There is no way to determine simply by examining CUSIP identifiers whether the $7.6 million (par value) in securities bearing this CUSIP identifier transferred to Barclays were LBI, LBSF or LOTC securities, or even some combination thereof.

Because there were numerous circumstances like this in which CUSIP identifiers were not unique to only one Lehman entity, the Examiner performed several different factual and legal analyses to determine whether any LBHI Affiliate Entity securities were transferred to Barclays.

(a) Lehman's Securities Trading Records and Systems

(i) General

GFS is a robust Lehman-developed data warehouse that served as the primary system Lehman used (and Barclays still uses) to track financing requirements and capabilities, to track securities in Lehman's custody by legal entity and to feed legal entity balance sheet data for Lehman's financial assets into Lehman's corporate general ledger ("DBS").[7475] While GFS was the system used to track Lehman's securities, multiple source systems fed relevant data into GFS. As such, GFS reflected consolidated positions and balances for Lehman legal entities as aggregated from multiple Lehman source systems.

Generally speaking, trades were recorded in one of the following Lehman systems: MTS (Mainframe Trading System), the system Lehman used to support the trade capture and settlement of U.S. dollar denominated fixed-income products;[7476] ITS, Lehman's multi-currency trade processing-system;[7477] TMS, a system Lehman used to process domestic LBI activity in listed and OTC equities, municipal bonds, corporate bonds and money market instruments[7478] and RISC, a commodity trade reporting system used to process (among other transactions) foreign exchange transactions, as well as futures and forward transactions related to fixed income products such as US

[7475] Global Funding System ("GFS") New User Training [LBEX-LL 3396270]; GFS System Description found on LehmanLive intranet.

[7476] MTS description in LehmanLive intranet.

[7477] ITS description in LehmanLive intranet.

[7478] TMS description in LehmanLive intranet.

treasuries or corporate bonds.[7479] Data from these systems was aggregated in the Activity, Positions and Balances ("APB") system. APB was primarily a central repository for data relating to several Lehman trading systems and contained end-of-day activities, trades, failed trades and positions for all listed products, including listed derivatives.[7480] The APB system differs from GFS in that the APB system accumulated all of the daily trade history from various trading systems, while GFS provided balance sheet and financing positions, typically at month-end.

The Examiner's financial advisors used GFS as their primary source for information about the LBHI Affiliate Entities' securities inventories and positions. The GFS information accessed by the Examiner's financial advisors not only included month-end data, but also data for two mid-month dates relevant to the Examiner's investigation – September 12, 2008 (the last trading day immediately preceding the LBHI petition date) and September 19, 2008 (which was the LBI petition date and the last trading date prior to the Barclays' sale transaction). The Examiner used the September 12, 2008 dataset to perform the securities analyses presented herein. The Examiner selected the September 12, 2008 dataset (as opposed to the September 19, 2008 dataset) after consultation with Lehman employees, Barclays personnel and A&M professionals, all of whom shared a common concern that standard daily protocols were

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[7479] Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 2; Examiner's Interview of Rob Eby, Jan. 6, 2010, at pp. 2-6.
[7480] APB description in Lehman Live intranet.

not consistently followed during the week ending September 19, 2008 as a consequence of the atypical market conditions and the extraordinary business disruption that occurred during that week. There was sufficient concern about the quality of the September 19, 2008 dataset to justify the selection of the September 12, 2008 dataset as the basis for the Examiner's analysis.

Because the Examiner used the September 12, 2008 dataset, it was possible that some transfers of securities from LBHI Affiliate Entities to LBI took place between September 15 and September 19, 2008. Although several sources indicated that no securities had been transferred from LBHI Affiliate Entities to LBI following LBHI's bankruptcy (other than transfers relating to public customer transactions), the Examiner's financial advisors reviewed trading activity during the week beginning September 15 and determined that two of the LBHI Affiliate Entities, LBSF and LCPI, continued to engage in a material amount of trading with LBI during that week.[7481] The Examiner evaluated the LBSF and LCPI trading activity which occurred during the week of September 15, and, as described below, determined that the trading activity was not improper and did not improve LBI's position vis-à-vis these LBHI Affiliate Entities.

[7481] The Examiner's financial advisors' review did not indicate that other LBHI Affiliates engaged in significant securities trading activity with LBI after September 12, 2008.

(ii) GFS System Assessment

The Examiner conducted several interviews to assess the capabilities and reliability of GFS. Criticisms of GFS included concerns regarding the reliability of valuation data and other data quality issues.[7482] GFS reports, however, were prepared daily and identified the financial assets each Lehman entity was holding on its respective balance sheet. The Legal Entity Controller group relied on these reports, in part, to monitor each legal entity's daily inventory positions.[7483] In addition, GFS provided the "inventory subledger" that was used as the basis for creating quarterly consolidated financial statements[7484] and was consistently referred to as the primary system used to track security inventory data.[7485]

Because the Examiner's financial advisors relied heavily on electronic data (and in particular the GFS information) to determine ownership of securities, they performed two distinct tests in order to gain sufficient confidence that GFS contained reliable information for the purpose of this analysis. The first test involved a comparison of the data reported by GFS to Lehman's 10-Q filings. The second test, which provided an additional check, compared the GFS data to Lehman's general ledger.

[7482] Examiner's Interview of Kristie Y. Wong, Dec. 2, 2009, at p. 4; e-mail from James Guarino, Barclays, to Akshay Bhargava, Duff & Phelps (Jan. 21, 2010).

[7483] Examiner's Interview of Kristie Y. Wong, Dec. 2, 2009, at p.4.

[7484] *Id.*

[7485] Global Funding System ("GFS") New User Training [LBEX-LL 3396270]; GFS System Description found on LehmanLive intranet.

a. Comparison of GFS Data to Lehman's 10-Q Filings

The Examiner's financial advisors obtained a copy of the reconciliation between the general ledger and GFS data that had been prepared by Lehman employees in connection with the Lehman financial statement consolidation for the first three quarters of 2008. This reconciliation was created for the purpose of supporting Lehman's FAS 157 Fair Value Balance Sheet footnote. The Examiner's ability to leverage the work performed by Lehman estate employees minimized the time and expense required to vet the data.

The Examiner's financial advisors prepared a comparison of the balances on the reconciliation worksheet with the balances reported on the 10-Qs. Only *de minimis* differences, which were determined to be immaterial relative to the overall balance sheet for those periods, were noted.

b. Comparison of GFS Data to Lehman's General Ledger

The Examiner's financial advisors also obtained GFS data for the first quarter (quarter ended February 29, 2008) and the second quarter (quarter ended May 31, 2008) of 2008 for a sample of two LBHI Affiliates, namely LBCC and LBCS. The Examiner's financial advisors summarized the GFS data for those periods by GAAP Asset Class.[7486] The Examiner's financial advisors then compared each of those GFS asset amounts to

[7486] Lehman categorized inventory in one of three "Asset Classes" based upon the apparent quality of inputs involved in determining valuation. Lehman's Asset Classes 1, 2 and 3 corresponded to the accounting literature's "Hierarchy Levels" 1, 2 and 3. This designation is required for reporting purposes according to the Statement of Fin. Accounting Standards No. 157, ¶ 22.

the corresponding accounts within the general ledger for each sample entity. The general ledger data was obtained using Essbase, which is a Lehman software program designed to extract general ledger data. The Examiner's financial advisors identified some differences for each entity, but determined that the differences were immaterial relative to the account balances in the general ledger. They further noted that the differences likely were attributable to closing adjustments subsequently made by Lehman personnel.

c. Reliability of September 12 Data

Based on the results of these sample tests (and the 10-Q filings reconciliation in particular) as well as several interviews, the Examiner's financial advisors maintained a sufficient level of confidence in the September 12, 2008 and earlier GFS data used for the purpose of this analysis.

(iii) GFS Data Extracted by Examiner

The Examiner's financial advisors used GFS's search capabilities to extract information for each CUSIP appearing on the Securities Lists. They relied upon the GFS "Positions Group" (also referred to as the "Balance Sheet Module") reporting functions to extract that data.

The Examiner's financial advisors extracted all relevant data fields from the Balance Sheet Module. Because the Balance Sheet Module does not take into account the impact of repurchase agreements, reverse repurchase agreements, stock loans, or

stock borrowing trades (collectively, "Financing Positions"), the Examiner's financial advisors also extracted relevant fields from the GFS "Trades Group" (also referred to as the "Financing Module"), which does incorporate the impact of Financing Positions. Data from the Financing Module served as a quality control check for certain fields extracted from the Balance Sheet Module.[7487] As explained in more detail below, data from the Financing Module was relevant to the Examiner's analysis because a security reflected in the securities inventory of an entity for balance sheet reporting purposes (and therefore appearing in the Balance Sheet Module) may have been traded to an affiliate in connection with a financing arrangement (for example, a repo).

A significant GFS limitation was that GFS did not capture certain Financing Positions for securities traded on Lehman's TMS trading system.[7488] As of September 2008, TMS had not yet been fully integrated into GFS, and therefore for any CUSIP where the source system that captured positions at September 12, 2008 was TMS, the Financing Positions for that CUSIP would not be reflected in the GFS Financing Module data.[7489] The Financing Positions for certain securities traded on Lehman's TMS are discussed in more detail below.

[7487] As explained below, the Examiner's financial advisors sampled 35 CUSIPs from the Securities List and examined the GFS data for these 35 CUSIPs in both the Balance Sheet Module and Financing Module. The data consistently demonstrated that GFS properly reflected open Financing Positions on September 12, 2008 between LBI and its affiliates.

[7488] *See* Duff & Phelps' Interview of Sven Farup, Sept. 24, 2009.

[7489] *Id*.

(2) Analysis of GFS Data

LBI was the primary broker/dealer through which Lehman entities conducted domestic securities trading activities. As such, LBI served as a repository and through-way for much of Lehman's securities inventory, and securities under its control would have included securities belonging to an affiliate that LBI may not have had the right to transfer to third parties, such as securities LBI held in custody for an affiliate or which the affiliate had delivered to LBI in connection with a third party transaction. The LBHI Affiliate Entities relied on LBI to provide a full range of broker/dealer services, including buying and selling securities, custodial services and financing using securities as collateral, and therefore securities were held by LBI in numerous different capacities.

The Examiner's financial advisors analyzed the data for the 11,257 unique CUSIPs presented in Schedules A and B, and the 1,192 CUSIPs presented in Annex A.[7490] The Examiner's financial advisors used GFS's search capabilities to extract, for each CUSIP appearing on the Securities Lists, both the Balance Sheet Module positions and Financing Module positions (consolidated by legal entity). Using the data extracted from GFS, the Examiner's financial advisors were able to identify the balance sheet positions and value, par or market, for many (but not all) of the securities transferred to Barclays.

[7490] As noted above, no CUSIPs were repeated in the 1,192 securities listed in Annex A (each CUSIP was unique to that list); however, 53 of the CUSIPs listed in Annex A also were reflected in Schedules A and B.

Of the 11,257 unique CUSIPs presented in Schedules A and B, and the 1,192 CUSIPs presented in Annex A, the Examiner's financial advisors identified 9,472 CUSIPs that did not appear in the balance sheet inventories of the LBHI Affiliate Entities as of September 12, 2008. Because the balance sheet inventories of these LBHI Affiliate Entities included no record of ownership of any securities bearing those 9,472 CUSIPs, the Examiner's financial advisors concluded that there was a very low probability that securities bearing those 9,472 CUSIPs were owned by an LBHI Affiliate Entity. Of the remaining securities transferred to Barclays, securities bearing 14 CUSIPs sold to Barclays with a par value of $0.6 million were associated in GFS with only an LBHI Affiliate Entity as of September 12, 2008; securities bearing 2,136 CUSIPs with $6.1 billion in par value were associated in GFS with both LBI and at least one LBHI Affiliate Entity as of September 12, 2008;[7491] and securities bearing 817 of the CUSIPs transferred to Barclays (795 from Schedules A and B and 22 from Annex A) with a par value of $695.8 million were not reflected at all in the Positions Group within GFS as of September 12, 2008. Ten additional CUSIPs with $13.5 million in par value were associated in GFS with "blank" legal entity fields.[7492]

[7491] The Examiner did not consider further analysis of those securities because, based upon the aggregate par value of these securities and the various potential defenses to any claims described herein, they were deemed immaterial for purposes of the ownership analysis and unlikely to give rise to any colorable claims. A list of these securities is attached as Appendix 29, CUSIPs associated with both LBI and LBHI Affiliate Entities prepared by Duff & Phelps.

[7492] For a list of these CUSIPs, see Appendix 26.

(a) CUSIPs Not Associated With LBHI Affiliate Entities

To determine whether any securities reflected on the balance sheet inventories of LBHI Affiliate Entities might have been transferred to Barclays, the Examiner's financial advisors relied upon and used data extracted from Lehman's GFS application to trace CUSIPs to the respective balance sheets of the Lehman legal entities as of September 12, 2008, the last date for which reasonably accurate balance sheet and other financial information was available, and used that data to reduce the aggregate number of securities the Examiner's financial advisors would need to examine.

The Examiner's financial advisors reviewed the data extracted from GFS and identified (i) CUSIPs which had some association with an LBHI Affiliate Entity, and (ii) CUSIPs for which there was no data found in GFS. The remaining CUSIPs were associated only with non-LBHI Affiliates (*i.e.*, CUSIPs that the LBHI Affiliate Entities did not reflect in their Balance Sheet inventories as of September 12, 2008). Understanding that GFS was the primary system used by Lehman to track balance sheet positions related to securities, the Examiner's financial advisors determined that this population of 9,472 CUSIPs presented a low probability that securities bearing such a CUSIP might have been owned by an LBHI Affiliate Entity at the time of the Barclays'

sale transaction. As a result, the securities bearing those 9,472 CUSIPs associated only with non-LBHI Affiliate Entities were excluded from further analysis.[7493]

(b) CUSIPs Associated Solely With an LBHI Affiliate Entity

Securities bearing 14 CUSIPs sold to Barclays with a par value of $0.6 million were associated in the GFS Balance Sheet Module with only an LBHI Affiliate Entity as of September 12, 2008. All 14 CUSIPs were associated solely with LBSF. The Examiner's financial advisors found that trading information for all 14 CUSIPs was captured by the TMS trading system which, as previously noted, was not fully integrated into GFS as of September 2008. As a result, GFS did not include complete data regarding potential financing trades involving these CUSIPs.

It is quite possible that the securities bearing these 14 CUSIPs transferred to Barclays were held by LBI in custody for LBSF, or were intended for delivery to a third party; however, it is also possible that these securities had been delivered by LBSF to LBI as part of a financing transaction. Regardless of the reason, given the Examiner's conclusions about Barclays' likely protected purchaser and securities intermediary defenses (*see* Section III.5.b.1) and LBSF's subordination agreement with LBI described below, as well as the immateriality ($0.6 million par value) of these securities to the Debtors' estates, the Examiner determined that it would not be a prudent use of the

[7493] A summary of the 9,472 CUSIPs excluded on the basis of lack of a balance sheet or Financing Position connection in GFS to an LBHI Affiliate Entity is attached as Appendix 27, CUSIPs not associated with an LBHI Affiliated prepared by Duff & Phelps.

Estate's resources to further investigate whether these securities should have been available for LBI to transfer to Barclays.[7494]

(c) CUSIPs Associated With Both LBI and LBHI Affiliate Entities

Securities bearing 2,136 CUSIPs with $6.1 billion in par value were associated in GFS with both at least one LBHI Affiliate Entity and another Lehman entity (primarily LBI) as of September 12, 2008. A list of these securities is included in Appendix 29 hereto. These securities formed the basis for further review and investigation on the part of the Examiner.

(i) CUSIPs Associated With Subordinated Entities

Several LBHI Affiliate Entities – including LBSF, LBCC and LBF – were parties to subordination agreements with LBI that generally conformed to the format specified in federal regulations.[7495] Under these regulations, subordination agreements are intended to "effectively subordinate any right of the lender to receive any Payment with respect thereto, together with accrued interest or compensation, to the prior payment or provision for payment in full of all claims of all present and future creditors of the

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[7494] A list of these 14 securities is attached as Appendix 28, CUSIPs associated solely with an LBHI Affiliate proposed by Duff & Phelps.

[7495] *See* 17 C.F.R. §§ 240.15c3-1d; *see also* Subordination Agreement between Lehman Brothers Inc. and Lehman Brothers Special Financing, Inc. (Feb. 21, 1995), at p. 1 [LBEX-SIPA 007456]; Subordination Agreement between Lehman Brothers Inc. and Lehman Brothers Commercial Corporation (Feb. 21, 1995), at p. 1 [LBEX-SIPA 007450]; Subordination Agreement between Lehman Brothers Inc. and Lehman Brothers Finance S.A. (Oct. 13, 1995) [LBEX-SIPA 007471].

broker or dealer…."[7496] In conformity with this rule, LBHI Affiliate Entity subordination agreements broadly provided that the affiliates' rights with respect to all securities the affiliates lent to LBI and all cash balances in securities or commodities accounts of the affiliates maintained at LBI were "subordinate in right of payment and subject to the prior payment or provision for payment in full of any indebtedness of any nature whatsoever which may now or hereafter be due to any present or future LBI creditor."[7497] In addition, the subordination agreements specifically provided that, in the event of LBI's liquidation under SIPA or any other proceeding for the benefit of creditors, the applicable LBHI Affiliate Entities "will not be entitled … to participate or share ratably or otherwise in the distribution of LBI's assets" until all other debts have been fully satisfied.[7498] In other words, LBI essentially had the right to pledge and dispose of securities in its custody belonging to affiliates that were parties to subordination agreements.[7499] Although legal and regulatory personnel associated with the LBHI Affiliate Entities at issue typically would have been aware of these

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[7496] 17 C.F.R. § 240.15c3-1d(b)(3) (2007).

[7497] Subordination Agreement between Lehman Brothers Inc. and Lehman Brothers Special Financing, Inc. (Feb. 21, 1995), at p. 3 [LBEX-SIPA 007456]; Subordination Agreement between Lehman Brothers Inc. and Lehman Brothers Commercial Corporation (Feb. 21, 1995), at p. 1 [LBEX-SIPA 007450]; Subordination Agreement between Lehman Brothers Inc. and Lehman Brothers Finance S.A. (Oct. 13, 1995) [LBEX-SIPA 007471].

[7498] *See, e.g.,* Subordination Agreement between Lehman Brothers Inc. and Lehman Brothers Special Financing, Inc. (Feb. 21, 1995), at ¶3 [LBEX-SIPA 007456].

[7499] Duff & Phelps' Interview of William Burke, Oct. 28, 2009, at p. 2; *see also* 17 C.F.R. § 240.15c3-1d(b)(4) ("The subordinated loan agreement shall provide that the cash proceeds thereof shall be used and dealt with by the broker or dealer as part of its capital and shall be subject to the risks of the business."); Attachment A to NASD Notice to Members 02-32 (June 2002) ("The funds or securities lent to a broker/dealer under a subordination agreement can be used by the broker/dealer almost entirely without restriction.").

subordination agreements and their provisions, many other personnel may not even have been aware of their existence.[7500]

LOTC also maintained a *de facto* subordinated position vis-à-vis LBI. LOTC was a registered broker/dealer.[7501] It was a subsidiary of LBHI whose trades were fully guaranteed by LBHI,[7502] and engaged in business as an over-the-counter derivatives dealer.[7503] Because LOTC's trading was limited to certain equity and fixed income derivatives products, including options on emerging market bonds,[7504] LOTC was authorized to apply to the SEC for permission to compute capital charges for market and credit risk pursuant to SEC Rule 15c3-1, Appendix F (value-at-risk) instead of SEC Rule 15c3-1(c)(2)(vi) (securities haircuts). This arrangement allowed Lehman to maintain lower net regulatory capital levels for the types of trading conducted through LOTC.[7505]

LOTC maintained an introducing broker relationship with LBI, with LBI serving as its clearing broker.[7506] As an introducing broker, LOTC's assets (including cash and securities) could be held in Proprietary Accounts of Introducing Brokers and Dealers (or

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[7500] Duff & Phelps' Interview of William Burke, Oct. 28, 2009, at p. 2.

[7501] *See* Lehman Brothers OTC Derivatives, Inc., Financial Statements and Supplemental Information, Notes to Financial Statements, Note 7 (year ended Nov. 30, 2007) [LBEX-DOCID 4512677].

[7502] Lehman, Unanimous Consent of Executive Committee of the Board of Directors of Lehman Brothers Holdings Inc. (June 9, 2005) [LBEX-AM 003415].

[7503] *See* Lehman Brothers OTC Derivatives, Inc., Financial Statements and Supplemental Information, Notes to Financial Statements, Note 1 (year ended Nov. 30, 2007) [LBEX-DOCID 4512677].

[7504] *Id*.

[7505] 17 C.F.R. § 240.15c3-1f. (2007).

[7506] Lehman Brothers Inc. Introducing Broker Agreement [LBEX-AM 5643193]; Duff & Phelps' Interview of William Burke, Oct. 28, 2009, at p. 2.

"PAIB") at LBI.[7507] In the context of this relationship, LOTC's "proprietary account" was an account carried by a broker/dealer for "a business affiliate that, directly or indirectly, is controlled by or is under common control with" such broker/dealer.[7508] The assets in proprietary accounts of such an introducing broker (in this case, LOTC) are not subject to the same protections as the assets of public customers (i.e. non-broker affiliates).[7509] Therefore, LBI, as a clearing broker, was not required to maintain physical possession or control over LOTC's PAIB assets, nor was it restricted in its use of LOTC's PAIB assets.[7510] Moreover, so long as LOTC provided a written notice to its customers, their deposits could be repledged or used in the course of LOTC's business.[7511] LOTC's Financial Statement for year ended November 30, 2007, recognized that "[t]he Company is typically permitted to sell or repledge securities received as collateral."[7512]

[7507] Lehman Brothers Inc. Introducing Broker Agreement, § 3(g) [LBEX-AM 5643193]; Duff & Phelps' Interview of William Burke, Oct. 28, 2009, at p. 2; e-mail from William Burke, Barclays, to TC Fleming, Duff & Phelps, Dec. 23, 2009; *see also* 17 C.F.R. § 240.15c3-3 (2007).

[7508] 17 C.F.R. § 1.3(y)(viii) (incorporated by 17 C.F.R. § 240.15c3-3(a)(1)).

[7509] *See* 17 C.F.R. § 240.15c3-3(a)(l)("[t]he term [customer] shall not include a broker or dealer"); The New York Stock Exchange, Inc., SEC No-Action Letter, 1998 WL 879557, at *2 (Nov. 10, 1998) (a clearing broker "is not subject to the restrictions of Rule 15c3-3 with regard to PAIB assets."); Duff & Phelps' Interview of William Burke, Oct. 28, 2009, at p. 2.

[7510] *Id.*; *see also* NASD Notice To Members 98-99 (Dec. 1998) ("since clearing broker/dealers are free of these customer-protection restrictions, it is possible for them to treat PAIB assets as their own.")

[7511] 17 C.F.R. § 240.15c3-3(a)(l) (providing that the term "customer" "shall not include a counterparty who has delivered collateral to an OTC derivatives dealer pursuant to a transaction in an eligible OTC derivative instrument" as long as the counterparty received a written notice that the dealer "may repledge or otherwise use the collateral in its business," that the counterparty will be considered an unsecured creditor, and that it does not receive SIPA protections).

[7512] Lehman Brothers OTC Derivatives, Inc. Financial Statements and Supplemental Information, Notes to Financial Statements, (year ended Nov. 30, 2007) at Note 4 [LBEX-DOCID 4512677].

The Examiner's financial advisors analyzed the 2,136 CUSIPs (2,128 from Schedules A and B and 8 from Annex A) associated with both LBHI Affiliate Entities and other Lehman entities to assess how many of the CUSIPs were reflected on the September 12, 2008 balance sheet inventories as net asset positions of LBHI Affiliates that were parties to subordination agreements or similar arrangements with LBI.[7513] As set forth in more detail in Appendices 29 and 30 hereto, of the 2,136 CUSIPs associated with both LBHI Affiliate Entities and other Lehman entities, 1,141 CUSIPs for securities with a par value of roughly $2.4 billion were associated with LBSF, and 778 of the CUSIPs for securities with a par value of $125.9 million were associated with LOTC. 316 of the CUSIPs linked to LBSF were also linked to LOTC (with a par value of $74.1 million). Both LBSF and LOTC were parties to subordination agreements or similar arrangements with LBI. Thus, based upon GFS data, 1,603 (or roughly 75 percent) of the 2,136 CUSIPs associated with both LBHI Affiliate Entities and other Lehman entities were associated with LBHI Affiliate Entities that were parties to subordination agreements or similar arrangements with LBI. As a result, their securities likely were available for use by LBI irrespective of whether they were held in custody by LBI or had been delivered to LBI pursuant to a financing arrangement.

[7513] "Net asset positions" for the purpose of this analysis reflect positive net par values found in GFS for a given CUSIP on a selected LBHI Affiliate's balance sheet, per the Balance Sheet Module.

(ii) Securities Financing Transactions

When securities were transferred by an LBHI Affiliate Entity to LBI as part of an intercompany financing transaction, that financing arrangement almost invariably took the form of a repurchase transaction.[7514] Between the parties, a repurchase transaction typically is regarded as an outright transfer of ownership of the security, such that the transferee (in this example LBI) obtains good title to the security.[7515] A failure on the part of the transferee to perform its obligations under the repurchase agreement (*i.e.* its promise to redeliver the security or its equivalent) is a breach of contract, but does not legally impair the transferee's right to sell or re-pledge the security that the transferee promised to redeliver.[7516] For accounting purposes, however, prior to a default, repurchase transactions usually are treated as financing (loan) transactions; absent a

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[7514] The Examiner's financial advisors reviewed the trading activity for the week of Sept. 12-19, 2008, and noted that approximately 95 percent of the trades involving LBI were repo or reverse repo trades.

[7515] *See, e.g.*, Master Repurchase Agreement between Lehman Brothers, Inc., Lehman Commercial Paper Inc. and Lehman Brothers OTC Derivatives, Inc. (Feb. 13, 2004), at p. 6 [LBEX-AM 060025] ("nothing in this Agreement shall preclude Buyer from engaging in repurchase transactions with the Purchased Securities or otherwise selling, transferring, pledging or hypothecating the Purchased Securities….").

[7516] For instance, in *SEC v. Drysdale Securities Corp.*, 785 F.2d 38, 41 (2d Cir. 1986), the Second Circuit held that "a most significant difference between repos and standard collateralized loans" is that "repo 'lenders' take title to the securities received and can trade, sell or pledge them. The repo merely imposes a contractual obligation to deliver identical securities on the settlement date set by the repo contract." *Id.* Likewise, in *Granite Partners, L.P. v. Bear, Stearns & Co., Inc.*, 17 F. Supp. 2d 275, 302 (S.D.N.Y. 1998), a New York federal district court ruled that transactions governed by industry standard repurchase agreements were purchase and sale agreements, not secured loans: "Critical to the usefulness, flexibility, and liquidity of the repo market is the transfer of ownership of the repo securities to the repo buyer and the repo buyer's ability to sell, transfer, or pledge the securities purchased in a repo transaction during its term." *Id. See also Bevill, Bresler & Schulan Asset Mgmt. Corp. v. Army Moral Support Fund*, 67 B.R. 557, 595-97 (D.N.J. 1986) (holding that repo transactions at issue were purchases and sales of securities, emphasizing "the repo buyer's unrestricted right to trade the securities during the term of the [repurchase] agreement").

default, the security that is the subject of the repurchase transaction usually remains on the balance sheet of the transferor as an asset.[7517]

The Examiner's financial advisors used data that had been extracted from GFS to determine how many of the 2,136 securities selected for further analysis were involved in financing transactions. Of the 2,136 CUSIPs that were included in the GFS data set on September 12, 2008, 2,043 (or all but 93 of the CUSIPs) were reflected in the Financing Module data set. Thus, per GFS information, the vast majority of the 2,136 CUSIPs associated with both LBHI Affiliate Entities and other Lehman entities had been delivered to LBI pursuant to a repo or other type of financing trade as of September 12, 2008.

Of the 93 CUSIPs that were not found in the Financing Module data set, 92 CUSIPs (all but one) were linked to an LBHI Affiliate Entity that was a party to a subordination agreement with LBI. The one remaining CUSIP was linked to LBCS, an entity that was not a party to a subordination agreement with LBI, but had an insignificant par value of only $388.[7518]

The Examiner's financial advisors also conducted further analysis beyond GFS, on a sample basis, of CUSIPs that had been identified in GFS as delivered pursuant to a financing transaction to determine (1) whether the securities actually had been

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[7517] Statement of Fin. Accounting Standards No. 140, ¶ 15. *See also Nebraska Dep't Revenue v. Loewenstein*, 513 U.S. 123, 132-34 (1994) (for tax law purposes, repo transactions are secured loans rather than sales).
[7518] A chart detailing these 93 CUSIPs is attached as Appendix 31.

delivered to LBI pursuant to intercompany financing transactions, and (2) whether the financing transactions were cash-settled, in which case LBI likely had the right to sell those securities. The Examiner's financial advisors found for a sample of these CUSIPs evidence consistently demonstrating that LBI had the right to sell the securities.

Specifically, the Examiner's financial advisors were informed by several witnesses that irrespective of whether LBI conducted a financing transaction with a subordinated entity (such as LBSF and LOTC) or a non-subordinated entity, all financing transactions involving LBI were settled in cash.[7519] To test these assertions, the Examiner's financial advisors examined a sample set of 35 open financing trades[7520] during the week of September 15, 2008, and found sufficient evidence that 100 percent of the trades involving LBI were netted and a corresponding wire transfer request was created for the net settlement amount. For these trades, the Examiner reviewed Lehman records detailing the calculation of the net settlement amount, and also records showing that wire transfer requests for the net settlement amount were submitted for

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[7519] *See* Duff & Phelps' Interview of William Burke, Oct. 28, 2009 (trades between LBI and affiliates were "always settled," the settlement amount would be "net of margin," and due to LBI's capital requirements, there would be no benefit to not settling trades). Essentially, LBI would need to keep an equivalent amount of assets on reserve for any unsettled trades, thus making it economically impractical. Duff & Phelps' Interview of Daniel J. Fleming, Oct. 21, 2009 (trades between LBSF and LBI were at "arm's length," as was the case with other intercompany trading activity with and among LBI, LBHI and LBHI Affiliates).

[7520] "Open financing trades" represent trades as to which GFS indicated that the security involved in a Financing Position remained open as of both September 12 and September 19, 2008.

payment in FPS (the cash settlement system). These findings support assertions by former Lehman personnel that trades involving LBI always net settled in cash.[7521]

As noted above, LBSF and LCPI continued to engage in a material amount of trading with LBI during the week of September 15, and that trading activity would not have been reflected in the September 12, 2008 GFS data set used by the Examiner's financial advisors to conduct their analysis. The Examiner's financial advisors did not observe any instances where LCPI traded any of the CUSIPs transferred to Barclays during the week of September 12, 2008. They did, however, observe that LBSF trade activity with LBI involved 32 CUSIPs transferred to Barclays. The Examiner's financial advisors therefore examined the trade activity involving these 32 CUSIPs, and Lehman records showed that wire transfer requests for the net settlement amount were submitted for all of the examined trades. Thus, the intercompany securities movements that occurred during the week of September 15, 2008 likely were not improper and did not improve LBI's position vis-à-vis any LBHI Affiliate Entity.

(iii) Alternative Analyses

The Examiner's financial advisors also analyzed the 2,136 CUSIPs associated with both LBHI Affiliate Entities and other Lehman entities from a different perspective, namely to assess whether the source of the CUSIPs transferred to Barclays could have been solely non-LBHI Affiliate Entities. Toward this end, the Examiner's

[7521] *See* Duff & Phelps' Interview of William Burke, Oct. 28, 2009; e-mail from William Burke, Barclays, to TC Fleming, Duff & Phelps (Dec. 23, 2009); Duff & Phelps' Interview of Daniel J. Fleming, Oct. 21, 2009.

financial advisors analyzed whether there was a sufficient quantity of each of the 2,136 CUSIPs at LBI to account for 100 percent of the balances transferred to Barclays.[7522] While this approach would not have absolutely excluded the possibility that securities of an LBHI Affiliate Entity had been transferred to Barclays, it would have corroborated that LBHI Affiliate Entity-owned securities were not included in the group of securities transferred to Barclays. However, this alternative methodology did not provide meaningful results that could be applied to a large population of the securities.

(d) 817 CUSIPs With No GFS Data

As of September 12, 2008, 795 of the CUSIPs listed on Schedules A and B and 22 of the CUSIPs listed on Annex A (817 total CUSIPs) did not exist in GFS.[7523] The Examiner's financial advisors' work included (but was not limited to) the following investigation in an attempt to determine ownership of those securities.

[7522] To determine the quantity of relevant CUSIPs in the securities inventory of each legal entity, the Examiner's financial advisors used the Positions Group data in GFS to calculate "Net Inventory" for each CUSIP by legal entity. As explained above, the Positions Group data do not present a complete picture of the securities in LBI's custody because it does not incorporate the value of Financing Positions, so the Examiner's financial advisors calculated a "Net Custody Value" for each CUSIP as of September 12, 2008 by combining three variables, as follows: *Net Custody Value = Market Value (Net of Long and Short Inventory Positions) + [Net of Stock Borrows and Stock Loans] + [Net of Repos & Reverse Repos].* If the par value for a given CUSIP on the Securities List was less than the Net Custody Value for that CUSIP, that indicated that as of September 12, 2008 there were sufficient securities to accomplish the securities transfer to Barclays without resorting to the use of securities that might have been held for the benefit of an LBHI Affiliate.

[7523] Because of the similarity in quantities, the Examiner compared the list of 814 Schedule B securities not delivered to Barclays against the 817 CUSIPs with no GFS data in order to determine whether there was any connection between the two lists. Only five of the securities overlapped, so there was no strong correlation between the two lists.

(i) September 19, 2008 GFS Dataset

As an additional approach to gathering relevant information regarding the 817 CUSIPs, the Examiner's financial advisors searched the September 19, 2008 GFS dataset, which (as set forth above) due to some reliability concerns was not the primary dataset used by the Examiner's financial advisors to conduct their analysis. Of these 817 CUSIPs, 52 were present in the September 19, 2008 dataset. Of the 52 CUSIPs, only one CUSIP was linked to LBHI Affiliate Entities, specifically LBSF and LOTC (both of which are subordinated entities). The par amount for the securities bearing this one CUSIP was insignificant – $95,554. The remaining 51 CUSIPs were not linked to an LBHI Affiliate Entity.

The total par amount of the securities associated with this group of 52 CUSIPs was $284.1 million, representing 41 percent of the total par amount of securities associated with the 817 CUSIPs for which there was no GFS data. As a result, the par amount of securities associated with CUSIPs not represented in either the September 12 or September 19, 2008 GFS datasets (765 CUSIPs) comprises approximately only 0.5 percent of the total par value transferred to Barclays.[7524]

[7524] For a list of these CUSIPs, see Appendix 32.

(ii) Search by ISIN Number and Product ID

Based upon suggestions from Barclays' personnel, the Examiner's financial advisors also analyzed the data associated with the 817 CUSIPS using ISIN numbers[7525] and Lehman-specific "Product Identifiers."[7526]

Initial results using ISIN numbers showed only 42 unique CUSIPs in GFS's Balance Sheet Module at September 12, 2008, and none in the Financing Module. Initial results using the Lehman-specific "Product Identifiers" showed only one unique CUSIP in GFS's Balance Sheet Module and only 14 CUSIPs in the Financing Module. Moreover, data from the initial results was insufficient to allocate the CUSIPs to Lehman legal entities. Thus, this analysis provided little insight into the ownership of the 817 CUSIPs.

(iii) TMS Source System

TMS is the Lehman trading system that captured certain domestic LBI trading activity. The system accepted listed and OTC equities, municipal bonds, corporate bonds and money market instruments. Based on initial data provided as of

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[7525] ISIN Numbers are the unique 12-digit numbers that are recognized by the International Standards Organization located in Geneva, Switzerland as security identifiers for cross-border securities transactions. *See* CUSIP Global Services, http://www.isin.cusip.com (last visited Feb. 2, 2010).

[7526] ISINs linked to these CUSIPs were sourced from A&M and Bloomberg, as available. The Examiner located ISINs for 779 of the 817 CUSIPs. The ISINs were then used to locate Lehman-specific "Product Identifiers" that could be used to query GFS. The corresponding Product Identifiers were sourced from Barclays and A&M. *See* e-mail from Lauren Sheridan, A&M, to Heather D. McArn, Examiner's Counsel (Oct. 2, 2009); Product Identifiers [LBEX-BARGFS 0000001], attached to e-mail from Uma Krishna, Barclays, to Ashkay Bhargava, Duff & Phelps (Sept. 28, 2009).

September 19, 2008, 755 of the missing 795 CUSIPs from the Schedules A and B were sourced from the TMS system.

Barclays' personnel provided stock reports related to these 755 CUSIPs.[7527] However, the data did not include fields identifying the corresponding legal entities associated with any of the securities. Moreover, the data provided was insufficient to allocate the corresponding market values or par amounts for these securities. Thus, the information provided was inconclusive for determining the ownership of the 817 CUSIPs.

(iv) Additional Data Sources

The Examiner's financial advisors did not have access to the LoanNet source system.[7528] Reports provided in response to requests for support for the missing 817 CUSIPs with missing information also did not provide sufficient information to determine the legal ownership of the securities.

The Examiner also sought assistance from A&M, as well as the SIPA Trustee, to identify the sources of these 817 CUSIPs transferred by LBI to Barclays as to which ownership data was inconclusive, but they were unable to provide sufficient information concerning these securities, prior to the delivery of this Report, to enable the Examiner to definitively link these securities to specific Lehman legal entities.

[7527] TMS stock records were obtained by Barclays via a separate Lehman system, ADP.

[7528] LoanNet was the Lehman system used to capture certain stock borrow/loan positions. LoanNet is currently owned by Nomura, and not directly accessible through Barclays or the estate.

Shortly before the filing of this Report, however, the SIPA Trustee conducted a review of the 817 CUSIPs, and was able to confirm that most of the 817 CUSIPs appeared to be Financing Positions or LBI inventory.[7529] At the Examiner's request, the SIPA Trustee's financial advisors examined a sample of the 20 largest CUSIPs, and were able to identify the accounts with which the CUSIP positions were associated. All 20 CUSIPs reflected securities originating from LBI, LBIE or LBI customer accounts, and none of the CUSIPs were associated with accounts owned by an LBHI Affiliate Entity.[7530] Thus, based upon this sample, it is unlikely that a material number of securities associated with the 817 CUSIPs were linked to an LBHI Affiliate Entity.

In the absence of records demonstrating the source of the securities, it is possible that some of the securities had been received by LBI but not yet allocated to a customer's account (that of either a Lehman affiliate or a third party). This could occur, for example, in circumstances involving failed trades or when counterparty data is missing.[7531] However, the Examiner was unable to conclusively determine whether either scenario was indeed the case.

The securities bearing these 817 CUSIPs that are not included in the September 12, 2009 GFS data set comprise a relatively small subset of the securities

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[7529] E-mail from Sarah Cave, Hughes, Hubbard & Reed LLP, to Vincent Lazar, Examiner's Counsel (Jan. 28, 2010).

[7530] *Id.*; e-mail from Jordan Pace, Hughes, Hubbard & Reed LLP, to Vincent Lazar, Examiner's Counsel (Feb. 3, 2010).

[7531] Duff & Phelps' Interview of James Guarino, Oct. 28, 2009; Duff & Phelps' Interview of William Burke, Dec. 9, 2009.

transferred to Barclays ($695.8 million in par value, which represents less than 2 percent of the par value of all CUSIPs transferred to Barclays). After taking into account the September 19, 2008 GFS dataset, the number of CUSIPs not captured in GFS (765 CUSIPs) had a corresponding par value of $411.7 million, or approximately 0.5 percent of the par value of all CUSIPs transferred to Barclays. In light of: (1) the conclusions the Examiner has reached with respect to likely ownership of the remainder of the securities; (2) the various defenses (including formidable securities intermediary and securities settlement defenses) to the avoidance of any securities transfers to Barclays; and (3) the involvement of various estate and other professionals who were unable to secure the data necessary to conduct an analysis of these remaining CUSIPs, the Examiner concludes that further investigation into ownership of these remaining CUSIPs is not cost justified.

b) Analysis of Tangible Asset Transfers

The Examiner's financial advisors determined that tangible assets[7532] of four LBHI Affiliates – LB 745, LBCS, LCPI and LBSF – were transferred to Barclays in connection with the sale transaction. The transfer of LB 745's assets was expressly provided for in the APA, and was approved by the Court. As described below, the Examiner concludes that the LBCS, LCPI and LBSF tangible assets that were transferred to Barclays

[7532] The Examiner and his financial advisors focused on fixed assets, which include various types of real and personal property. Tangible assets also could include certain types of financial assets, such as notes and loans. The Examiner and his financial advisors uncovered no facts indicating that such financial assets of LBHI Affiliates were transferred to Barclays.

consisted of communications equipment, computer equipment and furniture with a net book value of less than $10 million, and an actual value likely materially less.

To evaluate whether tangible assets of LBHI Affiliates were transferred to Barclays in connection with the sale transaction, the Examiner investigated whether it was possible to identify and trace the specific tangible assets that Barclays received in connection with the sale to identify those that were owned by LBHI Affiliates.

Lehman did not operate its businesses in a way that would facilitate the identification of specific tangible assets owned by LBHI Affiliates. At the time of the transfer, operations of many of the LBHI Affiliates were conducted out of the 745 Seventh Avenue headquarters. Lehman's operations at this facility generally were organized by product line, rather than legal entity, so that fixed assets owned by a particular entity would have been intermingled with those of other entities. As a result, it would have been very costly and time-consuming to physically trace specific fixed assets to determine what belonged to the LBHI Affiliates.

The Examiner's financial advisors identified a Lehman "asset" database (ADb), but determined that this database did not contain sufficient reliable and pertinent information for this analysis. Among other things, that database was not regularly

updated to reflect asset acquisitions and transfers or office moves, and assets were not necessarily allocated to the entity that had title to them.[7533]

The Examiner's professionals determined that the only reliable way to identify specific assets that were transferred to Barclays would be to conduct an extensive physical inventory of fixed assets, based on a review of serial numbers or other unique identifiers. That analysis, however, would have been time-consuming and expensive. Given the limited value of the transferred assets, the Examiner concluded that such an approach would not be a prudent use of the estate's assets.

Because the Examiner's financial advisors concluded that the fixed asset information in the balance sheets appeared to be relatively accurate, the Examiner concluded that using the asset values identified in the balance sheet was the most efficient method to identify tangible assets of LBHI Affiliates that potentially were transferred to Barclays.

Accordingly, the Examiner's financial advisors obtained and analyzed balance sheet information[7534] for each LBHI Affiliate as of September 12, 2008 (*i.e.*, before the sale transaction), and as of September 30, 2008 (after the sale transaction closed), to identify

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[7533] The Examiner confirmed that the Debtors and their financial advisors, A&M, also had evaluated the use of the ADb database to identify ownership of assets, but had concluded that it was not sufficiently reliable for that purpose. Examiner's Interview of Thomas E. Hommel, Kelly L. Gargiulo, Lauren Sheridan, William B. Gordon and Jeffrey Donaldson, Jan. 22, 2010.

[7534] The balance sheet information that the Examiner's financial advisors reviewed was obtained using the Debtors' Essbase system. Balance sheets for each of the individual LBHI Affiliates (except PAMI Statler, which was rolled up into the umbrella PAMI financial statements and did not have its own financial information) are available in Appendix 33.

whether the gross book value of any LBHI Affiliate's tangible assets declined during that period. A reduction in the value of tangible assets on the balance sheets of an LBHI Affiliate during that period might be attributable to transfers of assets, thus warranting further investigation to determine whether assets were transferred to Barclays in connection with the sale transaction. The Examiner also interviewed witnesses to gain an understanding of which tangible assets were transferred to Barclays, to confirm the accuracy of the balance sheet information and to confirm that the balance sheets had been adjusted to reflect all asset transfers.

The Examiner's financial advisors determined that the balance sheets of only seven LBHI Affiliates (LB 745, LBCS, LCPI, LBSF and the three CES Aviation asset holding companies) reflected tangible assets before the Barclays transaction. The balance sheets of the remaining LBHI Affiliates did not reflect any tangible assets as of Friday, September 12, 2008, and thus those entities likely did not own any tangible assets that might have been transferred to Barclays in connection with the sale transaction. Therefore, the Examiner and his financial advisors focused their analysis on the LBHI Affiliates that held tangible assets on their balance sheets as of September 12, 2008, that potentially could have been transferred to Barclays.

(1) LB 745

LB 745's balance sheet reflected several categories of tangible assets, including buildings, building and leasehold improvements, furniture, fine arts and antiques,

communications equipment (recorded as "equip-comm" on the balance sheet) and computer equipment (recorded as "EDP & PC").[7535] As expected, there were substantial decreases in all but one of those asset categories at or about the time of the Barclays sale transaction:

LB 745

	12-Sep-08	30-Sep-08		
	A	B	B-A	% Change
14010SUM F/A-COST-LAND	-	-	-	0.0%
14015SUM F/A-COST-BLDGS	522,920,456	-	(522,920,456)	-100.0%
104020SUM F/A-COST-FURNITURE	30,079,193	19,893	(30,059,300)	-99.9%
14025SUM F/A-COST-EQUIP-COMM.	28,990,441	0	(28,990,441)	-100.0%
14030SUM F/A-COST-EQUIP-EDP & PC	1,849,810	458,953	(1,390,858)	-75.2%
14040SUM F/A-COST-BLDNGS & L/H	183,523,963	33,483	(183,490,480)	-100.0%
14045SUM F/A-COST-CONSTR.IN PROGRESS	-	-	-	0.0%
14050SUM F/A-COST-TRANS. & CAR	-	-	-	0.0%
14055SUM F/A-CST-FINE ARTS & ANTIQUES	1,420,374	1,420,374	-	0.0%
14060SUM CAPITALIZED SOFTWARE	-	-	-	0.0%
71600SUM TOTAL F/A-COST	768,784,237	1,932,703	(766,851,534)	-99.7%
14515SUM F/A-A/D-BUILDINGS	(85,821,463)	(435,853)	85,385,610	-99.5%
14520SUM F/A-A/D-FURNITURE	(17,825,330)	(108,911)	17,716,419	-99.4%
14525SUM F/A-A/D-EQUIP.-COMM.	(23,381,422)	(144,411)	23,237,011	-99.4%
14530SUM F/A-A/D-EQUIP.-EDP & PC	(1,841,107)	(453,080)	1,388,026	-75.4%
14540SUM F/A-A/D-BLDGS. & L/H	(72,685,815)	(414,044)	72,271,772	-99.4%
14550SUM F/A-A/D-TRANS. & CAR COSTS	-	-	-	0.0%
14560SUM F/A-A/D CAPITALIZED SOFTWARE	-	-	-	0.0%
71700SUM TOTAL F/A-A/D[7536]	(201,555,137)	(1,556,299)	199,998,838	-99.2%
71750SUM PROPERTY, EQUIP. & LEASE.IM	567,229,100	376,404	(566,852,696)	-99.9%

For example, the gross book value of "buildings" on LB 745's balance sheet was $522,920,456 on September 12, 2008, and zero on September 30, 2008.[7537] Similarly, the value of furniture was $30,079,193 as of September 12, 2008, and $19,893 as of September 30, 2008 – a decline of 99.9 percent. Those declines in gross book value are

[7535] Appendix 34, Duff & Phelps, Tangible Asset Balance Sheet Variations, at p. 4.

[7536] The Examiner's financial advisors concluded that the changes in accumulated depreciation that are reflected for LB 745 and the other LBHI Affiliates appear to represent the estimated monthly depreciation of the listed assets taken over their useful lives.

[7537] Appendix 34, Duff & Phelps, Tangible Asset Balance Sheet Variations, at p. 4.

consistent with transfer of LB 745's real property and related assets pursuant to the express provisions of the APA and approved by the Court.[7538]

(2) LBCS

LBCS's balance sheet reflected several categories of tangible assets, including furniture, communications equipment, computer equipment and building and leasehold improvements:

LBCS

	12-Sep-08	30-Sep-08		
	A	B	B-A	% Change
14010SUM F/A-COST-LAND	-	-	-	0.0%
14015SUM F/A-COST-BLDGS	-	-	-	0.0%
104020SUM F/A-COST-FURNITURE	1,489,679	1,400,471	(89,208)	-6.0%
14025SUM F/A-COST-EQUIP-COMM.	1,079,384	754,359	(325,025)	-30.1%
14030SUM F/A-COST-EQUIP-EDP & PC	849,253	211,856	(637,397)	-75.1%
14040SUM F/A-COST-BLDNGS & L/H	3,062,460	3,037,036	(25,424)	-0.8%
14045SUM F/A-COST-CONSTR.IN PROGRESS	-	-	-	0.0%
14050SUM F/A-COST-TRANS. & CAR	-	-	-	0.0%
14055SUM F/A-CST-FINE ARTS & ANTIQUES	-	-	-	0.0%
14060SUM CAPITALIZED SOFTWARE	-	-	-	0.0%
71600SUM TOTAL F/A-COST	6,480,774	5,403,721	(1,077,053)	-16.6%
14515SUM F/A-A/D-BUILDINGS	-	-	-	0.0%
14520SUM F/A-A/D-FURNITURE	(92,913)	(85,416)	7,497	-8.1%
14525SUM F/A-A/D-EQUIP.-COMM.	(362,579)	(169,238)	193,342	-53.3%
14530SUM F/A-A/D-EQUIP.-EDP & PC	(538,076)	(88,627)	449,449	-83.5%
14540SUM F/A-A/D-BLDGS. & L/H	(232,360)	(245,805)	(13,445)	5.8%
14550SUM F/A-A/D-TRANS. & CAR COSTS	-	-	-	0.0%
14560SUM F/A-A/D CAPITALIZED SOFTWARE	-	-	-	0.0%
71700SUM TOTAL F/A-A/D	(1,225,929)	(589,085)	636,843	-51.9%
71750SUM PROPERTY, EQUIP. & LEASE.IM	5,254,846	4,814,636	(440,210)	-8.4%

The gross book values in several of those asset categories decreased over the period that the sale transaction closed. For example, the gross book value of communications equipment decreased by $325,025 between September 12, 2008, and

[7538] *See* APA, at p. 1.

September 30, 2008,[7539] and the gross book value of computer equipment decreased by $637,397 between September 12, 2008, and September 30, 2008.[7540] The Examiner's financial advisors confirmed that these reductions were the result of the transfer of assets in those categories to Barclays.[7541] In addition, the Examiner determined (and the Debtors confirmed) that, following publication of the September 30, 2008 balance sheet, the Debtors continued to make adjustments to the book values reflected on the balance sheet to reflect, among other things, transfers of assets to Barclays.[7542] Based upon his investigation, the Examiner has concluded that tangible assets of LBCS reflected on the September 30, 2008 balance sheet also were transferred to Barclays.

(3) LCPI

LCPI's balance sheet reflected several categories of tangible assets, including furniture, communications equipment and computer equipment:

[7539] Appendix 34, Duff & Phelps, Tangible Asset Balance Sheet Variations, at p. 2.

[7540] *Id.*

[7541] E-mail from Lauren Sheridan, A&M, to David C. Layden, Examiner's Counsel, *et al.* (Jan. 22, 2010). The Examiner's financial advisors also identified a *de minimis* ($89,208) decrease in the gross book value of furniture during the relevant time frame. That decline likely was due to the transfer of LBCS furniture assets to Barclays, particularly given that a substantial portion of LBCS' operations were conducted in the 745 Seventh Avenue headquarters building.

[7542] E-mail from Lauren Sheridan, A&M, to David C. Layden, Examiner's Counsel, *et al*. (Jan. 22, 2010). In addition, by Order dated June 25, 2009, the Court authorized LBHI to repurchase from Barclays certain tangible assets that had been transferred to Barclays in connection with the sale. *See* Order Pursuant to Sections 105(a) and 363 of the Bankruptcy Code Authorizing Lehman Brothers Holdings Inc. to Purchase Certain Furniture, Fixtures and Equipment from Barclays Capital Inc., Docket No. 4171, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. June 25, 2009). Those assets may have included tangible assets owned by LBCS.

LCPI

	12-Sep-08	30-Sep-08		
	A	B	B-A	% Change
14010SUM F/A-COST-LAND	-	-	-	0.0%
14015SUM F/A-COST-BLDGS	-	-	-	0.0%
104020SUM F/A-COST-FURNITURE	70,905	70,905	-	0.0%
14025SUM F/A-COST-EQUIP-COMM.	766,909	766,636	(273)	0.0%
14030SUM F/A-COST-EQUIP-EDP & PC	4,903,172	4,524,941	(378,231)	-7.7%
14040SUM F/A-COST-BLDNGS & L/H	2,634	1,050	(1,584)	-60.1%
14045SUM F/A-COST-CONSTR.IN PROGRESS	-	-	-	0.0%
14050SUM F/A-COST-TRANS. & CAR	-	-	-	0.0%
14055SUM F/A-CST-FINE ARTS & ANTIQUES	-	-	-	0.0%
14060SUM CAPITALIZED SOFTWARE	-	-	-	0.0%
71600SUM TOTAL F/A-COST	5,743,621	5,363,533	(380,087)	-6.6%
14515SUM F/A-A/D-BUILDINGS	-	-	-	0.0%
14520SUM F/A-A/D-FURNITURE	(42,455)	(42,724)	(269)	0.6%
14525SUM F/A-A/D-EQUIP.-COMM.	(443,871)	(397,841)	46,030	-10.4%
14530SUM F/A-A/D-EQUIP.-EDP & PC	(3,576,653)	(3,234,363)	342,290	-9.6%
14540SUM F/A-A/D-BLDGS. & L/H	(102)	(106)	(4)	4.3%
14550SUM F/A-A/D-TRANS. & CAR COSTS	-	-	-	0.0%
14560SUM F/A-A/D CAPITALIZED SOFTWARE	-	-	-	0.0%
71700SUM TOTAL F/A-A/D	(4,063,080)	(3,675,033)	388,047	-9.6%
71750SUM PROPERTY, EQUIP. & LEASE.IM	1,680,541	1,688,500	7,959	0.5%

The gross book values in certain of those asset categories decreased over the period that the sale transaction closed. For example, the gross book value of computer equipment declined by $378,231 between September 12, 2008, and September 30, 2008.[7543] The Examiner determined that reduction, however, was not related to the transfer of computer equipment to Barclays.[7544] The Examiner also determined (and the Debtors confirmed) that, following publication of the September 30, 2008 balance sheet, the Debtors continued to make adjustments to the book values reflected on the balance sheet to reflect, among other things, transfers of assets to Barclays.[7545] Based upon his

[7543] Appendix 34, Tangible Asset Balance Sheet Variations Prepared By Duff & Phelps, at p. 1.

[7544] E-mail from Lauren Sheridan, A&M, to David C. Layden, Examiner's Counsel, *et al.* (Jan. 22, 2010).

[7545] E-mail from Lauren Sheridan, A&M, to David C. Layden, Examiner's Counsel, *et al*. (Jan. 22, 2010). In addition, by Order dated June 25, 2009, the Court authorized LBHI to repurchase from Barclays certain

investigation, the Examiner has concluded that tangible assets of LCPI reflected on the September 30, 2008 balance sheet also were transferred to Barclays.

(4) LBSF

LBSF's balance sheet reflected several categories of tangible assets, including furniture, communications equipment, computer equipment and building and leasehold improvements:

LBSF

	12-Sep-08	30-Sep-08		
	A	B	B-A	% Change
14010SUM F/A-COST-LAND	-	-	-	0.0%
14015SUM F/A-COST-BLDGS	-	-	-	0.0%
104020SUM F/A-COST-FURNITURE	50,919	50,919	-	0.0%
14025SUM F/A-COST-EQUIP-COMM.	57,345	36,993	(20,353)	-35.5%
14030SUM F/A-COST-EQUIP-EDP & PC	9,350,025	8,819,693	(530,332)	-5.7%
14040SUM F/A-COST-BLDNGS & L/H	28,351	22,948	(5,403)	-19.1%
14045SUM F/A-COST-CONSTR.IN PROGRESS	-	-	-	0.0%
14050SUM F/A-COST-TRANS. & CAR	-	-	-	0.0%
14055SUM F/A-CST-FINE ARTS & ANTIQUES	-	-	-	0.0%
14060SUM CAPITALIZED SOFTWARE	-	-	-	0.0%
71600SUM TOTAL F/A-COST	9,486,641	8,930,553	(556,088)	-5.9%
14515SUM F/A-A/D-BUILDINGS	-	-	-	0.0%
14520SUM F/A-A/D-FURNITURE	(12,511)	(12,766)	(255)	2.0%
14525SUM F/A-A/D-EQUIP.-COMM.	(20,716)	(11,128)	9,587	-46.3%
14530SUM F/A-A/D-EQUIP.-EDP & PC	(6,432,240)	(6,082,223)	350,017	-5.4%
14540SUM F/A-A/D-BLDGS. & L/H	(12,602)	(12,836)	(234)	1.9%
14550SUM F/A-A/D-TRANS. & CAR COSTS	-	-	-	0.0%
14560SUM F/A-A/D CAPITALIZED SOFTWARE	-	0	0	0.0%
71700SUM TOTAL F/A-A/D	(6,478,069)	(6,118,953)	359,116	-5.5%
71750SUM PROPERTY, EQUIP. & LEASE.IM	3,008,572	2,811,600	(196,973)	-6.5%

The gross book values in certain of those asset categories decreased over the period that the sale transaction closed. For example, the gross book value of computer

tangible assets that had been transferred to Barclays in connection with the sale. *See* Order Pursuant to Sections 105(a) and 363 of the Bankruptcy Code Authorizing Lehman Brothers Holdings Inc. to Purchase Certain Furniture, Fixtures and Equipment from Barclays Capital Inc., Docket No. 4171, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. June 25, 2009). Those assets may have included tangible assets owned by LCPI.

equipment declined by $530,332 between September 12, 2008 and September 30, 2008.[7546] The Examiner determined that these reductions, however, were not related to transfers of computer equipment to Barclays at the time of the sale.[7547] The Examiner also determined (and the Debtors confirmed) that, following publication of the September 30, 2008 balance sheet, the Debtors continued to make adjustments to the book values reflected on the balance sheet to reflect, among other things, transfers of assets to Barclays.[7548] Based upon his investigation, the Examiner has concluded that tangible assets of LBSF reflected on the September 30, 2008 balance sheet also were transferred to Barclays.

(5) CES

CES's balance sheet reflected one tangible asset – a Gulfstream G-IV corporate jet:

[7546] Appendix 34, Duff & Phelps, Tangible Asset Balance Sheet Variations, at p. 1.

[7547] E-mail from Lauren Sheridan, A&M, to David C. Layden, Examiner's Counsel, *et al.* (Jan. 22, 2010).

[7548] E-mail from Lauren Sheridan, A&M, to David C. Layden, Examiner's Counsel, *et al*. (Jan. 22, 2010). In addition, by Order dated June 25, 2009, the Court authorized LBHI to repurchase from Barclays certain tangible assets that had been transferred to Barclays in connection with the sale. *See* Order Pursuant to Sections 105(a) and 363 of the Bankruptcy Code Authorizing Lehman Brothers Holdings Inc. to Purchase Certain Furniture, Fixtures and Equipment from Barclays Capital Inc., Docket No. 4171, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. June 25, 2009). Those assets may have included tangible assets owned by LBSF.

CES

	12-Sep-08	30-Sep-08		
	A	B	B-A	% Change
14010SUM F/A-COST-LAND	-	-	-	0.0%
14015SUM F/A-COST-BLDGS	-	-	-	0.0%
104020SUM F/A-COST-FURNITURE	-	-	-	0.0%
14025SUM F/A-COST-EQUIP-COMM.	-	-	-	0.0%
14030SUM F/A-COST-EQUIP-EDP & PC	-	-	-	0.0%
14040SUM F/A-COST-BLDNGS & L/H	-	-	-	0.0%
14045SUM F/A-COST-CONSTR.IN PROGRESS	-	-	-	0.0%
14050SUM F/A-COST-TRANS. & CAR	32,169,194	32,169,194	-	0.0%
14055SUM F/A-CST-FINE ARTS & ANTIQUES	-	-	-	0.0%
14060SUM CAPITALIZED SOFTWARE	-	-	-	0.0%
71600SUM TOTAL F/A-COST	32,169,194	32,169,194	-	0.0%
14515SUM F/A-A/D-BUILDINGS	-	-	-	0.0%
14520SUM F/A-A/D-FURNITURE	-	-	-	0.0%
14525SUM F/A-A/D-EQUIP.-COMM.	-	-	-	0.0%
14530SUM F/A-A/D-EQUIP.-EDP & PC	-	-	-	0.0%
14540SUM F/A-A/D-BLDGS. & L/H	-	-	-	0.0%
14550SUM F/A-A/D-TRANS. & CAR COSTS	(10,756,037)	(10,769,573)	(13,535)	0.1%
14560SUM F/A-A/D CAPITALIZED SOFTWARE	-	-	-	0.0%
71700SUM TOTAL F/A-A/D	(10,756,037)	(10,769,573)	(13,535)	0.1%
71750SUM PROPERTY, EQUIP. & LEASE.IM	21,413,157	21,399,621	(13,535)	-0.1%

The G-IV was not transferred to Barclays in connection with the sale transaction; rather, CES sold the jet to a third party in a transaction approved by the Court in December 2008.[7549] Consistent with those facts, the gross book value of "trans. and car"

[7549] Supplement to Debtors' Motion for Entry of an Order Pursuant to Section 363 of the Bankruptcy Code and Federal Rule of Bankruptcy Procedure 6004 Authorizing Lehman Brothers Holdings Inc. to Enter into a Sale and Purchase Agreement, at pp. 2-3, Docket No. 1257, *In re Lehman Bros. Holdings Inc.,* No. 08-13555 (Bankr. S.D.N.Y. Oct. 29, 2008); Order Pursuant to Section 363 of the Bankruptcy Code and Federal Rule of Bankruptcy Procedure 6004 Authorizing Lehman Brothers Holdings Inc. to Enter into an Amended Sale and Purchase Agreement, at p. 2, Docket No. 1399, *In re Lehman Bros. Holdings Inc.,* No. 08-13555 (Bankr. S.D.N.Y. Nov. 5, 2008); Debtors' Motion to Amend (I) Order Authorizing Sale of G-IVSP Aircraft and (II) Order Authorizing Sale of Falcon 50 Aircraft, at pp. 7-8, Docket No. 2318, *In re Lehman Bros. Holdings Inc.,* No. 08-13555 (Bankr. S.D.N.Y. Dec. 19, 2008); Amended Order Pursuant to Section 363 of the Bankruptcy Code and Federal Rule of Bankruptcy Procedure 6004 Authorizing Lehman Brothers Holdings Inc. to Enter into an Amended Sale and Purchase Agreement, Docket No. 2359, *In re Lehman Bros. Holdings Inc.,* No. 08-13555 (Bankr. S.D.N.Y. Dec. 23, 2008).

assets on the CES balance sheet did not decline over the period when the Barclays transaction occurred.[7550]

(6) CES V

The only material tangible asset reflected on CES V's balance sheet was a Sikorsky S-76C+ helicopter:

CES V

	12-Sep-08	30-Sep-08		
	A	B	B-A	% Change
14010SUM F/A-COST-LAND	-	-	-	0.0%
14015SUM F/A-COST-BLDGS	-	-	-	0.0%
104020SUM F/A-COST-FURNITURE	-	-	-	0.0%
14025SUM F/A-COST-EQUIP-COMM.	-	-	-	0.0%
14030SUM F/A-COST-EQUIP-EDP & PC	-	-	-	0.0%
14040SUM F/A-COST-BLDNGS & L/H	-	-	-	0.0%
14045SUM F/A-COST-CONSTR.IN PROGRESS	-	-	-	0.0%
14050SUM F/A-COST-TRANS. & CAR	6,043,710	4,518,502	(1,525,208)	-25.2%
14055SUM F/A-CST-FINE ARTS & ANTIQUES	-	-	-	0.0%
14060SUM CAPITALIZED SOFTWARE	-	-	-	0.0%
71600SUM TOTAL F/A-COST	6,043,710	4,518,502	(1,525,208)	-25.2%
14515SUM F/A-A/D-BUILDINGS	-	-	-	0.0%
14520SUM F/A-A/D-FURNITURE	-	-	-	0.0%
14525SUM F/A-A/D-EQUIP.-COMM.	-	-	-	0.0%
14530SUM F/A-A/D-EQUIP.-EDP & PC	-	-	-	0.0%
14540SUM F/A-A/D-BLDGS. & L/H	-	-	-	0.0%
14550SUM F/A-A/D-TRANS. & CAR COSTS	(1,815,135)	(1,818,502)	(3,367)	0.2%
14560SUM F/A-A/D CAPITALIZED SOFTWARE	-	-	-	0.0%
71700SUM TOTAL F/A-A/D	(1,815,135)	(1,818,502)	(3,367)	0.2%
71750SUM PROPERTY, EQUIP. & LEASE.IM	4,228,575	2,700,000	(1,528,575)	-36.1%

The helicopter was not transferred to Barclays in the sale transaction that the Court approved on September 20, 2008; rather CES V sold the helicopter in a transaction approved by the Court in March 2009.[7551] Though the gross book value of "trans. and

[7550] Appendix 34, Duff & Phelps, Tangible Asset Balance Sheet Variations, at p. 2.

[7551] Lehman, CES V World Records Report (Sept. 15, 2008) [LBEX-LL 027775]; Debtors' Motion Pursuant to Sections 105 and 363 of the Bankruptcy Code, Federal Rules of Bankruptcy Procedure 2002, 6004, and 9014, and Rules 6004-1, 9006-1 and 9014-1 of the Local Bankruptcy Rules for Approval of the Sale of

car" asset on the CES V balance sheet did decline during the period that the Barclays transaction occurred,[7552] the Examiner confirmed that this reduction was the result of an accounting adjustment (asset held for sale) to reflect the fair market value of the helicopter based on its liquidation value, not a transfer of assets to Barclays or any other entity.[7553]

(7) CES IX

The only material tangible asset reflected on the balance sheet of CES IX was a Falcon 50 corporate jet:

Debtors' Aircraft Pursuant to an Aircraft Sale and Purchase Agreement and Payment of Related Fees, at pp. 3-4, Docket No. 3003, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Mar. 5, 2009); Order Pursuant to Sections 105 and 363 of the Bankruptcy Code, Federal Rules of Bankruptcy Procedure 2002, 6004, and 9014, and Rules 6004-1, 9006-1 and 9014-1 of the Local Bankruptcy Rules Approving the Sale of Debtors' Aircraft Pursuant to an Aircraft Sale and Purchase Agreement and Payment of Related Fees, Docket No. 3219, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Mar. 25, 2009).

[7552] Appendix 34, Duff & Phelps, Tangible Asset Balance Sheet Variations, at p. 3.

[7553] E-mail from Lauren Sheridan, A&M, to David C. Layden, Examiner's Counsel, *et al.* (Jan. 22, 2010).

CES IX

	12-Sep-08	30-Sep-08		
	A	B	B-A	
				% Change
14010SUM F/A-COST-LAND	-	-	-	0.0%
14015SUM F/A-COST-BLDGS	-	-	-	0.0%
104020SUM F/A-COST-FURNITURE	-	-	-	0.0%
14025SUM F/A-COST-EQUIP-COMM.	-	-	-	0.0%
14030SUM F/A-COST-EQUIP-EDP & PC	-	-	-	0.0%
14040SUM F/A-COST-BLDNGS & L/H	-	-	-	0.0%
14045SUM F/A-COST-CONSTR.IN PROGRESS	-	-	-	0.0%
14050SUM F/A-COST-TRANS. & CAR	8,700,000	6,702,538	(1,997,462)	-23.0%
14055SUM F/A-CST-FINE ARTS & ANTIQUES	-	-	-	0.0%
14060SUM CAPITALIZED SOFTWARE	-	-	-	0.0%
71600SUM TOTAL F/A-COST	8,700,000	8,702,538	(1,997,462)	-23.0%
14515SUM F/A-A/D-BUILDINGS	-	-	-	0.0%
14520SUM F/A-A/D-FURNITURE	-	-	-	0.0%
14525SUM F/A-A/D-EQUIP.-COMM.	-	-	-	0.0%
14530SUM F/A-A/D-EQUIP.-EDP & PC	-	-	-	0.0%
14540SUM F/A-A/D-BLDGS. & L/H	-	-	-	0.0%
14550SUM F/A-A/D-TRANS. & CAR COSTS	(1,036,849)	(1,042,808)	(5,959)	0.6%
14560SUM F/A-A/D CAPITALIZED SOFTWARE	-	-	-	0.0%
71700SUM TOTAL F/A-A/D	(1,036,849)	(1,042,808)	(5,959)	0.6%
71750SUM PROPERTY, EQUIP. & LEASE.IM	7,663,151	5,659,730	(2,003,421)	-26.1%

The Falcon 50 was not transferred to Barclays in connection with the transaction; rather, CES IX sold the jet in a transaction approved by the Court in December 2008.[7554] Although the gross book value of "trans. and car" asset line on the CES IX balance sheet did decline over the period that the Barclays transaction occurred,[7555] the Examiner

[7554] Order Pursuant to Sections 105 and 363 of the Bankruptcy Code, Federal Rules of Bankruptcy Procedure 2002, 6004 and 9014, and Rules 6004-1, 9006-1 and 9014-1 of the Local Bankruptcy Rules Approving the Sale of the Debtors' Aircraft Pursuant to an Aircraft Sale and Purchase Agreement, Docket No. 2051, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Dec. 3, 2008); Debtors' Motion to Amend (I) Order Authorizing Sale of G-IVSP Aircraft and (II) Order Authorizing Sale of Falcon 50 Aircraft, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Dec. 19, 2008); Amended Order Pursuant to Sections 105 and 363 of the Bankruptcy Code, Federal Rules of Bankruptcy Procedure 2002, 6004 and 9014, and Rules 6004-1, 9006-1 and 9014-1 of the Local Bankruptcy Rules Approving the Sale of the Debtors' Aircraft Pursuant to an Aircraft Sale and Purchase Agreement, Docket No. 2362, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Dec. 23, 2008).

[7555] Appendix 34, Duff & Phelps, Tangible Asset Balance Sheet Variations Prepared By Duff & Phelps, at p. 3.

confirmed that this reduction was due to an accounting adjustment (asset held for sale) to reflect the fair market value of the aircraft based on its liquidation value, not a transfer of assets to Barclays.[7556]

c) Analysis of Intangible Asset Transfers

The Examiner and his financial advisors concluded that one LBCS intangible asset was transferred to Barclays in connection with the sale. That asset consisted of information regarding the customers with whom LBCS traded that were not within LBI's customer base, including the identity of those customers, the products they traded and the prices of those products (the "LBCS Customer Information"). LBCS also had an assembled workforce prior to LBHI's bankruptcy, but that asset was not transferred to Barclays in the sale.

The Examiner's financial advisors focused on facts that might indicate whether any of the LBHI Affiliates owned intangible assets falling into three categories:

- customer information assets, including customer lists and product and pricing information;
- proprietary software; and
- a trained, experienced assembled workforce.[7557]

[7556] E-mail from Lauren Sheridan, A&M, to David C. Layden, Examiner's Counsel, *et al.* (Jan. 22, 2010).

[7557] *See* ROBERT F. REILLY & ROBERT P. SCHWEIHS, VALUING INTANGIBLE ASSETS 19-20 (McGraw Hill 1999); Statement Of Fin. Accounting Standards No. 142. Firms also can own other categories of intangible assets, such as marketing-related intangibles (*e.g.*, trademarks, trade names and brand names), artistic-related intangibles, engineering-related intangibles, and contract-related intangibles (*e.g.*, favorable supplier contracts, license agreements and franchise agreements). REILLY & SCHWEIHS, at 19. Given the nature of their businesses, there is no reason to believe that the LBHI Affiliates owned artistic-related, engineering-related or contract-related intangibles, and the Examiner did not discover any facts

The Examiner's financial advisors reviewed the balance sheets of the LBHI Affiliates as of August 29, 2008, and September 12, 2008. Those balance sheets do not reflect any intangible assets.[7558] However, the absence of intangible assets on the balance sheets of the LBHI Affiliates would not necessarily indicate that those entities did not own intangible assets. Intangible assets typically are not reflected as assets on a firm's balance sheet unless the firm obtained them in connection with the acquisition of a business or otherwise (as opposed to developing the assets through its own efforts).[7559] Therefore, the Examiner and his financial advisors conducted a series of analyses to determine whether any LBHI Affiliates owned the types of intangible assets identified above.

(1) Customer Information Assets

A business that expends substantial effort to develop a compilation of customer data and keeps that information confidential may have a protectable interest in that data in the form of a trade secret.[7560]

There is no directly applicable case law providing firm guidance for determining, within a group of affiliated legal entities, which entity owns an intangible asset such as

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suggesting otherwise. With respect to marketing-related intangibles, the "Lehman" and "Lehman Brothers" marks were conveyed to Barclays by LBHI and LBI (and licensed by Barclays back to the Debtors' estates for use in the wind-down) in connection with the sale transaction. *See* APA, at pp. 8, (§ 1.1), 29-30 (§ 8.9). The Examiner did not discover any facts indicating that any LBHI Affiliates independently owned marks or trade names, and even if they arguably did, there is no reason to believe that any LBHI Affiliate mark or trade name was conveyed to Barclays.

[7558] Summary Balance Sheets of LBHI Affiliates Prepared by Duff & Phelps are available in Appendix 33.

[7559] *See, e.g.,* I.R.C. § 197 (2006); Statement Of Fin. Accounting Standards No. 142.

[7560] *E.g., Defiance Button Mach. Co. v. C & C Metal Prods. Corp.*, 759 F.2d 1053, 1063 (2d Cir. 1985).

a customer list. However, the Examiner's financial advisors used guidance from analogous contexts in analyzing whether LBHI Affiliates owned protectable customer information: the relationship between expenses incurred in the development of information, and the firm's ownership of that asset.[7561]

The Examiner's financial advisors determined that, although Lehman used LBI as the common "paymaster" for Lehman's employees in the United States (including, as described below, LBI employees who performed functions exclusively for certain LBHI Affiliates), Lehman allocated the compensation expenses relating to various legal entities within Lehman. Thus, certain LBHI Affiliates incurred employee expenses.[7562]

The Examiner also determined that, prior to the September 22, 2008 closing of the sale transaction, Lehman's consolidated computer systems contained information that could be used (and regularly was used) to generate lists of the counterparties with

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[7561] *See, e.g.*, *Kimball Laundry Co. v. United States*, 338 U.S. 1, 18 (1949) (holding, in context of Fifth Amendment takings claim, that it is legitimate to draw an "inference that expenditures for the purpose of soliciting business have resulted in a value which will continue to contribute to the earning capacity of the business in later years and which is therefore a value" that a purchaser may recognize); *Metal & Salvage Ass'n, Inc. v. Siegel*, 503 N.Y.S.2d 26, 28 (N.Y. App. Div. 1986) (noting that it is unlikely that a business has a protectable customer list if there is no indication that it "expended any sums on advertising or such efforts"); *see also Worldwide Sport Nutritional Supplements, Inc. v. Five Star Brands*, LLC, 80 F. Supp. 2d 25, 32 (N.D.N.Y. 1999) (determining that a business may not claim a trade secret in a product recipe if it does not actively contribute to its development or provide financial compensation to other parties who did); *Leo Silfen, Inc. v. Cream*, 278 N.E.2d 636, 640 (N.Y. 1972) (noting that customer lists are likely to be protectable when "the customers' patronage had been secured by years of effort and advertising effected by the expenditure of substantial time and money"); *Hair Say, Ltd. v. Salon Opus, Inc.*, No. 5106-01, 2005 WL 697538, at *5 (N.Y. Sup. Ct. Mar. 17, 2005) (noting that a hair salon's alleged customer list was not protectable in part because there was no evidence that the salon incurred any expenses or engaged in any networking, advertising or marketing in compiling or maintaining the list).

[7562] *See, e.g.*, FASB Statement of Financial Accounting Concepts No. 6: Elements of Financial Statements, at ¶ 24 (noting that elements, such as assets and expenses, that are reflected on financial statements "are defined in relation to a particular entity").

which the LBHI Affiliate "operating entities" – LBCS, LBCC, LCPI, LBSF, LOTC, LBDP and LBFP[7563] – traded.[7564] The information that could be, and was, generated using those systems included more than simply the identity of the counterparties; it included information such as the products traded (both currently and historically), historical trading prices, and the revenue generated by those trades.[7565]

Although this information included many counterparty names that are readily available to competitors in the industry, such as well-known investment banks, financial services firms and hedge funds, some of the counterparty names were not readily ascertainable from publicly-available sources of information,[7566] and specific product and pricing information was, by its nature, not readily determinable from sources outside of Lehman.

The Examiner also determined that, prior to the closing of the sale transaction on September 22, 2008, Lehman took steps to protect the confidentiality of the information, including corporate policies that prohibited the disclosure of such information to

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[7563] The Examiner also determined that BNC did not have any valuable customer-information assets. Even if BNC might once have had these types of assets, their value would have been lost long before September 2008, given that BNC had stopped originating subprime mortgages in August of 2007.

[7564] *See, e.g.*, Lehman, Derivative Balance Sheet Details (Aug. 2008) [LBHI_SEC07940_2528640] and (Aug. 29, 2008) [LBHI_SEC07940_2531361], attached to e-mail from Michael McGarvey, Lehman, to Jennifer Fitzgibbon, Lehman (Sept. 13, 2008) [LBHI_SEC07940_2528253]; Lehman, Fixed Income FID Client Rankings Summary (July 2008) [LBHI_SEC07940_2277547], attached to e-mail from Alex Milner, Lehman, to Thomas P. Humphrey, Lehman, *et. al.*, (Aug. 7, 2008) [LBHI_SEC07940_2277546].

[7565] Examiner's Interview of Satu S. Parikh, Jan. 4, 2010.

[7566] *Id.*

anyone outside of Lehman, and by requiring passwords to access Lehman's computer systems.[7567]

The fact that Lehman's computer systems held confidential customer-related information does not, without more, lead to the conclusion that an entity *owned* the customer-related information associated with the counterparties with which it traded.

Specifically, the Examiner's financial advisors determined that LBCS was the only LBHI Affiliate that incurred expenses relating to the development of a distinct and not readily accessible customer base. LBCS developed a commodity trading customer base that was, at least in part, separate and distinct from LBI's customer base.[7568] LBCS had been created by Lehman with the goal of developing a commodities and commodities derivative trading platform.[7569] As a result, while the trades booked in most LBHI Affiliates originated with the sales forces that served the umbrella business units,[7570] LBCS had its own dedicated sales staff.[7571] That sales force leveraged to some extent off of existing LBI customer relationships, but also was working to develop its own business opportunity leads at the time LBHI filed for bankruptcy.[7572] Therefore, although most of the customer information that LBCS used was known to competitors

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[7567] *See, e.g.*, Lehman, Lehman Brothers Confidentiality Agreement [LBEX-LL 3668555].

[7568] Examiner's Interview of Satu S. Parikh, Jan. 4, 2010.

[7569] Examiner's Interview of James P. Seery, Jr., Jan. 14, 2010, at p. 2.

[7570] Examiner's Interview of Thomas E. Hommel, Apr. 29, 2009, at p. 4.

[7571] A&M, spreadsheet of employees mapped to legal entities as of Sept. 20, 2008 [LBEX-AM 5642400]; Lehman, FID Full Population Roster (Aug. 31, 2008) [LBEX-DOCID 3102619], attached to e-mail from John Cannady Jr., Lehman, to Joann DeMange, Lehman, *et al.* (Sept. 4, 2008) [LBEX-DOCID 2880236]; Examiner's Interview of James P. Seery, Jr., Jan. 14, 2010, at p. 2.

[7572] Examiner's Interview of Satu S. Parikh, Jan. 4, 2010.

or was largely derived from LBI's customer base, LBCS did generate some unique and secret customer information of its own.

In contrast, other LBHI Affiliates that traded with counterparties did not have distinct customer bases developed by an independent sales team, but instead served largely as product booking entities into which LBI's businesses recorded transactions.[7573] For example, compensation expenses and employees were allocated to LBSF and LCPI, but there is no evidence that the employees who performed functions for these entities contributed to the development of a customer base that was distinct from LBI's customer base.[7574] Instead, employees allocated to LBSF and LCPI conducted activities primarily related to LBI transactions, with the resulting transactions booked to LBSF (for derivatives) and LCPI (for loans).[7575]

Therefore, the Examiner concludes that there was a sufficient basis to assert a colorable claim that LBCS owned the LBCS Customer Information, but that there are not sufficient facts to conclude that the other LBHI Affiliates owned customer information assets.

[7573] Examiner's Interview of James P. Seery, Jr., Jan. 14, 2010, at p. 2; Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 3; Examiner's Interview of Peter A. Tennyson, Oct. 13, 2009, at p. 2; Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 4; Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 5.

[7574] Examiner's Interview of James P. Seery, Jr., Jan. 28, 2010. The other LBHI Affiliates, including LBCC, had no employees specifically allocated to them according to Lehman's internal records. *See* A&M, Spreadsheet of Employees Mapped to Legal Entities (Sept. 20, 2008) [LBEX-AM 5642400].

[7575] *Id.*

The Examiner also concludes that the LBCS Customer Information was transferred to Barclays in connection with the sale transaction. The LBCS Customer Information all was stored in Lehman's consolidated computer systems, which were transferred to Barclays in connection with the sale closing.[7576] LBCS did not make any effort to remove the LBCS Customer Information from the consolidated systems, or to prevent Barclays from accessing or using that information, before the systems were transferred to the control of Barclays. Given the consolidated and interconnected nature of Lehman's computer system and the limited time available during the sale period, the Examiner concluded (and the Debtors confirmed) that it would not have been feasible to isolate or remove LBCS Customer Information before the Lehman systems were transferred to Barclays on September 22, 2008.[7577]

The LBCS Customer Information also likely was transferred to Barclays through the employees who performed functions exclusively for LBCS who were offered and accepted employment at Barclays.[7578]

[7576] Examiner's Interview of Thomas E. Hommel, Kelly L. Gargiulo, Lauren Sheridan, William B. Gordon and Jeffrey Donaldson, Jan. 22, 2010. *See* APA, at pp. 4 (§ 1.1), 6 (§ 1.1) (definitions of "Furniture and Equipment," "Hardware" and "Purchased Assets"); *see also* transition Services Agreement between LBHI and Barclays (Sept. 22, 2008), at Section 3.01 (providing for rights of Debtors' estates to access information systems now in the possession of Barclays); Transcript of deposition testimony of Bryan P. Marsal, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Dec. 22, 2009, at pp. 25-26.

[7577] Examiner's Interview of Thomas E. Hommel, Kelly L. Gargiulo, Lauren Sheridan, William B. Gordon and Jeffrey Donaldson, Jan. 22, 2010; Examiner's Interview of Jeffrey D. Osterman, Jan. 28, 2010.

[7578] LBI employees who performed functions exclusively for LBCS should not have been included within the group of "Offerees" that Barclays agreed to employ following the closing of the sale transaction. *See* APA, at p. 34 (§ 9.1(a)) (defining "Offeree" to include "each active employee employed primarily in connection with the Business at the Closing"); *id*. at p. 2 (§ 1.1) (defining "Business" as "the U.S. and

The Examiner thus concludes that LBCS Customer Information was transferred to Barclays in connection with the sale. As discussed below, however, that information likely would have been of little value to Barclays, given the small number of customers both unique to LBCS and not readily-determinable by competitors, and Barclays' superior commodities market share and customer base.

(2) Proprietary Software

The Examiner and his financial advisors determined that Lehman's consolidated computer systems included: (1) software developed or customized by Lehman's information technology (IT) department for product lines across numerous Lehman entities, or for a specific legal entity; and (2) "off-the-shelf" software.[7579]

Lehman's in-house IT department developed and customized software both for the entire Lehman organization, and also for individual legal entities. For example, as described above, Lehman developed GFS to track financing requirements, MTS to settle

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Canadian investment banking and capital markets businesses of [LBHI and LBI] including the fixed income and equities cash trading, brokerage, dealing, trading and advisory businesses, investment banking operations and LBI's business as a futures commission merchant."). The Examiner determined that Lehman HR personnel identified the employees that would be transferred to Barclays, and included, among others, all employees within FID, which included all of the employees who performed services for LBCS. E-mail from Tracy Binkley, Lehman, to Steven Berkenfeld, Lehman (Sept. 23, 2008) [BCI-EX-(S)-00005498]; Examiner's Interview of Tracy Binkley, Dec. 22, 2009.

[7579] Examiner's Interview of Michael Montella, Oct. 26, 2009, at p. 13; Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 2; Examiner's Interview of Jonathan D. Williams, Nov. 18, 2009, at p. 2.

certain fixed income products and ITS to process multi-currency trades.[7580] It also developed RISC as a front office derivatives trading system.[7581]

The Examiner's financial advisors evaluated whether any LBHI Affiliates owned software that was developed or customized for that entity by Lehman's IT department. The Examiner's financial advisors determined that software development costs meeting certain software capitalization requirements were capitalized on LBHI's balance sheet, and that no software development costs were capitalized on the balance sheets of the LBHI Affiliates.

The Examiner's financial advisors determined that expenses relating to software development and customization were booked to certain of the LBHI Affiliates.[7582] Under applicable legal principles, however, an entity does not own computer software simply because that entity pays for its development. The Copyright Act of 1976 protects "original works of authorship fixed in any tangible medium of expression."[7583] Computer programs may qualify for protection as a "literary work" under this definition.[7584] Though the Copyright Office grants registrations that serve as *prima facie*

[7580] *See* Section III.C.3.a.1.a.i.

[7581] Examiner's Interview of Kleber Rodriguez, Dec. 18, 2009, at p. 2.

[7582] The Examiner and his financial advisors determined that it would require incurring significant cost to attempt to specifically identify the software to which the expenses booked to the entity related, and that, in any event, such an analysis was unlikely to generate complete or reliable information.

[7583] 17 U.S.C. § 102(a) (2006).

[7584] *See Torah Soft Ltd. v. Drosnin*, 136 F. Supp. 2d 276, 283 (S.D.N.Y. 2001); *Jamison Bus. Sys., Inc. v. Unique Software Support Corp.*, No. CV 02-4887, 2005 WL 1262095, at *6 (E.D.N.Y. May 26, 2005).

evidence of valid copyrights,[7585] copyright protection exists automatically when an original work of authorship is created and fixed in a tangible medium.[7586] As a result, where software has been developed by one person for the benefit of another, the developer generally retains ownership of the software unless the parties have provided otherwise.[7587]

An exception to this rule exists when the software is produced as a "work for hire." In that case, the employer or other person for whom it was prepared is considered to be the owner.[7588] A "work for hire" can be either: (1) a work that an employee prepares in the scope of his or her employment; or (2) "a work specially ordered or commissioned for use . . . if the parties expressly agree in a written instrument signed by them that the work shall be considered a work made for hire."[7589]

Here, Lehman's IT department was employed by LBHI and LBI, not by the LBHI Affiliates. The Examiner's financial advisors also did not identify any evidence suggesting that LBHI Affiliates were parties to any work-for-hire agreements relating to software that was developed or customized exclusively for them by Lehman's IT department.

[7585] 17 U.S.C. § 410(c) (2006).
[7586] *Jamison*, 2005 WL 1262095, at * 6 (citing 17 U.S.C. § 102(a)).
[7587] 17 U.S.C. § 201(a) (2006); *Aymes v. Bonelli*, 980 F.2d 857, 860 (2d Cir. 1992).
[7588] 17 U.S.C. § 201(b) (2006).
[7589] 17 U.S.C. § 101 (2006).

As a result, the Examiner concludes that there is insufficient evidence to support a finding that the LBHI Affiliates owned proprietary software prior to the sale transaction.

Lehman also purchased off-the-shelf software that the LBHI Affiliates, among others, used in their operations. Numerous software licenses were assumed and assigned to Barclays pursuant to the Closing Date Contracts provisions in the APA.[7590] The Schedule of IT Closing Date Contracts, however, does not purport to assign to Barclays any software license agreements to which LBHI Affiliates are a party.[7591]

(3) Assembled Workforce

A trained and assembled workforce is a potentially valuable intangible asset.[7592] An assembled workforce has value because of the cost that would be incurred in replacing it.[7593]

The Lehman employees who moved to Barclays in connection with the sale were almost all employed by LBI.[7594] Compensation expenses for certain of those employees

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[7590] *See, e.g.,* APA, at p. 15 (§ 4.2(b)); List of IT Closing Date Contracts assumed and assigned under the APA (Oct. 1, 2008).

[7591] List of IT Closing Date Contracts assumed and assigned under the APA (Oct. 1, 2008).

[7592] ROBERT F. REILLY & ROBERT P. SCHWEIHS, VALUING INTANGIBLE ASSETS 400 (McGraw Hill 1999); *Ithaca Indus., Inc. v. Comm'r. of Internal Revenue*, 17 F.3d 684 (4th Cir. 1994); *Burlington N. R.R. Co. v. Blair*, 815 F. Supp. 1223 (S.D. Iowa 1993), *aff'd*, 60 F.3d 410 (8th Cir. 1995).

[7593] ROBERT F. REILLY & ROBERT P. SCHWEIHS, VALUING INTANGIBLE ASSETS 401 (McGraw Hill 1999); *La. Health Serv. & Indem. Co. v. United States*, Civil Action No. 05-914-JVP-DLD, 2009 WL 1916864, at *12 (M.D. La. July 2, 2009).

[7594] Transcript of deposition testimony of Bryan P. Marsal, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Dec. 22, 2009, at p. 32.

were booked to legal entities other than LBI, including LBCS, LBSF and LCPI.[7595] Those entities thus arguably owned an assembled workforce asset before the LBHI bankruptcy filing.

The Examiner determined, however, that the transfer of employees to Barclays does not provide a sufficient basis to conclude that a colorable claim arises from the transfer of an assembled workforce. While an assembled workforce may have ascertainable value for accounting purposes in the context of the sale of a business, it is not an asset that is subject to transfer in light of employees' inherent right to work where and for whom they choose, particularly when the business itself is not being sold as a going concern.[7596]

4. Lehman ALI Transaction

Shortly before LBI commenced its SIPA proceeding, LBHI and LBI management (in consultation with Weil) determined that all entities directly or indirectly owned by LBI that were not being sold to Barclays should be moved to an LBHI subsidiary. The reasoning was that as LBHI subsidiaries, the entities would have better access to personnel and working capital, and would be able to operate and/or wind down their businesses in a more orderly fashion than they would as a subsidiary of LBI, which was

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[7595] A&M, Spreadsheet of Employees Mapped to Legal Entities (Sept. 20, 2008) [LBEX-AM 5642400].

[7596] *See, e.g., In re 3dfx Interactive, Inc.*, 389 B.R. 842, 853 (Bankr. N.D. Cal. 2008) (terminated employees not subject to restrictive covenants were not property that could give rise to a fraudulent transfer action); *Atchison, Topeka & Santa Fe Ry. Co. v. Brown & Bryant, Inc.*, 159 F.3d 358 (9th Cir. 1997); *Orthotec, LLC v. REO Spineline, LLC*, 438 F. Supp. 2d 1122, 1129-30 (C.D. Cal. 2006); *cf. Robinson v. Watts Detective Agency, Inc.*, 685 F.2d 729, 734 (1st Cir. 1982) (an assembled workforce may be property that is subject to transfer when it is sold as part of a business that is transferred virtually wholesale to a competitor).

soon to be a debtor in a SIPA liquidation proceeding. This movement would have the practical effect of transferring control of the liquidation of these entities from the SIPA Trustee (who had not yet been appointed) to LBHI's estate.

A meeting of the LBI Board of Directors was held on September 19, 2008, at which Rod Miller of Weil presented the plan to transfer subsidiaries of LBI to Lehman ALI, a non-debtor entity that had been selected to hold these companies because it was identified primarily as a holding company.[7597] He informed the Board that all of these subsidiaries were part of LBI's Investment Management Division and/or shared resources with LBHI entities.[7598] He also advised the Board that a secured payment-in-kind (PIK) note would be executed in consideration for the transfer, and that the initial value of the note would be determined by Lazard. Miller reported that the SIPA Trustee supported this plan and had asked for input into the valuation method.[7599] Miller explained the terms of the note, stating that the intention was to provide the SIPA Trustee with the same cash flows and protections as if LBI had continued to own the subsidiaries.[7600] The Board determined that a memo should be prepared by Weil memorializing their discussions with the SIPA Trustee and his approval.[7601] The Board

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[7597] Lehman Brothers Inc., Minutes of Meeting of Board of Directors (Sept. 19, 2008), at pp. 1-2 [LBEX-AM 004030]; Examiner's Interview of Rod Miller, Feb. 27, 2009.

[7598] Lehman Bros. Inc., Minutes of Meeting of Board of Directors (Sept. 19, 2008), at p. 2 [LBEX-AM 004030].

[7599] *Id.*

[7600] *Id.*

[7601] *Id.*

also determined that the SIPA Trustee should be reminded of the plan to transfer the LBI subsidiaries to Lehman ALI at the sale hearing.[7602] The Board then authorized the transfer.[7603]

Counsel to the SIPA Trustee told the Examiner that the SIPA Trustee was informed about, but did not specifically approve, the transfer. Counsel noted that because LBI's SIPA proceeding had not yet been commenced and the SIPA Trustee had not yet been formally appointed, the SIPA Trustee technically could not agree to anything. The SIPA Trustee was informed that the book value of the affected subsidiaries was substantial, and believed the implication of this statement was that the Lehman ALI transaction therefore would result in substantial value for the LBI estate.[7604]

On September 19, 2008, 25 legal entities and their subsidiaries were transferred from LBI to Lehman ALI pursuant to a PIK Note & Security Agreement[7605] and Transfer Agreement.[7606] The legal entities transferred to Lehman ALI included:

a. Blue JAY Realty Corp.
b. FRAH Special Services Inc.
c. LBI Group Inc. (holding company for Townsend Analytics)
d. LBI India Holdings Mauritius III Limited
e. LB Leasing Inc.
f. Lehman Brothers (Israel) Inc.
g. Lehman Brothers (Spain) S.A.

[7602] *Id.*

[7603] *Id.* at pp. 2-3.

[7604] Examiner's Interview of Kenneth E. Lee, Jan. 8, 2010, at p. 2.

[7605] PIK Note & Security Agreement between Lehman ALI Inc. and Lehman Brothers Inc. (Sept. 19, 2008).

[7606] Transfer Agreement among Lehman Brothers Inc., LBI Group Inc., and Lehman ALI Inc. (Sept. 19, 2008); Examiner's Interview of Rajesh Ankalkoti and William Fox, May 6, 2009, at p. 2.

h. Lehman Brothers de Venezuela C.A.
i. Lehman Brothers Derivatives Products Inc.
j. Lehman Brothers Europe Inc.
k. Lehman Brothers Finance (Japan) Inc.
l. Lehman Brothers Financial Products Inc.
m. Lehman Brothers Investment Holding Company Inc.
n. Lehman Brothers International Services, Inc.
o. Lehman Brothers Holdings International Inc.
p. Lehman Brothers Investment Management Asia Limited
q. Lehman Brothers Overseas Inc.
r. Lehman Brothers Securities Taiwan Limited
s. Lehman Brothers South Asia Limited
t. Lehman Brothers Special Financing Inc. (parent company of Lehman Brothers Commodity Services)
u. Lehman Commercial Paper, Inc. and its subsidiaries
v. Lehman Realty and Development Corp.
w. MBR/GP Corp.
x. RIBCO LLC
y. RIBCO SPC, Inc.

These 25 legal entities generally had no business operations other than trading and/or acting as holding companies for private equity (limited and/or general partner) investments.[7607] Lazard believes that these entities had no going concern or other value over and above the value of their assets, and therefore has determined to value these entities based solely upon the value of the securities, derivatives, private equity investments and other assets held by them.[7608] The SIPA Trustee generally agrees that this valuation methodology is appropriate.[7609]

[7607] Examiner's Interview of Rajesh Ankalkoti and William Fox, May 6, 2009, at p. 2.
[7608] Examiner's Interview of David Descoteaux, Matthew Whiting, Philip Kruse and Thomas E. Hommel, Mar. 26, 2009, at p. 2.
[7609] Examiner's Interview of Kenneth E. Lee, Jan. 8, 2010, at p. 2.

The PIK Note & Security Agreement calls for a valuation of the transferred subsidiaries by Lazard as of the transfer date (September 19th).[7610] In connection with the Examiner's investigation into the Lehman ALI transaction, A&M provided to the Examiner a "PIK Note Analysis - Pro-forma Combining Balance Sheet," reflecting financial information for the transferred entities as of September 14, 2009.[7611] The Pro-forma Combining Balance Sheet consists of *pro forma* balance sheets for the five largest entities transferred to Lehman ALI, as well as a sixth *pro forma* balance sheet consolidating the remaining twenty entities.[7612] It shows approximately $175 billion in consolidated book value of assets on Sunday, September 14, 2008 (the last date on which Lehman's books were closed), and $173 billion in consolidated book value of liabilities.[7613] It excludes Lehman ALI's pre-existing businesses before the transfer of the 25 legal entities.[7614] A&M indicated that there are significant limitations to the values used in the Pro-forma Combining Balance Sheet, including the lack of marks current as

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[7610] PIK Note & Security Agreement between Lehman ALI Inc. and Lehman Brothers Inc. (Sept. 19, 2008), at p. 1.

[7611] September 14 Pro-forma Combining Balance Sheet [LBEX-AM 086496-086499]. On January 28, 2010, A&M provided the Examiner with an updated version of the September 14 Pro-forma Combining Balance Sheet. [LBEX-AM 5643211-5643214]. The changes were modest in nature, and did not impact the Examiner's analysis or conclusions.

[7612] *Id.*

[7613] Examiner's Interview of Rajesh Ankalkoti and William Fox, May 6, 2009, at p. 2.

[7614] *Id.*

of September 14, 2008, in some cases, and limitations inherent to an out-of-cycle, mid-month close.[7615]

The Pro-forma Combining Balance Sheet organized the assets transferred to Lehman ALI into six groups: (1) LB Special Financing, Inc., which is the parent company of LBCS; (2) LCPI and its subsidiaries, which were the group of companies engaged in origination and trading of secured and unsecured loans; (3) LBI Group, Inc., which is the holding company for a number of private equity investments; (4) LBFP (one of the two stand-alone AAA-rated derivatives trading entities); (5) LBDP (the other stand-alone AAA-rated derivatives trading entity); and (6) Other, representing the remaining 20 legal entities.[7616]

None of the data in the September 14 Pro-forma Combining Balance Sheet reflects September 19 values, or indeed trading information from the week of September 15.[7617] Tens of thousands of derivatives and other trades were terminated by counterparties beginning the week of September 15, so by September 19, substantial value in these entities had been lost, very likely in the range of tens of billions of dollars.[7618] In addition, many assets delivered to counterparties as collateral were

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[7615] *Id.* at pp. 2-3; Examiner's Interview of William Fox, Brad Goldsmith and Michael Tarsatana, Jan. 28, 2010.

[7616] Examiner's Interview of William Fox, Brad Goldsmith and Michael Tarsatana, Jan. 28, 2010, at p. 3.

[7617] Because September 14 was a Sunday, values from September 12 (the preceding Friday) were used. *Id.* at p. 4.

[7618] *Id.*

liquidated during the week of September 15 at very disadvantageous prices.[7619] As a result, the net book value of the transferred subsidiaries' assets, as marked by Lehman as of September 12, 2008, appears to be a very poor indicator of the value of those assets one week later.[7620] For example, according to Lehman's September 12, 2008 marks, the security assets included $19 billion in government securities, several billion dollars in asset backed securities, $4 billion in real estate securities, and smaller amounts of securities in other categories.[7621] Although Lazard has been unable to access much data for these securities for the period between September 12 and September 19, it is very likely that their values decreased significantly during this period.[7622]

More than 70,000 securities and derivatives were reflected on the books of the Lehman ALI entities, many of which were closed-out or liquidated by counterparties during the week of September 15.[7623] Virtually every asset liquidated by a counterparty presents unique valuation issues pertaining to the values selected by the counterparty at liquidation, the commercial reasonableness of the counterparty liquidation, and setoff issues with respect to in-the-money liquidations.[7624] It is likely that many of the valuations used by counterparties may be the subject of future litigation between the

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[7619] Examiner's Interview of David Descoteaux, Matthew Whiting, Philip Kruse and Thomas E. Hommel, Mar. 26, 2009, at p. 2.
[7620] *Id.*
[7621] *Id.*
[7622] *Id.*
[7623] *Id.* at pp. 2-3.
[7624] *Id.*

counterparties and the Debtors, and thus there appears to be no realistic scenario under which Lazard will be able to perform a meaningful valuation of the Lehman ALI assets until these complicated issues are sorted out during the course of administration of the Debtors' estates.[7625]

After taking into account the termination of derivatives positions, the consolidated balance sheets for the entities transferred to Lehman ALI will be severely negative.[7626] If one looks at individual entities rather than all 25 as a package, however, two of the entities (LBFP and LBDP, the AAA-rated derivatives trading entities) managed to maintain positive value.[7627] However, the PIK Note & Security Agreement does not specify whether the entities should be valued on an entity-by-entity or consolidated basis, and the Debtors and the SIPA Trustee are in disagreement on this issue. The SIPA Trustee maintains that any positive value attributable to LBFP and LBDP should be paid to the LBI estate under the PIK Note & Security Agreement,[7628] while the Debtors assert that any positive value in LSFP and LBDP should be offset

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[7625] *Id.*

[7626] Examiner's Interview of Rajesh Ankalkoti and William Fox, May 6, 2009, at p. 5; Examiner's Interview of Kenneth E. Lee, Jan. 8, 2010, at p. 2; Examiner's Interview of William Fox, Brad Goldsmith and Michael Tarsatana, Jan. 28, 2010, at p. 2.

[7627] Examiner's Interview of Kenneth E. Lee, Jan. 8, 2010, at pp. 2-3 (noting that a third entity might have inconsequential positive value); Examiner's Interview of William Fox, Brad Goldsmith and Michael Tarsatana, Jan. 28, 2010, at p. 2.

[7628] Examiner's Interview of Kenneth E. Lee, Jan. 8, 2010, at p. 3; Lehman, Lehman Brothers, Inc. and Principal Subsidiaries as of November 30, 2007 [LBEX-DOCID 003813].

against the negative value attributable to other LBI entities transferred to Lehman ALI.[7629]

5. Conclusions

a) Summary

As described above, the Examiner concludes that there is insufficient evidence to support a finding that there were any transfers to Barclays of securities owned by LBHI Affiliates in connection with the sale transaction. There are, however, as noted above, a limited number of securities associated with 817 CUSIPs that were transferred to Barclays for which the Examiner has been unable to obtain definitive ownership information. It therefore is possible that some of those securities were owned by LBHI Affiliates at the time they were transferred to Barclays.

With respect to the potential transfer of securities owned by LBHI Affiliates to Barclays, the Examiner concludes that, unless there is a determination that Barclays engaged in actual fraud or colluded with LBI in connection with the sale transaction (issues with respect to which the Examiner is not reaching conclusions, in light of the current litigation), the evidence does not support the existence of a colorable claim against Barclays.

The Examiner concludes that some assets of LBHI Affiliates were transferred to Barclays that were not supposed to be included in the sale transaction, namely: (1) the

[7629] Examiner's Interview of William Fox, Brad Goldsmith and Michael Tarsatana, Jan. 28, 2010.

LBCS Customer Information (information identifying customers of LBCS who were not part of LBI's customer base, the products that those customers traded and the prices at which the products were traded); and (2) communications equipment, computer equipment and furniture of LBCS, LBSF and LCPI (the "LBHI Affiliate Office Equipment").

The Examiner concludes that the transfers of LBCS Customer Information and LBHI Affiliate Office Equipment (together, the "LBHI Affiliate Assets") to Barclays in connection with the sale transaction give rise to colorable claims against Barclays under the Bankruptcy Code.

The Examiner also concludes that the evidence does not support the existence of a colorable claim against the officers and director of the LBHI Affiliates arising from the transfer to Barclays of the LBHI Affiliate Assets.

The Examiner concludes that the Lehman ALI transaction was undertaken in good faith, and properly disclosed under the circumstances.

b) Colorable Claims Arising from Transfer of LBHI Assets

(1) There Are No Colorable Claims Against Barclays Arising from Transfer of LBHI Affiliate Securities

As discussed in Section III.C.3.a of this Report, the Examiner's financial advisors did not identify any securities transferred to Barclays that were associated with LBHI Affiliates, which LBI did not own or have the authority to transfer. The Examiner was not able to verify that LBI held for its own account, or had the authority to transfer to

Barclays, a relatively small group of securities and securities entitlements that might be attributable to LBHI Affiliate Entities.[7630] Even if LBI did not have authorization from LBHI Affiliates to transfer securities held for their account, however, the securities intermediary and protected purchaser rules of Article 8 of the Uniform Commercial Code (the "UCC"), as well as the safe harbor provisions of the Bankruptcy Code, preclude claims by LBHI Affiliates against Barclays arising from transfers of securities unless Barclays had actual or constructive notice that the transfers were unauthorized, or Barclays engaged in fraud, collusive conduct or otherwise did not act in good faith in connection with the sale. Because those matters are the subject of litigation before this Court, the Examiner has not reached any conclusions with respect to such issues.

The LBHI Affiliates may use the Bankruptcy Code to compel Barclays to turn over to their estates any property in which they have an interest, potentially including LBHI Affiliate securities. Section 542 of the Bankruptcy Code provides that a debtor may compel the turnover of any property that a debtor is permitted to use, sell or lease under Section 363 of the Bankruptcy Code.[7631] Section 363, in turn, provides that a debtor may use "property of the estate."

[7630] As explained above in Section III.c.3.a.2.d, there is a relatively small number of securities (consisting of 817 CUSIPs) that were transferred to Barclays, for which the Examiner was unable to obtain sufficient information to make a definitive determination regarding ownership.

[7631] 11 U.S.C. § 542(a) (2006). Although these sections by their express terms refer to a trustee, section 1107(a) of the Bankruptcy Code makes them applicable to a debtor in a Chapter 11 case. Consequently, this Section refers interchangeably to a debtor and a trustee.

Section 541 of the Bankruptcy Code defines "property of the estate" broadly to encompass "all legal or equitable interests of the debtor in property as of the commencement of the case."[7632] In the absence of controlling federal law, "'property' and 'interests in property' are creatures of state law."[7633] In enacting the Bankruptcy Code, Congress "generally left the determination of property rights in the assets of a bankrupt's estate to state law."[7634]

New York – whose laws apply to the transactions at issue[7635] – has enacted Revised Article 8 of the Uniform Commercial Code, which sets forth rules governing, among other things, property rights and obligations of parties in connection with securities and securities entitlements.[7636] The LBHI Affiliates' rights to securities maintained at LBI are governed by Article 8 of the Uniform Commercial Code as adopted by New York.

[7632] 11 U.S.C. § 363(b), 541(a) (2006).

[7633] *Barnhill v. Johnson*, 503 U.S. 393, 398 (1992).

[7634] *Butner v. United States*, 440 U.S. 48, 54 (1979).

[7635] Under NY U.C.C. § 8-110 (2001), New York law is likely to govern an action by LBHI Affiliates in connection with LBI's transfers of the affiliates' securities, if any, to Barclays. *Id.* NY U.C.C. § 8-110(b)(4) states that "[t]he local law of the securities intermediary's jurisdiction" governs "whether an adverse claim can be asserted against a person who acquires a security entitlement from the securities intermediary…" *Id.* NY U.C.C. § 8-110(e)(5) defines "securities intermediary's jurisdiction" to include "the jurisdiction in which the chief executive office of the securities intermediary is located." *Id.* Here, LBI was headquartered in New York.

[7636] *See S.E.C. v. Credit Bancorp, Ltd.*, 386 F.3d 438, 447 (2d Cir. 2004). All states have adopted Revised Article 8 of the Uniform Commercial Code, the Official Text of which was promulgated in 1994 by the National Commissioners of Uniform State Laws and the American Law Institute. New York adopted the Official Text of Revised Article 8 on October 10, 1997. Revised Article 8 recognizes the indirect holding system for securities and provides rules governing entitlements held and transferred by securities intermediaries which are the subject of this section of the Examiner's Report.

UCC § 8-503 governs transfers made by "securities intermediaries" of "financial assets," in which "entitlement holders" have property interests. Here, LBI was a "securities intermediary" that held LBHI Affiliates' securities.[7637] The LBHI Affiliates were "entitlement holders"[7638] that held "security entitlements"[7639] to their securities through LBI acting as their securities intermediary.

The concept of "security entitlement" under Article 8 is not the same as the common law concept of property ownership: "the incidents of this property interest are established by the rules of Article 8, not by common law property concepts … it is a package of rights and interests that a person has against the person's securities intermediary and the property held by the intermediary."[7640] Article 8 substantially limits the rights of "entitlement holders," such as the LBHI Affiliates, to recover from third parties losses resulting from wrongful transfers of their securities by a securities intermediary. An entitlement holder "cannot assert rights directly against other persons, such as … third parties to whom the intermediary may have wrongfully transferred interests, except in extremely unusual circumstances where the third party

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[7637] U.C.C. § 8-102(a)(14) (1994) (defining "securities intermediary" to include "a broker that in the ordinary course of its business maintains securities accounts for others").
[7638] U.C.C. § 8-102(a)(7) (1994) (defining "an entitlement holder" as "a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary").
[7639] U.C.C. § 8-102(a) (1994) (defining "a security entitlement" as "the rights and property interest of an entitlement holder with respect to a financial asset" held by a securities intermediary).
[7640] U.C.C. § 8-503 cmt. 2 (1994).

was itself a participant in the wrongdoing."[7641] This broad protection of purchasers that acquire securities from securities intermediaries reflects "the general policy of the commercial law of the securities holding and transfer systems" to eliminate legal rules that might induce purchasers "to conduct investigations of the authority of persons transferring securities on behalf of others for fear that they might be held liable for participating in a wrongful transfer."[7642]

UCC § 8-503(d) provides that an "entitlement holder's property interest" with respect to financial assets held by a securities intermediary may be enforced against a purchaser of the financial assets only if: (1) the securities intermediary is insolvent, (2) it cannot satisfy the security entitlements of all of its entitlement holders to the financial asset, (3) it wrongfully transferred the financial assets to the purchaser and (4) the purchaser is not protected under subsection 8-503(e). UCC § 8-503(e) in turn, provides that an entitlement holder cannot assert any common law claims, including conversion, replevin, constructive trust or equitable lien, against the purchaser of the financial assets which were held by the securities intermediary, as long as the purchaser: (1) gives value, (2) obtains control and (3) does not act in collusion with the

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[7641] *Id.*

[7642] U.C.C. § 8-503 cmt. 3 (1994); Egon Guttman, Modern Securities Transfers §§ 11A-3; 11A-4 (Thompson 2009).

securities intermediary in violating the securities intermediary's obligations to the entitlement holder.[7643]

Similarly, the protected purchaser provisions of UCC § 8-303 provide that a purchaser of a certificated or uncertificated security, or of an interest therein, acquires its interest in the security free of any adverse claim if the purchaser: (1) gives value, (2) does not have notice of any adverse claim to the security and (3) obtains control of the certificated or uncertificated security.[7644] A person gives "value" for rights if he or she acquires them "in return for any consideration sufficient to support a simple contract."[7645]

With respect to obtaining control, "[t]he key to the control concept is that the purchaser has the present ability to have the securities sold or transferred without further action by the transferor."[7646] If a certificated security is in bearer form, control is obtained by delivery to the purchaser. Where certificated securities are in registered form, there must be both delivery and either an effective endorsement or registration of the transfer by the issuer.[7647] A purchaser has "control" of an uncertificated security if either the uncertificated security is delivered to the purchaser, or the issuer has agreed

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[7643] U.C.C. § 8-503(e) (1994).
[7644] U.C.C. § 8-303 (1994).
[7645] U.C.C. § 1-201(44)(d) (1994).
[7646] 17 Williston on Contracts § 51:57 (4th ed. 2004).
[7647] U.C.C. § 8-106(b) (1994).

that it will comply with instructions originated by the purchaser without further consent by the registered owner.[7648]

Under UCC § 8-105(a), a person has "a notice of an adverse claim" if the person: (1) has actual knowledge of the adverse claim, (2) is aware of facts sufficient to indicate that there is a significant probability that the adverse claim exists and deliberately avoids information that would establish the existence of the adverse claim or (3) has a duty, imposed by statute or regulation, to investigate whether an adverse claim exists, and the investigation so required would establish the existence of the adverse claim.[7649] UCC § 8-105 cmt. 6 explains that, "[k]nowledge of the existence of the representative relation is not enough in itself to constitute 'notice of an adverse claim' that would disqualify the purchaser from protected purchaser status. A purchaser may take a security on the inference that the representative is acting properly."[7650]

The UCC § 8-303 protected purchaser rule applies only to directly held securities.[7651] Purchasers of securities entitlements from securities intermediaries benefit from the protections as set forth in Part 5 of Article 8 of the UCC.

[7648] U.C.C. § 8-106(c) (1994); 17 Williston on Contracts § 51:57 (4th ed. 2004).

[7649] *See also* Egon Guttman, Modern Securities Transfers § 11A-3 (Thompson 2009).

[7650] Barclays would be deemed to have had a notice of an adverse claim if "the security certificate: (1) whether in bearer or registered form, has been indorsed 'for collection' or 'for surrender' or for some other purpose not involving transfer, or (2) is in bearer form and has on it an unambiguous statement that it is the property of a person other than the transferor, but the mere writing of a name on the certificate is not such a statement." 17 Williston on Contracts § 51:57 (4th ed. 2004).

[7651] 17 Williston on Contracts § 51:58 (4th ed. 2004).

Here, under both the securities intermediary rule of UCC § 8-503 and the protected purchaser rule of UCC § 8-303, Barclays "gave value" for the LBHI Affiliates' securities, if any, and "obtained control" of them.[7652] Barclays also "gave value" because it acquired any LBHI Affiliates' securities "in return for any consideration sufficient to support a simple contract."[7653] Finally, Barclays obtained control of those securities when it took delivery of them, registered them in its name, settled the entries on the books of its clearing corporation, or by other means.[7654]

The Examiner has not found material evidence that, prior to any transfers, Barclays had either actual or constructive notice of any adverse claims to the securities, or of collusion or other improper conduct specifically directed at violating LBI obligations to an LBHI Affiliate with respect to securities held by LBI in which an LBHI Affiliate may have had some interest or claim. Therefore, the Examiner concludes that even if any securities were transferred to Barclays in which an LBHI Affiliate held an interest and LBI lacked authority to make the transfer, in the absence of a showing of fraud or collusion on the part of Barclays, or Barclays' actual or constructive notice of the LBHI Affiliates' adverse claims, Article 8 of the UCC protects Barclays against common law claims to those securities that the LBHI Affiliates might assert.

[7652] The Examiner found no evidence that Barclays did not obtain control of the securities transferred to it by LBI by one of the methods contemplated by U.C.C. § 8-106 (1994).
[7653] U.C.C. § 1-204(d) (1994).
[7654] U.C.C. § 8-301 cmt. 3 (1994).

Because Article 8 of the UCC prevents LBHI Affiliates from asserting an interest or adverse claim under state law against LBHI Affiliate securities transferred to Barclays, any such securities, after their transfer to Barclays pursuant to the APA, likely were not property of the LBHI Affiliates' estates under Section 541 of the Bankruptcy Code at the time the LBHI Affiliates commenced their respective bankruptcy cases. Therefore, such securities (if any) could not be recovered from Barclays under Section 542 of the Bankruptcy Code.

The Examiner also concludes that, absent fraud or bad faith, any transfers of LBHI Affiliate securities also may not be avoided under applicable Bankruptcy Code avoidance provisions. By the weight of current judicial authority, in the absence of a showing of actual fraud on the part of LBI, LBI's securities transfers to Barclays would be protected from avoidance under Section 544 (transfers avoidable by debtor standing in the shoes of certain hypothetical or actual creditors), Section 545 (avoidance of statutory liens), Section 547 (preferences) and Section 548 (fraudulent transfers) of the Bankruptcy Code.

The Bankruptcy Code's safe harbor provision, Section 546(e) (as amended by the Financial Netting Improvements Act of 2006), provides:

> [T]he trustee may not avoid a transfer that is a margin payment … or settlement payment … made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with

> a securities contract … commodity contract … or forward contract, that is made before the commencement of the case, except under Section 548(a)(1)(A) of this title.

Section 548(a)(1)(A) allows a debtor to avoid only those transfers of the debtor's property that were made by the debtor "with actual intent to hinder, delay, or defraud." Fraudulent intent refers to the intent of the debtor transferor (LBI), not the intent of the transferee (Barclays).[7655]

The legislative history of the safe harbor provisions indicates that Congress sought to reduce the systematic risk in the financial marketplace and prevent a "ripple effect" in which the insolvency of one financial firm triggers failures elsewhere in the market.[7656] Many courts have interpreted the safe harbor provisions expansively, emphasizing that the phrase "in connection with" has a broad meaning.[7657] Courts have also construed the term "settlement payments" broadly,[7658] extending the safe harbor protections to purely private securities transactions, such as LBOs[7659]

[7655] *See Rubin Bros. Footwear, Inc. v. Chem. Bank* (*In re Rubin Bros. Footwear, Inc.*), 119 B.R. 416, 423 (S.D.N.Y. 1990) ("For the purposes of 11 U.S.C. § 548(a)(1), plaintiff must show fraudulent intent on the part of the transferor, rather than on the part of the transferee." (citation omitted)).

[7656] H.R. Rep. No. 97-420 (1982); U.S. Code Cong. & Admin. News (1982).

[7657] *See Interbulk, Ltd. v. Louis Dreyfus Corp.*, 240 B.R. 195, 202 (Bankr. S.D.N.Y. 1999) ("in connection with" is similar to related to); *In re Casa de Cambio Majapara*, 390 B.R. 595 (Bankr. N.D. Ill. 2008) (prejudgment attachments obtained in state court actions as a result of debtor's breach of swap agreements were transfers made "in connection with" swap agreements).

[7658] The Bankruptcy Court for the Southern District of New York recently ruled that, in determining whether a transfer constituted a "settlement payment" entitled to safe harbor protection, courts should consider, among other things, whether the transactions have long settled by means of actual transfers of consideration, so that subsequent reversal of the trade may result in disruption in the securities industry; whether consideration was paid out in exchange for the securities or property interest as part of settlement of the transaction; and whether the transfers were made to financial intermediaries involved in the national clearance and settlement systems. *Alfa, S.A.B. de C.V. v. Enron Creditors Recovery Corp. (In re*

The Financial Netting Improvements Act of 2006 ("FNIA") substantially broadened the safe harbor protections by extending them not only to settlement and margin payments, but also to transfers "made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract … commodity contract … or forward contract."[7660] Consequently, absent a showing that LBI made the securities transfers to Barclays with "actual intent to hinder, delay, or defraud" the LBHI Affiliates or other creditors, the Bankruptcy Code's safe harbor provisions likely protect Barclays from avoidance claims that might be asserted by the LBHI Affiliates' estates.[7661]

Even if LBI made the transfers with actual fraudulent intent, however, Section 548(c) still may provide a limited defense to Barclays against any avoidance claims. Under Section 548(c), a transferee that "takes for value and in good faith" has a lien or may retain an interest transferred (or enforce an obligation incurred) to the extent it

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Enron Creditors Recovery Corp.), Bankruptcy No. 01-16034 (AJG) 2009 WL 5174119 at *16 (S.D.N.Y. Nov. 20, 2009) (transactions in which notes were redeemed by debtor prior to maturity, using the customary mechanism of the Depository Trust Company for trading in commercial paper, constituted "settlement payments").

[7659] *In re QSI Holdings Inc.*, 571 F.3d 545 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009); *In re Resorts Int'l, Inc.*, 181 F.3d 505 (3d Cir. 1999); *In re Kaiser Steel Corp.*, 952 F.2d 1230 (10th Cir. 1991); *Kaiser Steel Corp. v. Charles Schwab & Co., Inc.*, 913 F.2d 846 (10th Cir. 1990).

[7660] 11 U.S.C. § 546(e).

[7661] For a more detailed discussion see Section D.2 of Appendix 1.

gave value to the debtor in exchange for such transfer or obligation.[7662] The Bankruptcy Code does not define "good faith" as used in Section 548(c). Nonetheless, "federal courts have reached a consensus that 'good faith' as used in Section 548(c) must be determined according to an 'objective' or 'reasonable person' standard, and does not turn on the subjective knowledge or belief of the transferee."[7663] Consequently, a "transferee cannot be found to have taken a transfer in good faith if the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose, and a *diligent* inquiry would have discovered the fraudulent purpose."[7664]

So long as the securities transfers were not made with the actual intent to hinder, delay, or defraud LBHI Affiliates or other creditors, or Barclays acted in good faith (issues as to which the Examiner reaches no conclusions in light of the ongoing Barclays litigation), the safe harbor provisions of the Bankruptcy Code likely would protect Barclays from an avoidance action or claim arising from transfers, if any, to Barclays of securities in which an LBHI Affiliate may have held an interest.[7665]

[7662] *See* 11 U.S.C. §548(c); *see also In re Adler, Coleman Clearing Corp.*, 263 B.R. 406, 471 (Bankr. S.D.N.Y. 2001) ("As a threshold matter, by its very terms § 548(c) provides that, in order to invoke this defense, the transferee must satisfy three standards: take (1) for value *and* (2) in good faith, and (3) claim the applicable right to the interest only to the extent the transferee gave value to the debtor in exchange").

[7663] *In re Bayou Group, LLC, et al.*, 396 B.R. 810, 844 (Bankr. S.D.N.Y. 2008) (citations omitted).

[7664] *Id.* at 845.

[7665] In addition, cases have held that state law causes of action based upon the same underlying facts as the federal bankruptcy causes of action are preempted by federal law. *See Contemporary Indus.*, 564 F.3d at 988 (state law claims for unjust enrichment and illegal and/or excessive shareholder distributions preempted by Section 546(e)); *Official Comm. Unsecured Creditors of Hechinger Inv. Co. v. Fleet Retail Fin. Group (In re Hechinger Inv. Co.),* 274 B.R. 71, 96 (D. Del. 2002) (unjust enrichment claim preempted by

As noted above, whether fraudulent or improper conduct occurred in connection with the sale of LBI's business to Barclays is the subject of ongoing litigation, including extensive fact and expert discovery. The Examiner is not reaching conclusions in this Report pertaining to the matters that are the subject of that litigation. The Examiner's findings here are limited solely to whether additional claims, independent of the claims that are the subject of the Barclays sale litigation, may be asserted against Barclays for the transfer of LBHI Affiliate securities to Barclays.

(2) There Are Colorable, Limited Claims Against Barclays Arising from Transfer of LBHI Affiliate Office Equipment and LBCS Customer Information

The Examiner concludes that the transfer to Barclays of LBHI Affiliate Assets gives rise to colorable claims against Barclays. However, in the context of the Debtors' cases, the transferred assets may not be of material value to the Debtors' estates, and the costs of pursuing recovery of those assets may even exceed their value.

The Examiner notes that whether fraud or improper conduct occurred in connection with the sale of LBI's assets to Barclays is the subject of ongoing litigation. Except for the facts reported in Section III.C.6 of the Report, the Examiner is not addressing facts or reaching conclusions in this Report pertaining to the matters that are the subject of that litigation. Thus, the Examiner's findings here are limited solely to whether additional claims, independent of the claims that are the subject of the Barclays

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section 546(e)). Thus, the safe harbor provisions also may preempt a trustee or debtor from proceeding on alternative state law theories to recover on account of otherwise unavoidable transfers.

sale litigation, may be asserted against Barclays for the transfer of LBHI Affiliate Assets to Barclays.

(a) Bankruptcy Code Claims

(i) Section 542

Colorable claims against Barclays exist under Section 542 of the Bankruptcy Code arising from the transfers of LBHI Affiliate Assets to Barclays in connection with the sale transaction.

Section 542(a) provides that "an entity, other than a custodian, in possession, custody, or control, during the case, of property" of the estate "shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate."[7666] Section 541 of the Bankruptcy Code, in turn, provides that the debtor's estate consists of "all legal and equitable interests of the debtor in property as of the commencement of the debtor's [bankruptcy] case."[7667] Even property transferred by the debtor to a third party may be subject to Section 542's mandatory turnover provisions, if the debtor retains its interest in the property.[7668] Thus, under this framework, if a debtor's assets were stolen or otherwise improperly transferred without the debtor's authorization, the debtor could

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[7666] 11 U.S.C. § 542(a) (2006).

[7667] 11 U.S.C. § 541(a) (2006).

[7668] *See, e.g.*, *U.S. v. Whiting Pools*, 462 U.S. 198, 206 (1983) ("While there are explicit limitations on the reach of § 542(a), none requires that the debtor hold a possessory interest in the property at the commencement of the [bankruptcy case]."); *In re Pyatt*, 486 F.3d 423 (8th Cir. 2007) (debtor's postpetition transfer of funds recoverable pursuant to § 542); *In re U.S.A. Diversified Prods., Inc.*, 193 B.R. 868 (Bankr N.D. Ind. 1995) (trustee may recover debtor's prepetition transfer of funds to trust account).

compel the return of the property pursuant to Section 542 as the debtor would retain a non-possessory interest in the property.[7669] In *Whiting Pools*, the Second Circuit held that even if Section 542 were narrowly construed, it would, at a minimum, authorize the debtor to recover property "from persons in wrongful possession following theft or conversion."[7670]

As indicated above in Sections III.C.3.b and III.C.3.c, the Examiner concludes that (1) LBHI Affiliate Office Equipment owned by LBCS, LCPI and LBSF; and (2) LBCS Customer Information, were transferred to Barclays as part of the sale. As was made clear in the Sale Order and at the sale hearing, the Bankruptcy Court did not authorize the transfer to Barclays of any assets owned by LBHI Affiliates, and Barclays specifically disclaimed any expectation that it would receive such assets. Because the assets are property of LBCS, LBSF and LCPI, those estates have colorable claims under Section 542 to recover the assets, or their value.[7671]

In response to such a claim, Barclays might argue, among other things, that a claim does not exist under Section 542 because the assets were transferred to Barclays before the LBHI Affiliates' respective petition dates, and that therefore the assets do not constitute "property of the estate." That argument, however, may not preclude a Section 542 claim with respect to those assets. The assets were owned by LBCS, LBSF

[7669] *United States v. Whiting Pools, Inc.*, 674 F.2d 144 (2d Cir. 1982), *aff'd by* 462 U.S. 198 (1983).

[7670] *Id*. at 155; *see also In re Vogt*, 245 B.R. 53 (Bankr. E.D. Va. 2000).

[7671] 11 U.S.C. § 542(a) (2006); *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 207 (1983); *Braunstein v. McCabe*, 571 F.3d 108, 116 (1st Cir. 2009).

and LCPI at the time of the sale transaction. The transfers of those assets were neither authorized by the owners of the assets (LBCS, LBSF and LCPI) nor by the Court's Sale Order, and Barclays asserted that it would not be buying any LBHI Affiliate assets. LBCS, LBSF and LCPI thus likely maintained interests in the LBHI Affiliate Assets at the time they filed their respective Chapter 11 petitions, and those assets remain property of their bankruptcy estates.[7672]

With respect to the LBCS Customer Information, it is possible that any protectable property rights were lost in connection with consummation of the sale transaction. LBCS may have waived the secrecy necessary to possess legally protectable rights in the LBCS Customer Information when that information was transferred to Barclays without any confidentiality restrictions. Because one of the elements required for the legal protection of a competitively valuable trade secret or customer-related asset is that the holder take reasonable steps to maintain its secrecy,[7673] the Second Circuit has held that when a business sells most of its assets to a competitor, even when it does not intend to include otherwise protectable customer lists in the sale, the failure to take adequate measures to remove the lists from assets that are transferred constitutes legal abandonment of the trade secret.[7674] Because Lehman and its employees made no effort to extract or segregate the LBCS Customer Information from

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[7672] 11 U.S.C. § 542(a) (2006) (property of the estate includes "property that the trustee may use, sell or lease under Section 363").

[7673] *Defiance Button Mach. Co. v. C&C Metal Prods. Corp.*, 759 F.2d 1053, 1063 (2d Cir. 1985).

[7674] *Id.* at 1063-64.

the other assets transferred to Barclays,[7675] the secrecy of this intangible could have been lost, thus stripping it of legally protectable property rights.

Nonetheless, the terms of the Transition Services Agreement ("TSA") likely preserved the secrecy of the LBCS Customer Information and other proprietary assets transferred in the sale transaction. The TSA specifically provided for the "Treatment of Confidential Information" that might have been exchanged in the course of the sale.[7676] Pursuant to this agreement, the parties were obligated to keep confidential any secret or proprietary information of the other party to which they obtained access,[7677] though the TSA did not purport to transfer rights to this information or specify the information to which it applied. The LBCS Customer Information likely retained its protected status, therefore, because the parties took reasonable steps to maintain its secrecy despite the transfer to Barclays.[7678]

In any event, the Examiner concludes that this asset has little value. As discussed above, most of the customer information that LBCS possessed related to customers that were well known in the industry and easily identifiable.[7679] In addition, Barclays had a more established and robust commodities business than LBCS, which

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[7675] Examiner's Interview of Thomas E. Hommel, Kelly L. Gargiulo, Lauren Sheridan, William B. Gordon and Jeffrey Donaldson, Jan. 22, 2010.

[7676] Transition Services Agreement between Lehman Brothers Holdings Inc. and Barclays Capital Inc. (Sept. 22, 2008), at p. 17.

[7677] *Id.*

[7678] *Cf. Defiance*, 759 F.2d at 1063-64 (noting that a business failed to protect its rights when it took no steps to protect secrecy of confidential information in connection with a transfer of assets).

[7679] Examiner's Interview of Joe Gold, Jan. 15, 2010; Examiner's Interview of Satu S. Parikh, Jan 4, 2010.

was still building its business at the time of the bankruptcy, and as a result already independently knew much of the information that may have been included in the LBCS Customer Information.[7680]

A limited number of LBCS customers were unknown to the public and Barclays, and the identity and historical trading information for such customers would have had some value. However, without LBI and LBHI's credit and other support, none would have maintained their relationships with LBCS. Any value in the LBCS Customer Information would have dissipated almost immediately following LBHI's bankruptcy, as customers terminated safe-harbored derivatives transactions, and sought new trading counterparties and shared their trading information with them. Thus, to the extent LBCS had a protectable interest in the LBCS Customer Information, the Examiner concludes that the value of this asset would have been minimal by September 19, 2009.

(ii) Section 548

If a court were to find that any of the LBHI Affiliate Assets were not property of the bankruptcy estates of the LBHI Affiliates at the time of the commencement of their respective bankruptcy cases – a finding that could preclude a Section 542 claim – colorable claims might still exist for the benefit of the LBCS, LBSF and LCPI's estates against Barclays under Section 548 of the Bankruptcy Code.

[7680] Examiner's Interview of Joe Gold, Jan. 15, 2010.

Section 548 permits a debtor to avoid any transfer made within two years of the bankruptcy filing that is actually or constructively fraudulent.[7681] A transfer is constructively fraudulent if the debtor received less than reasonably equivalent value or fair consideration for the transfer or obligation, and, *inter alia*, (1) the debtor was insolvent or rendered insolvent as a result of the transfer or obligation or (2) the debtor was undercapitalized.[7682]

Here, the Examiner concludes that there is credible evidence sufficient to establish that the LBHI Affiliates did not receive anything in exchange for the transfer of any of their assets to Barclays in connection with the sale transaction, and therefore they received "less than reasonably equivalent value or fair consideration for the transfer or obligation." There also is credible evidence to support a finding that LCPI, LBSF and LBCS were insolvent as of September 22, 2008, the date on which their assets were transferred to Barclays.[7683] Barclays might argue that the LBHI Affiliates received indirect benefits from the sale transaction to establish the receipt of reasonably equivalent value, and also might contest insolvency. A trier of fact would need to resolve these conflicts.

[7681] 11 U.S.C. § 548(a)(1) (2006).

[7682] 11 U.S.C. § 548(a)(1)(B)(2006). For a more detailed discussion of the law applicable to constructively fraudulent transfers, see Appendix 1.

[7683] In particular, as of September 22, 2008, counterparties had closed out as many of their positions with these entities at prices that were very unfavorable to LCPI, LBSF and LBCS. For a discussion of the counterparty terminations and their effect on LBHI Affiliates' businesses, see Section III.C.6.b.2.

The Examiner concludes that, in the event a court were to determine that the LBHI Affiliate Assets transferred to Barclays were no longer property of their estates at the time of the commencement of their bankruptcy cases, the LCPI, LBSF and LBCS estates nonetheless may assert claims under Section 548 of the Bankruptcy Code for the transfer of the LBHI Affiliate Assets to Barclays. As explained above, however, the Examiner concludes that the value of such assets is limited, and that the cost of pursuing any claims may exceed the value of the transferred assets.[7684]

(b) Common Law Claims

The Examiner also evaluated whether colorable claims against Barclays exist for recovery of chattel, conversion, unjust enrichment, misappropriation of trade secrets, unfair competition or tortious interference with employment relations in connection with the transfer of the LBHI Affiliate Assets to Barclays. The Examiner concludes that the evidence does not support the existence of a colorable claim on any of these grounds with respect to the transfer of those assets to Barclays.

(i) Recovery of Chattel

The Examiner evaluated whether the LBHI Affiliates have a colorable claim against Barclays for recovery of chattel transferred to Barclays.[7685] An action to recover chattel provides a plaintiff with the right to seek possession of chattel on the basis of the

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[7684] *See* Section III.C.5.b.2.

[7685] For a further discussion of the applicable law, *see* Appendix 1.

plaintiff's superior right of possession to it.[7686] Even if a court finds that the defendant's original assertion of possession of the chattel was "lawful," if the plaintiff has superior right of possession, the plaintiff is entitled to recovery. The plaintiff must demand return of the chattel, and the defendant must refuse the demand, in order for the plaintiff to sustain an action to recover chattel.[7687] There is an exception to this demand requirement when demand would be futile or useless.

Here, Barclays obtained the LBHI Affiliate Assets in the wholesale transfer of LBHI and LBI assets that occurred following the closing of the sale transaction. Though Barclays was entitled only to LBHI, LBI and LB 745 assets under the terms of the sale documents, certain assets of the LBHI Affiliates were so intermingled with LBHI's and LBI's property that it would have been exceedingly difficult to identify and segregate them in the short time before the sale closing. When the sale was consummated, Lehman delivered to Barclays in bulk all of the facilities, communications and computer equipment and furniture in the Lehman headquarters building and the other properties

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[7686] *See* N.Y. C.P.L.R. § 7101 (McKinney 2009) ("An action under this article may be brought to try the right of possession of a chattel."); *see also Byrne Compressed Air Equip. Co. v. Sperdini*, 506 N.Y.S.2d 593, 594 (App. Div. 1986).

[7687] *See N.Y. City Transit Auth. v. N.Y. Historical Soc'y*, 635 N.Y.S.2d 998, 1001 (Sup. Ct. 1995) ("A demand is only a substantive requirement of a cause of action to recover chattels where one in possession of the chattels acquired such possession lawfully or where . . . the initial possession of the chattels is not considered wrongful" (citations omitted)); *Borneo Sumatra Trading Co. v. Sec. Door & Panel Corp.*, 183 N.Y.S.2d 137, 138 (Sup. Ct. 1959).

it had purchased, and neither LBHI nor the LBHI Affiliates made any effort to segregate or retain the LBCS Customer Information or the LBHI Affiliate Office Equipment.[7688]

Further, there is evidence that would support a finding that, at the time of the consummation of the Barclays sale, Lehman and Barclays personnel believed that all of the property Barclays was acquiring actually belonged to LBHI and LBI, and was being transferred pursuant to the terms of the sale. In the days preceding the consummation of the sale, Barclays interviewed LBI employees who had performed work solely for LBCS. Those employees had been designated by Lehman for transfer to Barclays. Thus, Barclays was left by Lehman with the impression that those employees were to be transferred to Barclays in connection with the sale.[7689] Some of those employees possessed LBCS Customer Information, and shared it with Barclays during the course of their employment interviews. As a result, although Barclays received customer information to which it may not have been entitled under the sale documents, Barclays' conduct in this respect was not wrongful or unlawful.[7690]

Because there is evidence to suggest a finding that Barclays' possession of the LBHI Affiliate assets was not wrongful or unlawful, in order to recover chattel that was improperly transferred to Barclays, the LBHI Affiliates would need to make a demand

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[7688] Examiner's Interview of Thomas E. Hommel, Kelly L. Gargiulo, Lauren Sheridan, William B. Gordon and Jeffrey Donaldson, Jan. 22, 2010.

[7689] *See*, *e.g.*, e-mail from Satu S. Parikh, Lehman, to Joe Gold, Barclays (Sept. 19, 2008) [LBEX-DOCID 3456032]; Examiner's Interview of Joe Gold, Jan. 15, 2010.

[7690] *N.Y. City Transit Auth.*, 635 N.Y.S.2d at 1001.

for its return. Though the Debtors have evaluated claims they might have to property that was transferred to Barclays,[7691] the Examiner has uncovered no evidence that the LBHI Affiliates have requested or demanded, to date, that Barclays actually return the LBHI Affiliate assets addressed here. The facts thus do not support the existence of a colorable claim against Barclays to recover chattel, unless the LBHI Affiliates determine to seek recovery of the LBHI Affiliate assets.

(ii) Conversion

The Examiner evaluated whether the LBHI Affiliates have a colorable claim for conversion against Barclays. Conversion is "the unauthorized assumption and exercise of the right of ownership over goods belonging to another to the exclusion of the owner's rights."[7692] The defendant must commit some affirmative act of ownership over the property without the right to do so,[7693] and the defendant's action (or refusal to act) must interfere with the plaintiff's rights of ownership (such as possession, control, or dominion) over its property.[7694] Although, as a general rule, a plaintiff need not demand

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[7691] Examiner's Interview of Thomas E. Hommel, Kelly L. Gargiulo, Lauren Sheridan, William B. Gordon and Jeffrey Donaldson, Jan. 22, 2010.

[7692] *Vigilant Ins. Co. of Am. v. Hous. Auth. of El Paso*, 660 N.E.2d 1121, 1126 (N.Y. 1997); *see also Hoffman v. Unterberg*, 780 N.Y.S.2d 617, 619 (App. Div. 2004), *abrogated on other grounds by Tzolis v. Wolff*, 885 N.Y.S.2d 6 (App. Div. 2008). *See* Appendix 1, Section V.N to the Report, which discusses the law applicable to conversion claims in greater detail.

[7693] *See N.Y. City Transit Auth.*, 635 N.Y.S.2d at 1001; *New York v. Seventh Regiment Fund, Inc.*, 774 N.E.2d 702, 711 (N.Y. 2002); *see Colavito v. N.Y. Organ Donor Network, Inc.*, 860 N.E.2d 713, 717 (N.Y. 2006).

[7694] *See Colavito*, 860 N.E.2d at 717; *Galtieri v. Kramer*, 648 N.Y.S.2d 144, 145 (App. Div. 1996); *Thyroff v. Nationwide Mut. Ins. Co.*, 460 F.3d 400, 404 (2d Cir. 2006).

the return of the property from the defendant to prevail in an action for conversion,[7695] where the defendant's original possession was lawful, the plaintiff must first demand the return of property from the defendant.[7696]

As discussed above, it is unlikely that Barclays' possession of the LBHI Affiliate assets would qualify as unlawful. At the time of the consummation of the sale transaction, Lehman transferred assets to Barclays in bulk form and did not make any effort to segregate the LBCS Customer Information or the LBHI Affiliate Office Equipment assets from the LBHI and LBI assets that were being transferred in connection with the sale transaction.[7697] There is sufficient evidence to establish that Barclays believed that the assets it received in connection with the sale were those of LBHI and LBI, to which Barclays was entitled under the terms of the sale documents, and that Barclays did not target any assets of LBHI Affiliates.[7698] If, as the evidence indicates, Barclays' possession of any LBHI Affiliates' assets was lawful, then the LBHI Affiliates would need to make a demand for the return of their assets before they could state a claim for conversion. No evidence was presented to the Examiner that they have done so to date.

[7695] *See N.Y. City Transit Auth*, 635 N.Y.S.2d at 1001; *see also D'Amico v. First Union Bank*, 728 N.Y.S.2d 146, 151 (App. Div. 2001).

[7696] *See Heneghan v. Cap-A-Radiator Shops*, 506 N.Y.S.2d 132, 134 (App. Div. 1986); *Johnson v. Gumer*, 464 N.Y.S.2d 318, 319 (App. Div. 1983); *Lawrence v. Meloni*, 558 N.Y.S.2d 360, 361 (Sup. Ct. 1990).

[7697] Examiner's Interview of Thomas E. Hommel, Kelly L. Gargiulo, Lauren Sheridan, William B. Gordon and Jeffrey Donaldson, Jan. 22, 2010.

[7698] Examiner's Interview of Joe Gold, Jan. 15, 2010.

Even if Barclays' original possession or control of the LBHI Affiliate Assets was unlawful, or if the LBHI Affiliates did make the required demand, there is no indication that Barclays has asserted such continued ownership or control over the assets that the LBHI Affiliates would have a colorable conversion claim against Barclays. While a defendant need not act in bad faith in holding or controlling an asset to be liable for conversion, the defendant must exercise dominion over the property to the exclusion of the plaintiff.[7699] If Barclays denied the LBHI Affiliates access to their assets, Barclays could be liable for conversion,[7700] but there is no indication that Barclays has done so. Although the Debtors have evaluated whether or not Barclays currently has property that belongs to the LBHI Affiliates, they have not asserted any such claims to date against Barclays arising from that analysis.[7701] For these reasons, the facts do not support the existence of a colorable claim against Barclays for conversion.

(iii) Unjust Enrichment

The Examiner also considered whether the LBHI Affiliates would have a colorable claim for unjust enrichment arising from the transfer of the LBHI Affiliate Assets to Barclays. A defendant is liable for unjust enrichment when: (1) the plaintiff conferred a benefit on the defendant; (2) without being adequately compensated by the

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[7699] *Dywer v. Citizens United Bank, N.A.*, 470 N.Y.S.2d 200, 202 (App. Div. 1983); *N.Y. City Transit Auth.*, 635 N.Y.S.2d at 1001.

[7700] *Thyroff*, 460 F.3d at 403-05.

[7701] Transition Services Agreement between Lehman Brothers Holdings Inc. and Barclays Capital Inc. (Sept. 22, 2008), at p. 17; Examiner's Interview of Thomas E. Hommel, Kelly L. Gargiulo, Lauren Sheridan, William B. Gordon and Jeffrey Donaldson, Jan. 22, 2010.

defendant for the conferred benefit; and (3) equity and good conscience require restitution.[7702] Unjust enrichment "does not require wrongful conduct by the one enriched[,] only that the enrichment be unjust."[7703] Even a defendant that did not take any action to obtain the benefit can be unjustly enriched.[7704]

In order to be unjustly enriched by an acquisition of property, the "benefit" received must actually be of value to the defendant.[7705] Moreover, where a defendant that did not engage in tortious conduct and was not at fault, or at least not more at fault than the plaintiff for the conferral of the benefit, the measure of recovery is limited to the value of the benefit in advancing the interests of the defendant.[7706]

Here, the LBHI Affiliate assets that were transferred conferred limited benefit on Barclays, particularly in the context of the billions of dollars of assets acquired and liabilities assumed under the sale transaction. For example, the LBCS Customer Information was largely either readily-determinable or duplicative of what Barclays

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[7702] *See Wiener v. Lazard Freres & Co.*, 672 N.Y.S.2d 8, 13 (App. Div. 1998); *In re Mid-Island Hosp., Inc.*, 276 F.3d 123, 129-30 (2d Cir. 2002); s*ee also Bradkin v. Leverton*, 257 N.E.2d 643, 645 (N.Y. 1970); *Whitman Realty Group, Inc. v. Galano*, 838 N.Y.S.2d 585, 588 (App. Div. 2007). *See* Appendix 1, Section V.E to this Report, which discusses the law applicable to claims for unjust enrichment in greater detail.

[7703] *Ultramar Energy, Ltd. v. Chase Manhattan Bank, N.A.*, 579 N.Y.S.2d 353, 355 (App. Div. 1992) (citations omitted).

[7704] *See Aetna Cas. & Sur. Co. v. LFO Constr. Corp.*, 615 N.Y.S.2d 389, 391 (App. Div. 1994); *Ultramar Energy*, 579 N.Y.S.2d at 355.

[7705] *Cyberchron Corp. v. Calldata Sys. Dev.*, 831 F. Supp. 94, 110-12 (E.D.N.Y. 1993); *McGrath v. Hilding*, 41 N.Y.2d 625, 630 (1977).

[7706] *See* 22A N.Y. JUR. 2D, *Contracts* § 587 (2009) (citing RESTATEMENT (FIRST) OF RESTITUTION § 142 cmt. b (1937).

already possessed through its much larger existing commodities trading business.[7707] Given such comparatively limited benefit, and the facts indicating that Barclays did not target any LBHI Affiliate assets or otherwise play a role in causing their transfer, the Examiner concludes that there are insufficient facts to support a finding that equity and good conscience require restitution by Barclays and that there is no colorable claim for unjust enrichment.

(iv) Trade Secret Misappropriation

The Examiner also evaluated whether LBCS has a colorable claim for trade secret misappropriation arising from Barclays' acquisition of the LBCS Customer Information. To prevail on a claim for misappropriation of trade secrets, a plaintiff must demonstrate (1) that it had a protectable trade secret; and (2) that the trade secret was misappropriated in violation of a confidentiality obligation or agreement, or was used or disclosed with the knowledge it was obtained through improper means.[7708]

It is well-established that a customer list developed by a business through substantial effort, and kept in confidence, may be a trade secret protected against disclosure to a competitor.[7709] Whether a customer list is entitled to protection typically turns on whether the information on the list is readily ascertainable from other

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[7707] Examiner's Interview of Satu S. Parikh, Jan. 4, 2010; Examiner's Interview of Joe Gold, Jan. 15, 2010.

[7708] *See* Appendix 1, Section V.K to this Report, which discusses the law that applies to trade secret misappropriation claims in greater detail.

[7709] *E.g., Defiance Button Mach. Co. v. C & C Metal Prods. Corp.*, 759 F.2d 1053, 1063 (2d Cir. 1985).

sources.[7710] Even if it is obtainable from readily accessible sources, a compilation of customer names may be protectable if a company has catalogued those customers' buying practices and preferences in such a way that would be difficult, time-consuming or expensive to replicate.[7711]

The Examiner concludes that there is a colorable claim that the LBCS Customer Information constituted a trade secret. Through the efforts of its dedicated sales force, LBCS developed a list of customer identities and product and pricing information that was separate and distinct from the LBI customer base.[7712] At least some of that information was unknown to others in the industry.[7713] Lehman took steps to maintain the secrecy of that information by establishing corporate confidential information

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[7710] *E.g.*, *Meyers Assocs. v. Conolog Corp.*, No. 600824/07, 2008 WL 711702, at *1 (N.Y. Sup. Ct. Mar. 5, 2008); *N. Atl. Instruments, Inc. v. Haber*, 188 F.3d 38, 40-47 (2d Cir. 1999) (concluding that even though the sizable companies on a customer list were easily identifiable, a compilation of the identities of the one or two engineers within those companies who would purchase a specialized device was protectable); *Velo-Bind, Inc. v. Scheck*, 485 F. Supp. 102, 103-07 (S.D.N.Y. 1979) (a customer list designating the specific companies that used a particular type of document binding machine was protectable even though the names of those companies all appeared in publicly available sources).

[7711] *See, e.g.*, *Garvin GuyButler Corp. v. Cowen & Co.*, 548 N.Y.S. 2d 56, 57 (Sup. Ct. 1992); *IKON Office Solutions, Inc. v. Usherwood Office Tech., Inc.*, No. 9202-08, 2008 WL 5206291, at *5 (N.Y. Sup. Ct. Dec. 12, 2008); *Johnson Controls, Inc. v. A.P.T. Critical Sys., Inc.*, 323 F. Supp. 2d 525, 538 (S.D.N.Y. 2004); *Am. Building Maint. Co. of N.Y. v. Acme Property Servs., Inc.*, 515 F. Supp. 2d 298, 308 (N.D.N.Y. 2007) (noting that "information related to [an employer's] clients' preferences and the customization of its services undertaken to address those preferences are trade secrets").

[7712] Examiner's Interview of Satu S. Parikh, Jan. 4, 2010.

[7713] *Id.*

policies, and by requiring employees to sign confidentiality agreements.[7714] As a result, there is a colorable claim that the LBCS Customer Information was a trade secret.[7715]

To establish a colorable claim for trade secret misappropriation, however, LBCS would need to show that Barclays either obtained the LBCS Customer Information by improper means, or used or disclosed the information knowing it had been obtained by improper means. The Examiner has uncovered no facts indicating that Barclays did so. The facts the Examiner found indicate that Barclays believed the LBCS Customer Information it received belonged to LBI.[7716] In light of the confusion surrounding the closing of the sale and the integrated manner in which Lehman ran its businesses, that belief was reasonable. Further, to date LBCS has not requested and is unlikely to request at this late date that Barclays return the LBCS Customer Information, and Barclays therefore never was put on fair notice that the information was not its to use. As a result, there are not sufficient facts to support a colorable claim for trade secrets misappropriation claim against Barclays.

(v) Unfair Competition

The Examiner also considered whether LBCS would have a colorable claim for unfair competition against Barclays. An unfair competition claim allows a plaintiff to

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[7714] *See, e.g.*, Lehman, Lehman Brothers Confidentiality Agreement [LBEX-LL 3668555].

[7715] *See infra* Section III.C.5.b.2.a.i of the Report, which discusses that an argument could be made that LBCS waived protection of the Customer Information by failing to segregate it from the assets that were properly transferred to Barclays, thereby relinquishing its secrecy. It is likely, however, that the confidentiality provisions in the TSA would have preserved the secrecy of the information, which would allow LBCS to proceed with a trade secrets misappropriation claim.

[7716] Examiner's Interview of Joe Gold, Jan. 15, 2010, at p. 2.

recover when competitively useful information it has spent time, resources and effort to create is acquired by a defendant through actions rising to the level of bad faith.[7717] Bad faith typically is found where a party acquires information through trespass, fraud or similar wrongdoing.[7718]

Here, the Examiner has found no facts that would indicate Barclays, or Lehman employees acting on Barclays' behalf, took wrongful actions to cause the LBCS Customer Information to be transferred to Barclays. The facts uncovered by the Examiner suggest that Barclays believed that the LBCS Customer Information it received belonged to LBI, and therefore was properly included in the sale.[7719] In the days preceding the consummation of the sale, Barclays and Lehman personnel discussed some of the information that comprised LBCS Customer Information, but appear to have been unaware that the information was not LBI's to sell.[7720] Given the immense time pressures and the complexity of Lehman's organization and operations, it would have been exceedingly difficult for the parties to evaluate ownership issues in the few days that they had to negotiate the sale, and there is no indication that either Barclays or Lehman employees acting on Barclays' behalf deliberately transferred the

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[7717] *See* Appendix 1, Section V.L of this Report, which discusses the law that applies to unfair communications in greater detail.

[7718] *Demetriades v. Kaufman*, 698 F. Supp. 521, 526-28 (S.D.N.Y. 1988); *Robotic Vision Sys., Inc. v. General Scanning, Inc.*, No. 96-CV-3884 JG, 1997 WL 1068696 at *5-6 (E.D.N.Y. Sept. 8, 1997); *LinkCo, Inc. v. Fujitsu, Ltd.*, 230 F. Supp. 2d 492, 501-02 (S.D.N.Y. 2002).

[7719] Examiner's Interview of Joe Gold, Jan. 15, 2010.

[7720] *See*, *e.g.*, e-mail from Satu S. Parikh, Lehman, to Joe Gold, Barclays (Sept. 19, 2008) [LBEX-DOCID 3456032]; Examiner's Interview of Joe Gold, Jan. 15, 2010.

information with the knowledge it belonged to LBCS. As a result, the Examiner concludes that there are insufficient facts to support a colorable claim for unfair competition against Barclays.

(vi) Tortious Interference With Employment Relations

As discussed above, the Examiner concludes that the LBHI Affiliates did not have assembled workforces that were transferred to Barclays in connection with the sale. The Examiner did consider, however, whether there is a colorable claim against Barclays for tortious interference with employment relations for hiring the LBI employees that performed functions solely for the LBHI Affiliates.[7721]

To prevail on a claim for tortious interference with contractual employment relations, a plaintiff must establish that: (1) there is a valid contract; (2) a third party knew of the contract; (3) the third party intentionally and improperly procured the breach of the contract; and (4) the plaintiff was damaged by the breach.[7722] If the employee did not have a contract and was an at-will employee, however, the plaintiff would have to show that the third party engaged in "fraud or misrepresentation or acted with malice" in interfering with the employment relationship in order to recover.[7723]

[7721] *See* Appendix 1, Section V.M to this Report, which discusses the law that applies to tortious interference with employment relations claims in greater detail.

[7722] *Siotkas v. LabOne, Inc.*, 594 F. Supp. 2d 259, 274-75 (E.D.N.Y. 2009).

[7723] *Id.* at 275; *see also Albert v. Loksen*, 239 F.3d 256, 274 (2d Cir. 2001) (recognizing that an at-will employee may not recover for tortious interference with employment relations under New York law unless he or

The facts identified by the Examiner indicate that LBI employees who performed functions solely for LBHI Affiliates were not subject to restrictive covenants.[7724] Even if those employees were parties to contracts with such clauses, Barclays would only be liable if it actually knew that those provisions existed. Given the confusion surrounding the sale and the sheer volume of employees transferred, there are insufficient facts to conclude that Barclays had knowledge of the existence or terms of employment contracts with restrictive covenants (if any exist) to possess the requisite intent to establish a claim for tortious interference with employment relations.

The Examiner's sampling of Lehman employment offers confirms that employees were hired on an at-will basis.[7725] As discussed in the previous subsections, there is no indication that Barclays knew that the employees it was hiring were anything other than LBI employees who "were employed primarily in connection with

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she demonstrates that the interference was procured by fraud, misrepresentation, or threats or that the defendant acted with malice or in violation of a duty).

[7724] *See e.g.*, letter from Scott Kimmel, Lehman, to Thomas J. Noto, Lehman, re: employment offer (Mar. 26, 2007) [LBEX-DOCID 024128]; letter from Christopher M. O'Meara, Lehman, to John DeRosa, Lehman, re: employment offer (Nov. 10, 2006) [LBEX-AM 023144]; letter from Karen Dennehy, Lehman, to Peter Keavey, Lehman, re: employment offer (Dec. 12, 2005) [LBEX-AM 017535]; letter from Christine Thomson, Lehman, to Roy Salame, Lehman (May 5, 2007) [LBEX-AM 027429]; letter from Christine Thomson, Lehman, to Jeff Frase, Lehman (May 10, 2007) [LBEX-AM 011714]; Examiner's Interview of Tracy Binkley, Dec. 22, 2009.

[7725] *See* letter from Scott Kimmel, Lehman, to Thomas J. Noto, Lehman, re: employment offer (Mar. 26, 2007), at p. 3 [LBEX-DOCID 024128]; letter from Christopher M. O'Meara, Lehman, to John DeRosa, Lehman, re: employment offer (Nov. 10, 2006), at p. 2 [LBEX-AM 023144]; letter from Karen Dennehy, Lehman, to Peter Keavey, Lehman, re: employment offer (Dec. 9, 2005), at p. 2 [LBEX-AM 017535]; letter from Christine Thomson, Lehman, to Roy Salame, Lehman (May 5, 2007), at p. 3 [LBEX-AM 027429]; letter from Christine Thomson, Lehman, to Jeff Frase, Lehman (May 10, 2007), at p. 4 [LBEX-AM 011714].

the Business,"[7726] to whom Barclays was contractually obligated to offer employment.[7727] The LBI employees at issue believed that they were employed by LBI rather than any LBHI Affiliate,[7728] which was reasonable in light of the fact that LBI hired and paid almost all Lehman employees regardless whether they performed services for a particular subsidiary.[7729] Moreover, it was Lehman, not Barclays, that identified the employees to be offered employment at Barclays.[7730] There is no indication that Barclays intended to harm the LBHI Affiliates by offering employment to the LBI employees that Lehman identified (which included LBI employees who performed work solely for LBHI Affiliates). As a result, the facts uncovered by the Examiner do not support the existence of a colorable claim for tortious interference with employment relations against Barclays.

(3) Claims Against LBHI Affiliate Officers and Directors

The Examiner concludes that the facts do not support the existence of a colorable claim against the LBHI Affiliate officers and directors for breach of the duty of care, duty of good faith or duty to monitor arising from the transfer of LBHI Affiliate assets to Barclays.

[7726] APA, at p. 35 (¶ 9.1(a)).

[7727] *Id.*

[7728] *See, e.g.,* e-mail from Paul Gregg, Lehman, to Peter Keavey, Lehman (Sept. 16, 2008) [LBEX-DOCID 3571486] (employees allocated to LBCS discussing transfer of LBI employees to Barclays and noting "that's us").

[7729] E-mail from Kaushik Amin, Lehman, to Herbert H. McDade, III, Lehman (Sept. 19, 2008) [LBHI_SEC07940_656489].

[7730] Examiner's Interview of Tracy Binkley, Dec. 22, 2009.

The circumstances of Lehman's collapse and the LBHI bankruptcy made it difficult, if not impossible, for LBHI Affiliate officers and directors to focus their attention before the sale closing on Monday, September 22 on potential transfers of LBHI Affiliate Assets to Barclays. As just one example, during this period, LBHI Affiliate officers and directors were attempting to preserve the value of (or at least to limit losses pertaining to) derivatives positions worth billions of dollars. The LBHI Affiliate Assets that were ultimately transferred to Barclays – office equipment and customer information – were of limited value by comparison. Taking the circumstances surrounding Lehman's collapse as a whole, it would have been unreasonable to expect LBHI Affiliate officers and directors to shift their focus from the other pressing matters that required their immediate and undivided attention.

As noted elsewhere herein, except for the facts described in Section III.C.6 of this Report, the Examiner is not addressing facts or reaching conclusions in this Report pertaining to the matters that are the subject of the litigation arising from the sale. The Examiner's findings here are limited solely to whether additional claims, independent of the claims that are the subject of the sale litigation, may be asserted against LBHI Affiliate officers and directors as a result of the LBHI Affiliate assets that were transferred to Barclays.

(a) Duty of Care

As explained above, the Examiner concluded that certain assets of LBCS, LBSF and LCPI were transferred to Barclays in the sale. LBCS and LBSF were Delaware corporations. LCPI was a New York corporation. The Examiner therefore primarily addresses Delaware law here, and discusses New York law only to the extent there is a difference.

Under Delaware law, disinterested directors of an insolvent subsidiary enjoy the protection of the business judgment rule in carrying out their duties, such that only grossly negligent actions or inactions will give rise to liability.[7731] While the party to whom the directors owe their fiduciary duties expands upon insolvency to embrace creditors of the company, the degree of scrutiny applied to the directors' actions and the applicability of the business judgment rule remains unchanged.[7732]

A director of a wholly owned subsidiary who also is an employee of the parent entity is treated as disinterested, and entitled to the protection of the business judgment rule, so long as the subsidiary is solvent.[7733] This is so because a solvent wholly owned subsidiary's interests are aligned with those of the parent.[7734] If the subsidiary is insolvent, however, the subsidiary's directors owe duties to creditors as well as to the

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[7731] *Trenwick*, 906 A.2d at 174.

[7732] S*ee* Appendix 1, Section II.D to this Report, which discusses fiduciary duties for officers and directors of wholly-owned subsidiaries in greater detail.

[7733] *Trenwick*, 906 A.2d at 174; *see* Appendix 1, Section II.D to this Report, which discusses in detail the fiduciary duties of the directors of a wholly-owned subsidiary.

[7734] *Id.*

parent, which renders the directors who are employees of the parent interested and deprives them of the protection of the business judgment rule.[7735]

Absent the protection of the business judgment rule, a court will examine a challenged transaction under the stricter "entire fairness" standard.[7736] Under that standard, a director must show that the transaction was a product of fair dealing and that the corporation received a fair price.[7737] The court will consider "all relevant factors" to determine whether the transaction was fair.[7738] In order for a transaction to satisfy entire fairness, directors must demonstrate "their utmost good faith and the most scrupulous inherent fairness of the bargain."[7739]

Even if the officers and directors of LBCS, LBSF and LCPI were interested as a result of the insolvency of those entities and their employment relationships with LBHI or LBI, the Examiner concludes that there is sufficient evidence to support the conclusion that the officers' and directors' actions were, in their entirety, fair to LBCS, LBSF and LCPI.

In light of all the circumstances, it would have been unreasonable, in the brief window before the closing of sale, to expect the LBHI Affiliate officers and directors to

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[7735] *Id.*

[7736] *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).

[7737] *Id.* at 711.

[7738] *Id.*

[7739] *Id.* at 710; New York law does not differ: "[W]hen there is an inherent conflict of interest, the burden shifts to the interested directors or shareholders to prove good faith and the entire fairness" of the transaction. *Alpert v. 28 Williams St. Corp.*, 473 N.E.2d 19, 26 (N.Y. 1984).

divert their attention from, among other things, attempting to prevent (or at least limit) losses in the billions of dollars arising primarily from the termination of derivatives contracts, to identifying LBHI Affiliate assets that potentially would be transferred to Barclays. The actions of the officers and directors were vital to preserving billions of dollars in value for the LBHI Affiliates, compared to the relatively limited value of LBHI Affiliate assets that were transferred to Barclays. Indeed there is no evidence that the LBHI Affiliate officers and directors made any conscience decision to permit the LBHI Affiliate Assets to be transferred to Barclays. The Examiner thus concludes that the evidence does not support the existence of a colorable claim against the LBHI Affiliate officers and directors for breach of the duty of care.

(b) Duty of Good Faith

The facts do not support a colorable claim that the LBHI Affiliate officers and directors breached their duty of good faith. "A failure to act in good faith may be shown . . . where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[7740] Because the facts uncovered by the Examiner do not suggest that any LBHI Affiliate officer or director acted – with respect to the LBHI Affiliate Assets – with a purpose

[7740] *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 67 (Del. 2006).

other than that of advancing the best interests of LBCS, LBSF and LCPI, or ignored a known duty to act to prevent the transfer of the LBHI Affiliate Assets to Barclays, there are not sufficient facts to support a colorable claim against the officers and directors for breach of the duty of good faith.

(c) Duty to Monitor

Finally, the Examiner concludes that, in light of the circumstances surrounding the sale, the LBHI Affiliate officers and directors did not breach their duty to monitor LBHI Affiliate operations. Directors breach the duty to monitor if "'(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.'"[7741] "[I]mposition of liability [for breach of the duty to monitor] requires a showing that the directors knew that they were not discharging their fiduciary obligations."[7742] A duty to monitor claim "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[7743]

Here, the officers and directors of the LBHI Affiliates had only a very short period of time before the September 22 closing of the transaction to implement systems

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[7741] *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 123 (Del. Ch. 2009) (quoting *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006)).

[7742] *Stone*, 911 A.2d at 370.

[7743] *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996). *See* Appendix 1, Section II.A.4 to this Report, which discusses the duty to monitor in greater detail

or controls intended to prevent the transfer of LBHI Affiliate assets to Barclays in connection with the sale. That was also the period during which those same officers and directors were called upon to deal with far more pressing matters. It would have been unreasonable for the LBHI Affiliate officers and directors to have diverted resources necessary to set up systems and controls to monitor the sale, and then to actually engage in that monitoring.

Whether there was any fraudulent or improper conduct in connection with the sale of LBI's business to Barclays is the subject of ongoing litigation, including extensive fact and expert discovery. Except for the facts reported in Section III.C.6 of the Report, the Examiner is not addressing facts or reaching conclusions in this Report pertaining to the matters that are the subject of litigation. The Examiner's findings here are limited solely to whether additional claims, independent of the claims that are the subject of the Barclays sale litigation, may be asserted against the LBHI Affiliate officers and directors for the transfer of LBHI Affiliate Assets to Barclays.

Subject to the above qualifications, the Examiner concludes that the facts do not support the existence of a colorable claim for breach of the duty of care, good faith or the duty to monitor against LBHI Affiliate officers and directors arising from the transfer of the LBHI Affiliate Assets to Barclays.

c) Lehman ALI Transaction

The Examiner concludes that the decision to transfer certain subsidiaries of LBI to Lehman ALI shortly before the commencement of LBI's SIPA proceeding was the result of a good-faith, well-grounded business judgment, and that therefore no colorable claim (other than claims arising under the PIK Note & Securities itself) arises from that decision. The Examiner notes that the valuation of the subsidiaries transferred to Lehman ALI (and therefore the consideration to be paid to LBI's estate under the PIK Note & Security Agreement) will be exceedingly challenging if not resolved by agreement.

6. Barclays Transaction

The facts set forth in this Section pertain to matters that are the subject of pending litigation involving the Debtors, the SIPA Trustee, the Creditors Committee and Barclays. Because these matters are the subject of pending litigation before this Court with respect to which discovery is ongoing, with limited exceptions the Examiner does not discuss in this Section of the Report the law or the parties' arguments, and expresses no view on the merits of the parties' positions or whether the evidence supports the existence of colorable claims.

a) Pre-Bankruptcy Negotiations

(1) Barclays' Interest in a Transaction Involving Lehman

Barclays' interest in a transaction involving Lehman dated back to at least April 2008.[7744] Robert E. Diamond, Jr., the President of Barclays PLC and chief executive of Barclays' investment banking and investment management (IBIM) businesses, received a telephone call from Robert Steel, who at the time was Undersecretary for Domestic Finance at the United States Department of the Treasury.[7745] Steel inquired whether, if there was a situation with Lehman similar to what had happened with Bear Stearns, there was a price at which Barclays would be interested in purchasing Lehman, and if so, what Barclays would need in terms of a working relationship with the Treasury Department.[7746] Diamond told Steel that the question was interesting and thought-provoking, and thanked him for the call.[7747]

In July 2008, Barclays prepared a "Discussion Document," apparently for its board of directors, regarding a potential Lehman transaction.[7748] The document's executive summary notes that "Long Island [the Barclays code name for Lehman] had been a prime victim of the recent market turmoil, and consequently might be 'on the

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[7744] Transcript of deposition testimony of Robert E. Diamond, Jr., *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 11, 2009, at p. 9.

[7745] *Id.*

[7746] *Id.*

[7747] *Id.* at p. 10.

[7748] Barclays, Project Long Island Discussion Document (July 2008) [BCI-EX(S)-00026269], attached to e-mail from Richard Haworth, Barclays, to Robert E. Diamond, Jr., Barclays, *et al.* (Sept. 9, 2008) [BCI-EX-(S)-00026268].

block.'"[7749] The summary analyzes a potential acquisition under two "aggressive scenarios given the possibility of a distressed sale," including "Bear Stearns valuation metrics" and a 50 percent discount to current market value, and opines that "[s]trategically, Long Island would be an excellent fit for [Barclays'] IBIM business," but notes that "[f]urther due diligence is needed to get comfort around their book and exposures."[7750]

Following the Barclays board meeting, Diamond contacted Treasury to advise that, if there was a distressed situation involving Lehman, Barclays would like to get a call.[7751]

In August and early September 2008, as Lehman's distress became more apparent, and the company actively shopped itself to potential suitors,[7752] Barclays took steps toward entering into discussions with Lehman. Barclays spoke with Lazard, which was advising Lehman with respect to strategic alternatives, including the sale of part or all of the company.[7753] Those communications were focused on whether Barclays would be interested in purchasing Lehman's asset management business, which

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[7749] *Id.*

[7750] *Id.*

[7751] Transcript of deposition testimony of Robert E. Diamond, Jr., *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 11, 2009, at pp. 28-29.

[7752] S*ee* Section III.A.3.C of the Report, which discusses Lehman's efforts to find a strategic partner in greater detail.

[7753] E-mail from Robert E. Diamond, Jr., Barclays, to John Varley, Barclays, *et al*. (Aug. 24, 2008) [BCI-EX-00078686]; e-mail from John Varley, Barclays, to Robert E. Diamond, Jr., Barclays, *et al*. (Aug. 25, 2008) [BCI-EX-00078684]; e-mail from Robert E. Diamond, Jr., Barclays, to Richard Haworth, Barclays, *et al*. (Aug. 25, 2008) [BCI-EX-00078653].

included the Neuberger Berman business.[7754] Lazard advised Barclays that Lehman needed to do something to add stability and capital, and was looking for someone to purchase more than 50 percent, but less than all, of the asset management business.[7755] Barclays' response was that Barclays' prime goal in the United States was a high net worth business, and that while Neuberger Berman was not a "pure play" in that regard, Barclays did not want to be "on the outside," as there were pieces of Neuberger Berman that would be of interest to Barclays.[7756]

During the first two weeks of September, Barclays was in contact with senior officials at Treasury and the FRBNY.[7757] Secretary Henry M. Paulson, advised Diamond that Treasury would be pleased to have Barclays take a look at Lehman, but, according to Diamond, "was very clear" that there would be no government money for a deal.[7758] FRBNY President Timothy F. Geithner encouraged Diamond to call Fuld.[7759] According to Diamond, he resisted because he believed the only way Barclays would pursue an

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[7754] E-mail from Robert E. Diamond, Jr., Barclays, to John Varley, Barclays, *et al*. (Aug. 24, 2008) [BCI-EX-00078686]; e-mail from John Varley, Barclays, to Robert E. Diamond, Jr., Barclays, *et al*. (Aug. 25, 2008) [BCI-EX-00078684]; e-mail from Robert E. Diamond, Jr., Barclays, to Richard Haworth, Barclays, *et al*. (Aug. 25, 2008) [BCI-EX-00078653].

[7755] E-mail from Robert E. Diamond, Jr., Barclays, to John Varley, Barclays, *et al.* (Aug. 24, 2008) [BCI-EX-00078686].

[7756] *Id.*

[7757] Transcript of deposition testimony of Robert E. Diamond, Jr., *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 11, 2009, at p. 24; Henry M. Paulson, Jr., U.S. Dept. of Treasury, Call Log, (Sept. 11, 2008), available at http://www.scribd.com/doc/21221123/Too-Big-To-Fail-Paulson-Call-Logs-and-Calendar-Sept-2008 (noting that Paulson spoke to Diamond from 5:10 p.m. to 6:00 p.m.).

[7758] Transcript of deposition testimony of Robert E. Diamond, Jr., *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 11, 2009, at p. 29.

[7759] *Id.* at p. 30.

acquisition of Lehman was at a distressed price, "and at a distressed price this is a rescue and you are not going to want Dick Fuld there."[7760]

On Wednesday, September 10, Diamond e-mailed John Varley, Group Chief Executive for Barclays PLC, and Christopher Lucas, Group Finance Director for Barclays PLC, and stated, in the subject line of his message: "Geithner called, long conversation, call when convenient."[7761] Varley replied to Diamond's e-mail, stating: "One further thought: given pattern so far, fuld will ring. Think we should push him off. If we engage with him, he will use it. That's why I'm cautious about the 'marriage broker' phrase. Think the [U.S.] authorities need to be more activist than that if we are to be prepared to play."[7762] Diamond, in turn, responded to Varley's e-mail, saying "[y]es, but given my conversation with Geithner do not think [Fuld] will[] ring."[7763]

Later in the day on September 10, Diamond e-mailed Varley, Jerry del Missier, Lucas, and Rich Ricci, Chief Operating Officer for Barclays' IBIM division, and said "[g]ood conversation with both Fed and Treasury, talk in am."[7764]

[7760] *Id.*

[7761] E-mail from Robert E. Diamond, Jr., Barclays, to John Varley, Barclays, *et al.* (Sept. 10, 2008) [BCI-EX-00078635]; *see also* transcript of deposition testimony of Robert E. Diamond, Jr., *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 11, 2009, at p. 30.

[7762] E-mail from John Varley, Barclays, to Robert E. Diamond, Jr., Barclays (Sept. 10, 2008) [BCI-EX-00078635]; *see* e-mail from Robert E. Diamond, Jr., Barclays, to John Varley, Barclays (Sept. 10, 2008) [BCI-EX-00078643].

[7763] E-mail from Robert E. Diamond, Jr., Barclays, to John Varley, Barclays (Sept. 10, 2008) [BCI-EX-00078643].

[7764] E-mail from Robert E. Diamond, Jr., Barclays, to John Varley, Barclays, *et al.* (Sept. 10, 2008) [BCI-EX-00078630]; *see* e-mail from John Varley, Barclays, to Robert E. Diamond, Jr., Barclays (Sept. 10, 2008) [BCI-EX-00078655].

Diamond also had been discussing the potential Lehman acquisition with Steel, who had left Treasury, and was the president and CEO of Wachovia. On Wednesday, September 10, Diamond e-mailed Steel and said "can u call me, rather important."[7765] Steel responded that "[he] spoke with HMP [Paulson], he will call you."[7766] Diamond replied that he "had substantive and interesting calls with Tim G [Geithner] and Tony R. [presumably Anthony Ryan, Steel's successor as Undersecretary for Domestic Finance at the Treasury Department] . . . did not hear from Hank, disappointing but probably understandable. . . . Bob, your help has been perfect, thanks!! there may be a way forward, we will know very soon."[7767]

Others at Barclays also were in contact with Lehman during that time. On Wednesday, September 10, Archibald Cox, Jr., Chairman of Barclays Americas, sent an e-mail to Diamond that stated:

> I got an email and a call last night from Long Island after another call late in the afternoon. (No names, please.) In the afternoon call I was asked whether you had talked with their CEO. I said I didn't know, but that if you had I didn't think it was substantive. In the evening call I was further questioned about whether you had talked with their CEO as their impression was that you had. I was asked to check on this, because they wanted to make sure you had and, if not, to make sure that happened. I

[7765] E-mail from Robert E. Diamond, Jr., Barclays, to Robert K. Steel, Wachovia (Sept. 10, 2008) [BCI-EX-00078662].

[7766] E-mail from Robert K. Steel, Wachovia, to Robert E. Diamond, Jr., Barclays (Sept. 10, 2008) [BCI-EX-00078662].

[7767] E-mail from Robert E. Diamond, Jr., Barclays, to Robert K. Steel, Wachovia (Sept. 10, 2008) [BCI-EX-00078662].

> said I would get in touch with you early this morning. I think their CEO is under the impression we have no interest.[7768]

On Wednesday, September 10, and Thursday, September 11, Cox was passing on to Diamond requests to contact Fuld[7769] and the word that "apparently many at LI [Long Island] think Barclays would be the best home for them. That would help in keeping people."[7770]

The Barclays Board of Directors met by conference call on Thursday afternoon (London time), September 11, to discuss whether to authorize the company to enter into a due diligence process with the goal of potentially acquiring Lehman.[7771]

At 10:00 a.m. London time on Friday, September 12 (5:00 a.m. in New York), Varley, Diamond, Lucas and Ricci participated in a conference call to prepare for the board meeting scheduled for 2:00 p.m. London time that day.[7772] A board presentation

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[7768] E-mail from Archibald Cox, Jr., Barclays, to Robert E. Diamond, Jr., Barclays, *et al.* (Sept. 10, 2008) [BCI-EX-00078697].

[7769] *See* e-mail from Archibald Cox, Jr., Barclays, to Robert E. Diamond, Jr., Barclays (Sept. 10, 2008) [BCI-EX-00078661]; e-mail from Archibald Cox, Jr., Barclays, to Robert E. Diamond, Jr., Barclays (Sept. 11, 2008) [BCI-EX-00078769].

[7770] E-mail from Archibald Cox, Jr., Barclays, to Robert E. Diamond, Jr., Barclays (Sept. 11, 2008) [BCI-EX-00078660].

[7771] *See, e.g.*, e-mail from Lawrence Dickinson, Barclays, to Robert E. Diamond, Jr., Barclays (Sept. 10, 2008) [BCI-EX-00078637]; e-mail from Robert E. Diamond, Jr., Barclays, to Lawrence Dickinson, Barclays (Sept. 10, 2008) [BCI-EX-00078626]; e-mail from Marie Smith, Barclays, to Marcus Agius, Barclays, *et al.* (Sept. 12, 2008) [BCI-EX-00081498].

[7772] *See* e-mail from Richard Haworth, Barclays, to John Varley, Barclays, *et al.* (Sept. 12, 2008) [BCI-EX-(S)-00053305]. Diamond, del Missier, Ricci and other senior Barclays executives had flown from London to New York on Thursday evening, September 11. Transcript of deposition testimony of Robert E. Diamond, Jr., *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 11, 2009, at p. 24; e-mail from Robert E. Diamond, Jr., Barclays, to Patrick Durkin, Barclays (Sept. 11, 2008) [BCI-EX-00078759] (informing Patrick Durkin at 11:26 p.m. on September 11 that Diamond "just landed in ny").

was circulated in advance of the call, which set forth two acquisition scenarios, both involving transactions for $5 per share of Lehman stock.[7773]

During the board meeting on Friday, September 12, beginning at 2:00 p.m. (London time), the Barclays Board of Directors authorized the company to pursue due diligence to determine whether there was an opportunity for a transaction with Lehman.[7774]

(2) Negotiations Before September 15

Diamond and Fuld met face-to-face on Friday morning, September 12.[7775] In order to avoid the TV cameras that were stationed outside Lehman's Manhattan headquarters, Fuld sent his driver to pick up Diamond and take him into Lehman's building through the garage.[7776]

Diamond explained to Fuld that there could be "no deal at . . . the current market price, because of the risk and because of the overlap [between Barclays and Lehman],"

[7773] Barclays, Long Island Transaction Overview (Sept. 12, 2008) [BCI-EX-(S)-00053305], attached to e-mail from Richard Haworth, Barclays, to John Varley, Barclays, *et. al* (Sept. 12, 2008) [BCI-EX-(S)-00053306].

[7774] Transcript of deposition testimony of Robert E. Diamond, Jr., *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 11, 2009, at p. 24; e-mail from Marie Smith, Barclays, to Marcus Agius, Barclays, *et al.* (Sept. 12, 2008) [BCI-EX-00081498].

[7775] E-mail from Heidi Smith, Barclays, to Robert E. Diamond, Jr., Barclays, *et al.* (Sept. 12, 2008) [BCI-EX-00078716]; transcript of deposition testimony of Robert E. Diamond, Jr., *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 11, 2009, at p. 25.

[7776] E-mail from Heidi Smith, Barclays, to Robert E. Diamond, Jr., Barclays, *et al.* (Sept. 12, 2008) [BCI-EX-00078716]; transcript of deposition testimony of Robert E. Diamond, Jr., *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 11, 2009, at pp. 25-26.

but that Barclays had "an interest if this is a rescue situation, meaning if this is a very, very distressed price."[7777]

At 2:26 p.m. New York time on September 12, Varley e-mailed Diamond and Ricci to prepare for a call that afternoon with Secretary Paulson:

> Bob
>
> Ahead of our next chat, my thoughts on the gist of the hp [Secretary Paulson] call would be:
>
> 1. Since we last spoke bob has met dick. That meeting went well.
> 2. We've also had a further meeting of the board
> 3. That meeting went well.
> 4. We see a way forward but there are two areas where we will need help.
> 5. Both are areas of potential concern to the fsa.
> 6. First is the subject of long term funding. We need to know that we would continue to have access in such size as we need to run the business prudently.
> 7. Second is the subject of certain risk assets, which you and we referred to in our conversation of yesterday. Bob's team has been analyzing the data and let me hand over to him to give you our thoughts.
> 8. Red [Diamond] covers, including the ask.
> 9. Although we have further work to do in many areas, we believe that if you can give us the help we need in these two areas, we can get this done, and will continue to work round the clock to that end

[7777] Transcript of deposition testimony of Robert E. Diamond, Jr., *In re Lehman Bros. Holdings Inc.*, No. 08-13555, Bankr. S.D.N.Y., Sept. 11, 2009, at pp. 26-27, 32.

> to get to a position where there can be an announcement ahead of market opening at the beginning of next week.[7778]

On Friday, September 12, Barclays retained Cleary Gottlieb Steen & Hamilton LLP ("Cleary Gottlieb") to represent Barclays in its negotiations with Lehman.[7779] Victor Lewkow and Robert Davis led the Cleary Gottlieb team.[7780]

Barclays and Cleary began negotiations with Lehman and its legal counsel, Simpson Thacher, on Friday morning, September 12th.[7781] John Finley led the Simpson Thacher team. Those negotiations continued until Sunday, September 14, at about noon.[7782]

The Barclays team included Diamond Cox, Jerry del Missier, Ricci, Michael Klein, Gerard LaRocca, Michael Keegan, Stephen King, Michael Evans, and Patrick Clackson.[7783] The principal negotiators for Lehman were Bart McDade, Mark G. Shafir,

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[7778] E-mail from John Varley, Barclays, to Robert E. Diamond, Jr., Barclays, *et al.* (Sept. 12, 2008) [BCI-EX-00078748]. That evening, between 5:10 p.m. and 6:00 p.m., Varley and Diamond participated in a conference call with Paulson and Geithner. *See* Henry M. Paulson, Jr., U.S. Dept. of Treasury, Call Log (Sept. 12, 2008), available at http://www.scribd.com/doc/21221123/Too-Big-To-Fail-Paulson-Call-Logs-and-Calendar-Sept-2008.

[7779] E-mail from Richard Smith, Barclays, to Gerard LaRocca, Barclays, *et al.* (Sept. 12, 2008) [BCI-EX-00078725]. Barclays requested and received from Lehman a conflict waiver that allowed Cleary Gottlieb to work on Barclays' behalf in connection with the transaction. E-mail from Victor I. Lewkow, Cleary Gottlieb, to Thomas A. Russo, Lehman (Sept. 12, 2008) [BCI-CG00000004].

[7780] *See, e.g.*, e-mail from Richard Smith, Barclays, to Gerard LaRocca, Barclays, *et al.* (Sept. 12, 2008) [BARCLAYS-LB00042759] forwarding Cleary Gottlieb contact list); e-mail from Richard Smith, Barclays, to Gerard LaRocca, Barclays, *et al.* (Sept. 12, 2008) [BCI-EX-00078725].

[7781] Examiner's Interview of Lindsee P. Granfield and Robert Davis, Mar. 10, 2009, at p. 2.

[7782] *Id.*

[7783] *See* e-mail from Hans-Joerg Rudloff, Barclays, to Robert E. Diamond, Jr., Barclays, *et al.* (Sept. 12, 2008) [BCI-EX-00078742] (noting Michael Klein's interest in assisting Barclays); e-mail from Hans-Joerg Rudloff, Barclays, to Robert E. Diamond, Jr., Barclays (Sept. 12, 2008) [BCI-EX-00078729] (passing along Klein's statement that he did not have any conflicts); e-mail from Rich Ricci, Barclays, to Robert E. Diamond, Jr.,

Michael Gelband and Alex Kirk.[7784] McDade did not "engage with" Diamond and his team until late Friday evening, September 12; before then, McDade, Hugh E. "Skip" McGee, III and others were focused on the due diligence in which Bank of America was engaged.[7785] Barclays already had begun assembling its due diligence team and requesting due diligence information on the afternoon of Thursday, September 11, but Lehman was not able to begin delivering the bulk of the information until September 12.[7786]

On Saturday morning, Richard Haworth of Barclays circulated to Clackson and LaRocca a document on "'key' DD [due diligence] findings to date" as part of a "pre-Board briefing" going to Varley and Diamond.[7787] The summary stated, among other

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Barclays (Sept. 12, 2008) [BCI-EX-00078740] (advising that Citigroup had agreed to permit Klein to advise Barclays, notwithstanding that Klein was within his "gardening leave" period after leaving Citigroup); transcript of deposition testimony of Rich Ricci, *In re Lehman Bros. Holdings Inc.*, No. 08-13555, Bankr. S.D.N.Y., Sept. 8, 2009, at pp. 10-11; transcript of deposition testimony of Alex Kirk, *In re Lehman Bros. Holdings Inc.*, No. 08-13555, Bankr. S.D.N.Y., Aug. 31, 2009, at p. 28; transcript of deposition testimony of Patrick Clackson, *In re Lehman Bros. Holdings Inc.*, No. 08-13555, Bankr. S.D.N.Y., Sept. 4, 2009, at p. 7.

[7784] Transcript of deposition testimony of Alex Kirk, *In re Lehman Bros. Holdings Inc.*, No. 08-13555, Bankr. S.D.N.Y., Aug. 31, 2009, at p. 28; transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.*, No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at pp. 11-12.

[7785] Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.*, No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at pp. 8-9, 10.

[7786] *See, e.g.*, e-mail from Diahann Turner, Barclays, to Haejin Baek, Barclays, *et al.* (Sept. 11, 2008) [BARCLAYS-LB 00023235]; e-mail from Haejin Baek, Barclays, to Gerard LaRocca, Barclays, *et al.* (Sept. 11, 2008) [BCI-EX-(S)-00033903]; e-mail from James Walker, Barclays, to Patrick Clackson, Barclays (Sept. 11, 2008) [BCI-EX-(S)-00021957]; e-mail from Gerard LaRocca, Barclays, to Rich Ricci, Barclays (Sept. 11, 2008) [BCI-EX-00078752]; e-mail from Gerard LaRocca, Barclays, to Rich Ricci, Barclays (Sept. 11, 2008) [BCI-EX-00078770]; e-mail from Erin Mansfield, Barclays, to Haejin Baek, Barclays, *et al.* (Sept. 11, 2008) [BARCLAYS-LB 00023388]; transcript of deposition testimony of Gerard LaRocca, *In re Lehman Bros. Holdings Inc.*, No. 08-13555, Bankr. S.D.N.Y., Aug. 19, 2009, at pp. 13-15, 17-18.

[7787] E-mail from Richard Haworth, Barclays, to Patrick Clackson, Barclays, *et al.* (Sept. 13, 2008) [BCI-EX-00081257]. Barclays had gone "through business by business . . . looking at those assets and ascribing what [Barclays] thought were the fair values to those assets." Transcript of deposition testimony of

things, that "[i]n the previous report to the Board, we estimated a total of $7.5 bn in further write-downs to Long Island assets based on a high level analysis of the risks of the valuation of key assets," but that "[b]ased upon due diligence undertaken in the last 24 hours, this estimate of the further immediate write-downs to L.I.'s book has increased significantly to $23bn-$27bn . . . [including] $3-5bn trading write-downs, primarily relating to RMBS."[7788] The summary further states that "[t]hese revisions are based upon: [b]ringing L.I. marks in line with [Barclays'] valuation policies . . . [and] [f]or the most material segments (*e.g.* CMBS) this estimate is based on an asset-by-asset basis, while elsewhere, where markets are highly illiquid, these are conservative top-down estimates."[7789]

During that weekend, Barclays and Lehman reached agreement in principle on a transaction under which Barclays would purchase certain "good" assets of Lehman and

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Patrick Clackson, *In re Lehman Bros. Holdings Inc.,* No. 08-13555, Bankr. S.D.N.Y., Sept. 4, 2009, at p. 13. Transcript of deposition testimony of Jerry del Missier, *In re Lehman Bros. Holdings Inc.,* No. 08-13555, Bankr. S.D.N.Y., Sept. 1, 2009, at pp. 25-28; transcript of deposition testimony of Patrick Clackson, *In re Lehman Bros. Holdings Inc.,* No. 08-13555, Bankr. S.D.N.Y., Sept. 4, 2009, at pp. 13-16; transcript of deposition testimony of Jerry del Missier, *In re Lehman Bros. Holdings Inc.,* No. 08-13555, Bankr. S.D.N.Y., Sept. 1, 2009, at p. 26. The teams were instructed "to get a genuine, realistic value of what . . . this stuff was worth." *Id.*

[7788] Barclays, Long Island key exposures – key due diligence findings (Sept. 13, 2008), at p. 1 [BCI-EX-00081255], attached to e-mail from Richard Haworth, Barclays, to Patrick Clackson, Barclays, *et al.* (Sept. 13, 2008) [BCI-EX-00081257]. Barclays made "very clear" to Lehman that they were not interested in purchasing Lehman's private equity and commercial real estate assets because of the impact on Barclays' balance sheet, and because of the difficulty in valuing those assets. Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.,* No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at p. 14; transcript of deposition testimony of Patrick Clackson, *In re Lehman Bros. Holdings Inc.,* No. 08-13555, Bankr. S.D.N.Y., Sept. 4, 2009, at pp. 10-11.

[7789] Barclays, Long Island key exposures – key due diligence findings (Sept. 13, 2008), at p. 1 [BCI-EX-00081255] attached to e-mail from Richard Haworth, Barclays, to Patrick Clackson, Barclays, *et al.* (Sept. 13, 2008) [BCI-EX-00081257].

leave certain "bad" assets (the private equity and commercial real estate assets) behind in a shell that would be financed by a consortium of Wall Street firms.[7790]

On Sunday, September 14, it became clear that the proposed transaction would not go forward.[7791] That afternoon, Lehman personnel started working on an "orderly" liquidation plan, which contemplated a six-month period to effect an orderly unwinding of Lehman's positions. During that time, Lehman would continue to employ a substantial number of people, and would pay bonuses to keep them.[7792] The plan assumed that the FRBNY would provide financing support throughout the wind-down process.[7793]

Work on an orderly six month liquidation plan came to an abrupt halt when word circulated that, as described in Section III.A.3, LBHI would file bankruptcy that evening.[7794]

[7790] Examiner's Interview of Lindsee P. Granfield and Robert Davis, March 10, 2009, at pp. 2-3; Share Exchange Agreement [Draft] [STB-LEH 0001507], Acquisition Agreement [Draft] [STB-LEH 0001518], and Stockholder Voting Agreement [Draft] [STB-LEH 0001567], attached to e-mail from Michael Salerno, Cleary Gottlieb, to H. Rodgin Cohen, Sullivan & Cromwell, *et al*. Sept. 14, 2008 [STB-LEH 0001506]; transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.,* No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at pp. 14-15.

[7791] *See* Section III.A.3 of the Report, which discusses in greater detail the interactions between the FSA, Treasury and the FRBNY.

[7792] Examiner's Interview of James P. Seery, Jr., Nov. 12, 2009, at p. 2.

[7793] *Id.*

[7794] *Id.*; Examiner's Interview of Richard S. Fuld, Jr., Apr. 28, 2009, at pp. 12-13; Examiner's Interview of Harvey R. Miller, Apr. 23, 2009, at pp. 7-8; Examiner's Interview of Scott Alvarez, Nov. 12, 2009, at p. 8 (explaining that the FRBNY did not consider bankruptcy inevitable until Sunday night when it was apparent there was no buyer for Lehman). *See* Section III.A.3 of this Report, which describes 'Lehman's decision to file bankruptcy in greater detail.

b) LBHI Bankruptcy

(1) LBHI Files Chapter 11

At 1:45 a.m. on the morning of Monday, September 15, LBHI filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York.[7795] The case was assigned to the Honorable James M. Peck.

(2) Post-Petition Clearing and Financing

Prior to LBHI's bankruptcy, LBI relied on clearing banks and organizations to settle and clear its trading activity. Clearing banks and organizations advanced substantial amounts intraday to LBI in order to clear trades, and held the assets they cleared as collateral for LBI obligations.[7796] Lehman also relied on short-term repo financing to fund its business operations.[7797] These clearing and financing arrangements were vital to LBI's continued viability following LBHI's bankruptcy, because LBI could not conduct its core business without an ability to clear and finance securities and derivative trades. JPMorgan acted as LBI's principal clearing bank for securities trading and triparty repo transactions.[7798] LBI could not continue to operate its business without the services provided by JPMorgan.

[7795] *See* Introduction to this Report.

[7796] *See* Section III.A.5 of this Report which discusses clearing in greater detail.

[7797] Examiner's Interview of Paolo R. Tonucci, Sept. 16, 2009, at pp. 4, 8.

[7798] *See* Section III.A.5.b of this Report, which discusses LBI's relationship with JPMorgan in greater detail.

LBI did not file a bankruptcy petition at the same time as LBHI. Rather, as Lehman advised JPMorgan when LBHI filed its bankruptcy proceedings, Lehman's plan was to conduct an "orderly" liquidation of LBI by unwinding LBI's repos and its matched book, while at the same time attempting to find a buyer for LBI's broker-dealer business.[7799]

The FRBNY had been a primary source of short-term financing for Lehman.[7800] On Sunday, September 14, the FRBNY publicly announced that it would expand the categories of collateral accepted through the Primary Dealer Credit Facility ("PDCF").[7801] Previously, the FRBNY had accepted only investment-grade securities; on Monday, September 15, the FRBNY announced that it would accept any collateral that was acceptable for triparty repos.[7802]

[7799] E-mail from Jane Buyers-Russo, JPMorgan, to Jamie L. Dimon, JPMorgan, *et al.* (Sept. 14, 2008) [JPM-2004 0006506] (recounting conversation between Jane Buyers-Russo and Paolo R. Tonucci); Examiner's Interview of Shari D. Leventhal, Apr. 30, 2009, at pp. 4-5.

[7800] Examiner's Interview of Shari D. Leventhal, Apr. 30, 2009, at pp. 4-5; Declaration of Shari D. Leventhal in Support of Trustee's Motion for Entry of an Order Approving a Settlement Agreement, ¶ 6, *In re Lehman Bros. Inc.*, No. 08-01420 (Bankr. S.D.N.Y. Dec. 5, 2008) (the "Leventhal Decl."), attached to Motion Under 11 U.S.C. §§ 105 and 363 Fed. R. Bankr. P. 9019(a) for Entry of an Order Approving Settlement Agreement, Docket No. 387, *In re Lehman Bros. Inc.*, No. 08-01420 (Bankr. S.D.N.Y. Dec. 5, 2008).

[7801] Federal Reserve Press Release (Sept. 14, 2008) available at http://www.federalreserve.gov/newsevents/press/ monetary/20080914a.htm; Examiner's Interview of Christopher R. Burke, July 7, 2009, at p. 3; Examiner's Interview of Harvey R. Miller, Apr. 23, 2009, at p. 8; Examiner's Interview of Scott Alvarez, Nov. 12, 2009, at p. 9.

[7802] Examiner's Interview of Christopher R. Burke, July 7, 2009, at p. 3; e-mail from Christopher Killian, Securities Industry and Financial Markets Association, to Jack Fondacaro, Lehman (Sept. 14, 2008) [LBEX-DOCID 30719] (attaching the FRBNY's announcement); e-mail from Ricardo Chiavenato, JPMorgan, to Christopher Carlin, JPMorgan, *et al.* (Sept. 15, 2008) [JPM-2004 0055329].

The FRBNY advised Lehman that it would not allow Lehman to access the PDCF as a means of avoiding a bankruptcy filing.[7803] The FRBNY, however, advised Lehman that it would provide up to two weeks of overnight secured financing through the PDCF to allow LBI to accomplish an orderly liquidation.[7804]

The FRBNY anticipated that LBI ultimately would need to be placed in a SIPA proceeding, but that most of LBI's customers would move their accounts to other broker-dealers during the "orderly unwinding" of LBI, leaving a relatively small portion of LBI's customer accounts when the SIPA proceeding was commenced (which the FRBNY hoped could be delayed until approximately two weeks after the LBHI filing).[7805] Without FRBNY funding an orderly unwind of LBI's business, customers might be forced to wait months to gain access to their money in a SIPA proceeding.[7806]

The FRBNY and Lehman believed, correctly, that it would be necessary for the FRBNY to provide expanded PDCF financing to Lehman because, with the filing of the LBHI's bankruptcy petition, parties that previously had provided Lehman with

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[7803] Examiner's Interview of Shari D. Leventhal, Apr. 30, 2009, at p. 5 (explaining the FRBNY would provide up to two weeks of funding for an orderly unwind of LBI); Examiner's Interview of Richard S. Fuld, Jr. Apr. 28, 2009, at p. 13.

[7804] Examiner's Interview of Shari D. Leventhal, Apr. 30, 2009, at pp. 4-5; Leventhal Decl. ¶ 6. Some at the FRBNY believed that the FRBNY was risking too much exposure with the two week funding timeframe. Examiner's Interview of Shari D. Leventhal, Apr. 30, 2009, at p. 5.

[7805] Examiner's Interview of Shari D. Leventhal, Apr. 30, 2009, at p. 5.

[7806] *Id.*

overnight secured financing through repos would refuse to "roll" (*i.e.*, renew) those repos beginning on Monday, September 15.[7807]

Although the FRBNY had expanded the categories of collateral generally eligible for pledge through the PDCF, the FRBNY limited the collateral that LBI could pledge to the collateral that had been in LBI's clearance box at JPMorgan as of Friday, September 12.[7808] This restriction was referred to as the "Friday criteria."[7809] In addition, the FRBNY imposed larger PDCF borrowing haircuts on LBI than it did on other investment banks.[7810] These haircuts also were larger than the haircuts applied under

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[7807] Leventhal Decl. ¶ 6; Examiner's Interview of Shari D. Leventhal, Apr. 30, 2009, at p. 5; e-mail from Robert Azerad, Lehman, to Monique Wise, Lehman, *et al.* (Sept. 21, 2008) [BCI-EX-(S)-00013154] (explaining the Federal Reserve "extended the PDCF to a much wider range of asset classes Sunday night – thereby providing a backup source of funding to mitigate any loss of repo capacity, which was bound to happen once LBHI filed for bankruptcy"); *see also* JPMorgan Analysis (Sept. 11, 2008), at p. 3 [JPM-2004 0032965] (analyzing a "worst-case scenario," in which triparty investors did not renew their repos and Lehman was forced to rely on the PDCF for overnight financing); e-mail from David Weisbrod, JPMorgan, to Jamie L. Dimon, JPMorgan, *et. al*. (Sept. 15, 2008) [JPM-2004 0080146] (reporting that Lehman's triparty repo borrowing fell from $87 billion on Friday evening to $51 billion ($28 billion from the PDCF, $2 billion from Barclays, and $21 billion from other investors) on Monday evening).

[7808] Examiner's Interview of Robert Azerad, Apr. 20, 2009, at p. 5; Examiner's Interview of Christopher R. Burke, July 7, 2009, at p. 3.

[7809] Examiner's Interview of Robert Azerad, Apr. 20, 2009, at p. 5; Examiner's Interview of Christopher R. Burke, July 7, 2009, at p. 3; *see also* e-mail from Timothy G. Lyons, Lehman, to Ian T. Lowitt, Lehman (Sept. 14, 2008) [LBEX-DOCID 70210] (stating "the [FRBNY] is letting the other eighteen broker dealers fund a much broader range of collateral than us").

[7810] Examiner's Interview of Robert Azerad, Apr. 20, 2009, at p. 5; *see also* e-mail from Ricardo Chiavenato, JPMorgan, to Christopher Carlin, JPMorgan, *et al.* (Sept. 15, 2008) [JPM-2004 0055329] (noting the FRBNY "set a Lehman-specific PDCF schedule . . . with higher margin than for other dealers"); Chase Triparty Haircut Summary of Trades Maturing Sept. 15, 2008, as of Sept. 12, 2008 [LBEX-DOCID 428627] (listing an estimate haircut impact at approximately $4 billion), attached to e-mail from Sindy Aprigliano, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Sept. 15, 2008) [LBEX-DOCID 4146462]; e-mail from Sindy Aprigliano, Lehman, to George V. Van Schaick, Lehman, *et al.* (Sept. 15, 2008) [LBEX-DOCID 077028] (discussing the larger haircuts imposed by the FRBNY on Lehman's PDCF borrowing); e-mail from Robert Azerad, Lehman, to Susan E. McLaughlin, Lehman, *et al*. (Sept. 15, 2008) [LBEX-DOCID 457643] (explaining the PDCF haircuts would "result in a $4 billion drain in liquidity . . ."); PDCF Schedule of Eligible Securities (Sept. 14, 2008) [LBEX-DOCID 405695] (detailing the PDCF haircuts applied to Lehman

Lehman's pre-bankruptcy triparty borrowing facilities. The increased haircuts reduced the liquidity generated by Lehman's PDCF borrowing.[7811]

The FRBNY's post-LBHI bankruptcy financing of LBI began Monday evening, September 15, with Lehman borrowing approximately $28 billion via the PDCF,[7812] and continued through Thursday morning, September 18.[7813] In addition to the PDCF, Lehman also continued to borrow under two other FRBNY programs, Open Market Operations ("OMO") and the Term Securities Lending Facility ("TSLF").[7814] On Monday, the FRBNY advanced approximately $18.5 billion to LBI under the TSLF, and approximately $2.8 billion in OMO,[7815] and continued to advance funds to LBI under these programs through Thursday morning, September 18, when Barclays replaced the FRBNY pursuant to the Replacement Transaction described below.

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for the various categories of accepted securities); e-mail from Ricardo Chiavenato, JPMorgan, to Christopher Carlin, JPMorgan, *et al.* (Sept. 15, 2008) [JPM-2004 0055329].

[7811] Examiner's Interview of Robert Azerad, Apr. 20, 2009, at p. 5. *See* e-mail from Robert Azerad, Lehman, to Susan E. McLaughlin, FRBNY, *et al*. (Sept. 15, 2008) [LBEX-DOCID 457643] (explaining the PDCF haircuts would "result in a $4 billion drain in liquidity . . .").

[7812] *See* e-mail from Edward J. Corral, JPMorgan, to William Walsh, FRBNY, *et al.* (Sept. 15, 2008) [JPM-2004 0031195] (notifying the FRBNY that the Lehman assets used in LBI's $28 billion PDCF repo on Monday night satisfied the Friday criterion). Earlier on Monday, Lehman estimated that it would borrow up to $35 billion through the PDCF on Monday night. *See* e-mail from Sindy Aprigliano, Lehman, to Robert Azerad, Lehman (Sept. 15, 2008) [LBEX-DOCID 1071653] (providing Feraca's PDCF estimate of $27 billion plus a buffer of $8 billion); e-mail from Robert Azerad, Lehman, to Susan E. McLaughlin, FRBNY, *et al.* (Sept. 15, 2008) [LBEX-DOCID 071550] (estimating $34 billion of PDCF borrowing); e-mail from Paolo R. Tonucci, Lehman, to Susan E. McLaughlin, FRBNY, *et al.* (Sept. 15, 2008) [LBEX-DOCID 071550] (estimating $28.3 billion for the collateral value of the PDCF borrowing).

[7813] Examiner's Interview of Robert Azerad, Apr. 20, 2009, at p. 5.

[7814] *Id.*

[7815] A&M's Interview of James W. Hraska, Oct. 8, 2008, at p. 1.

On Sunday, September 14, JPMorgan was immediately advised of the fact that the FRBNY had agreed to extend PDCF financing to LBI.[7816] LBI's ability to obtain PDCF financing from the FRBNY was critical to JPMorgan because Lehman needed to pay JPMorgan on a daily basis for clearing advances (which were, in effect, intraday extensions of credit), or JPMorgan would refuse to continue to clear trades and act as a triparty repo agent for LBI.[7817]

By late Sunday evening, internal JPMorgan e-mails indicate that it had decided to "continue as the operating bank for [LBI] as long as it didn't file and was doing an orderly liquidation . . . . [JPMorgan also] would unwind tri-party and return cash to investors."[7818] Early Monday morning, however, the extent to which JPMorgan would continue to provide clearing and settlement services for LBI was unclear.[7819] Kevin Murphy of JPMorgan said in an internal e-mail, "So our stance will be that we are not going to facilitate an orderly unwind but that we are rather going to potentially put Lehman in default of its obligations to the various clearing houses? Is this the message

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[7816] E-mail from Jane Buyers-Russo, JPMorgan, to Jamie L. Dimon, JPMorgan, *et al*. (Sept. 14, 2008) [JPM-2004 0054242]; e-mail from Barry L. Zubrow, JPMorgan, to Bill T. Winters, JPMorgan, *et al.* (Sept. 15, 2008) [JPM-2004 0006510].

[7817] *See* e-mail from Robert Azerad, Lehman, to Monique Wise, Lehman, *et al.* (Sept. 21, 2008) [BCI-EX-(S)-00013154] (explaining that because of the LBHI bankruptcy filing, LBI needed a backup source of funding, the PDCF, "to collateralize the clearing banks against their intraday exposure to Lehman Brothers").

[7818] E-mail from Jane Buyers-Russo, JPMorgan, to Jamie L. Dimon, JPMorgan, *et al*. (Sept 14, 2008) [JPM-2004 0054242].

[7819] *See* e-mail from Scott Sandler, JPMorgan, to Edward J. Corral, JPMorgan, *et al.* (Sept. 15, 2008) [JPM-2004 0030786] (conveying confusion regarding what Lehman trades were cancelled and what Lehman trades were permitted to settle).

our senior management wants us to send?"[7820] The FRBNY also grew concerned on Monday morning that JPMorgan would not continue to extend intraday credit to LBI, prompting an e-mail from Thomas C. Baxter, Jr., General Counsel to the FRBNY, to Stephen Cutler at JPMorgan.[7821]

Throughout the morning, Scott Sandler and Jane Buyers-Russo at JPMorgan, among others, emailed back and forth regarding why Lehman trades were cancelled and whether trades, if any, should have been cancelled.[7822] By mid-morning on Monday, JPMorgan clarified its position, and determined that "JPM [would] continue to act as the operating bank for [LBI] which include[d] being settlement bank for the various exchanges and the fed wire . . .," but limited its aggregate exposure to $1 billion.[7823]

Other clearing banks and organizations also continued to provide clearing services and financing to LBI during the week following LBHI's bankruptcy. From Monday, September 15 through Wednesday, September 17, Barclays provided LBI with secured financing pursuant to an overnight repo facility. Barclays' financing under that repo facility grew from approximately $2 billion on Monday to $15.8 billion by

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[7820] E-mail from Kevin Murphy, JPMorgan, to Henry Steward, JPMorgan, *et al.* (Sept. 15, 2008) [JPM-2004 0047736].

[7821] *See* e-mail from Thomas C. Baxter, Jr., FRBNY, to Stephen Cutler, JPMorgan (Sept. 15, 2008) [JPM-2004 0055286] (expressing the FRBNY's concern that JPMorgan was not willing to provide intraday credit to LBI).

[7822] *See* e-mail from Scott Sandler, JPMorgan, to Edward J. Corral, JPMorgan, *et al*. (Sept. 15, 2008) [JPM-2004 0030786].

[7823] E-mail from Jane Buyers-Russo, JPMorgan, to Barry L. Zubrow, JPMorgan, *et al.* (Sept. 15, 2008) [JPM-2004 0055008].

Wednesday evening.[7824] Barclays also agreed to provide LBHI with $450 million in DIP financing.[7825]

Depository Trust & Clearing Corporation ("DTCC") entities, which provided clearing and settlement services for a range of equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments and OTC derivatives, continued to clear transactions for LBI during the week following LBHI's bankruptcy.[7826] The CME Group, which was comprised of four commodities markets (the Chicago Board of Trade, the Chicago Mercantile Exchange, the New York Mercantile Exchange and COMEX), also continued to clear customer transactions; however, when on Wednesday, September 17, the CME learned that Barclays would not be assuming any LBI house positions as part of the sale, the CME liquidated all of LBI's house positions at the CME at a substantial loss to LBI and its affiliates.[7827] The Options Clearing Corporation ("OCC"), the clearing organization for most domestic exchange-traded commodities options, also continued to clear option transactions for LBI even after BofA, LBI's settlement bank for OCC transactions, refused to continue acting for LBI and the OCC had to settle directly with LBI by wire.[7828]

[7824] Examiner's Interview of James W. Hraska, Oct. 8, 2008, at p. 4; e-mail from Teri Scott, Barclays, to Jonathan Stone, Barclays, *et al.* (Sept. 18, 2008) [BCI-EX-(S)-00038011].

[7825] *See* Senior Secured Superpriority Debtor in Possession Credit Agreement among LBHI, Barclays Bank PLC and Barclays Capital (Sept. 17, 2008).

[7826] Examiner's Interview of Isaac Montal, May 19, 2009, at p. 5.

[7827] Examiner's Interview of Timothy Doar, Oct. 16, 2009, at pp. 4-5.

[7828] S*ee* Section III.C.6.f.3 of this Report, which discusses the OCC in greater detail.

Citi,[7829] Lehman's provider of Continuous Linked Settlement, or "CLS," services for transactions conducted in more than one currency, also continued to provide clearing services to LBI post-petition, albeit only after LBI posted a deposit with Citi. As with JPMorgan, Citi provided short-term financing to Lehman to facilitate its multi-currency transactions. Citi terminated LBI's access to Citi's CLS services on September 17, 2008, but withdrew that termination after Barclays pledged $700 million to Citi on Lehman's behalf.[7830]

LBI also was party to triparty term repos that had not yet expired, and also continued to obtain overnight funding through GCF (General Collateral Finance) repos, a triparty dealer-to-dealer program offered by Fixed Income Clearing Corporation (a DTCC subsidiary) on an anonymous basis.[7831]

Together, these sources of clearing and secured repo financing permitted LBI to survive while a sale to Barclays was negotiated and consummated.

c) Negotiations Leading to APA

As news of the impending LBHI bankruptcy spread through Lehman on Sunday, September 14, Lehman began to consider whether a sale of only the broker/dealer (LBI)

[7829] *See* Section III.A.5.c of this Report, which discusses Citi in greater detail.

[7830] *See* Section III.A.5 of this Report, which discusses Citi's termination of C&S Services in greater detail.

[7831] *See* e-mail from David Weisbrod, JPMorgan, to Jamie L. Dimon, JPMorgan, *et. al*. (Sept. 15, 2008) [JPM-2004 0080146] (listing $21 billion in "mainly term repos" as part of LBI's triparty borrowing for September 15).

in bankruptcy was possible.[7832] At about 6:00 p.m. on Sunday, September 14, Mark J. Shapiro, the head of the restructuring group at Lehman, went to McDade's office to "make sure that [McDade] understood that" Barclays could purchase Lehman in bankruptcy.[7833]

McDade called Diamond and asked if Barclays was interested.[7834] Diamond called McDade back a short time later, said that Barclays was, and that Lehman should have its team ready to meet with Barclays' team at 7:00 a.m. the next morning.[7835] Calls also were made to Bank of America, HSBC and Nomura, but Barclays was the only entity interested in pursuing a transaction with LBI.[7836]

Around 10:30 p.m. that evening, Shapiro called Bryan Marsal of A&M and asked Marsal to serve as the chief restructuring officer of LBHI.[7837]

[7832] Examiner's Interview of James P. Seery, Jr., Nov. 12, 2009, at p. 2.

[7833] Transcript of deposition testimony of Mark J. Shapiro, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 7, 2009, at p. 16. Shapiro had not been involved in the previous negotiations between Lehman and Barclays; he had been preparing for a possible bankruptcy filing. *Id.* at pp. 14-15.

[7834] Transcript of deposition testimony of Mark J. Shapiro, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 7, 2009, at pp. 16-17; transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at p. 16; transcript of deposition testimony of Rich Ricci, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 8, 2009, at pp. 18-19; transcript of deposition testimony of Jerry del Missier, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 1, 2009, at pp. 42-43.

[7835] E-mail from Michael Klein, consultant retained by Barclays, to Robert E. Diamond, Jr., Barclays (Sept. 15, 2008) [BCI-EX-(S)-00110306] (discussing the 7:00 a.m. meeting scheduled for that morning with Lehman); transcript of deposition testimony of Mark J. Shapiro, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 7, 2009, at p. 20; transcript of deposition testimony of Rich Ricci, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 8, 2009, at p. 21.

[7836] Examiner's Interview of James P. Seery, Jr., Nov. 12, 2009, at p. 2.

[7837] Transcript of deposition testimony of Bryan P. Marsal, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Dec. 22, 2009, at pp. 6-7; transcript of deposition testimony of Philip Kruse, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Dec. 17, 2009, at p. 8. A&M's first day at

Barclays had anticipated that there might be an opportunity to negotiate a deal with Lehman after LBHI filed its Chapter 11 petition. In a memorandum to the Barclays Board of Directors dated September 15, Varley stated:

> We mentioned at the telephone meeting of the Board on Sunday evening that we would seek to pursue vigorously opportunities coming to out of Long Island going into Chapter 11 in the US and into administration elsewhere around the world.
>
> As we anticipated, [Diamond] was contacted overnight by the Long Island leadership team asking whether we might be in a position to acquire large parts of the business from the administrators; and that if so they would seek to protect as much of the business as they could as a going concern. We received assurance from them that this was a conversation taking place only with Barclays and we have no reason to doubt that assurance although, of course, Long Island staff are being raided freely around the world as I write.
>
> We are urgently dimensioning what we think may be available. The core would be the US broker deal[er] (securities trading, investment banking and wealth management). We are assessing what this might imply in terms of balance sheet take-on and associated WRA's [risk-weighted assets] and capital requirements; and people take-on. We are also seeking to form a view – which is much less scientific now that there is no Long Island share price – as to the consideration that we might be prepared to pay to the administrator.
>
> We have had contact with the US authorities today and they are, as you would expect, very supportive of this initiative . . . .[7838]

Lehman was on Sept. 15, 2008. Transcript of deposition testimony of Bryan P. Marsal, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Dec. 22, 2009, at pp. 6-7.

[7838] Memorandum from John Varley, Barclays, to Barclays Board of Directors, re: Long Island (Sept. 15, 2008) [BCI-EX-00079170]; *see also* e-mail from Marie Smith, Barclays, to Marcus Agius, Barclays, *et al.* (Sept. 15, 2008) [BCI-EX-00079168] (transmittal e-mail to board members); transcript of deposition testimony of Michael Klein, *In re Lehman Bros. Holdings Inc.*, Case *No.* 08-13555, Bankr. S.D.N.Y., Sept. 12, 2009, at p. 36 (testifying that, after word spread on Sunday that the proposed transaction between Barclays and Lehman was not going forward, the Barclays team had a number of calls to determine "how dead is dead," and what could be done next).

The post-bankruptcy negotiations between Lehman and Barclays began in earnest with a telephone call early Monday morning between McDade, McGee and Shafir for Lehman, and Diamond, del Missier and Klein for Barclays.[7839] During that call, Barclays expressed concern about whether Barclays would be buying an intact business, given media reports about Lehman employees leaving the headquarters building in droves.[7840] Lehman responded that it was confident that, if the deal was done quickly enough, it could keep a large part of the business together and deliver it to Barclays.[7841]

(1) Participants

The negotiations between Lehman and Barclays principally were conducted on the 32nd floor of Lehman's headquarters building.[7842] That floor included a main dining room that housed the principal negotiators and various others who came and went during the negotiations; fifteen or so other dining rooms were assigned to the teams that Lehman, Barclays and others had formed to address various aspects of the deal.[7843]

[7839] Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at p. 16; *see also* transcript of deposition testimony of Michael Klein, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 12, 2009, at p. 38 (recalling call).

[7840] Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at p. 17.

[7841] *Id.*

[7842] Transcript of deposition testimony of Steven Berkenfeld, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 6, 2009, at p. 37.

[7843] Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at pp. 21-22; transcript of deposition testimony of Mark J. Shapiro, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 6, 2009, at p. 42.

McDade, Shapiro, Shafir and McGee of Lehman, and Harvey R. Miller, Lori Fife, Thomas A. Roberts and Michael Lubowitz of Weil were the principal negotiators for Lehman.[7844] They were supported by a number of senior Lehman personnel, including Steven Berkenfeld, Gerald Donini, Eric Felder, Michael Gelband, Martin Kelly, Alex Kirk, Ian Lowitt, James Seery and Paolo Tonucci.[7845] Lazard, which was advising Lehman, also sent several people, including Barry Ridings, to participate in the negotiations.[7846]

Ricci, Cox, and Klein of Barclays, and Lewkow of Cleary Gottlieb, were the principal negotiators for Barclays.[7847] They were supported by a number of Barclays employees as well as Cleary Gottlieb and Sullivan & Cromwell lawyers.

[7844] *See* Lehman, Project Green Working Group List (Sept. 15, 2008) [BCI-CG00001917], attached to e-mail from Elizabeth Dayton, Lehman, to Archibald Cox, Jr., Barclays, *et al.* (Sept. 15, 2008) [BC1-CG00001916] (contact list for negotiations); *see also* transcript of deposition testimony of Mark J. Shapiro, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 7, 2009, at pp. 46-48; transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at pp. 18-19; transcript of deposition testimony of Steven Berkenfeld, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 6, 2009, at pp. 37-39.

[7845] Transcript of deposition testimony of Martin Kelly, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 18, 2009, at pp. 52-53; transcript of deposition testimony of Hugh E. McGee, III, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 10, 2009, at pp. 11-13; transcript of deposition testimony of Mark J. Shapiro, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 7, 2009, at pp. 46-54; transcript of deposition testimony of James P. Seery, Jr., *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 3, 2009, at pp. 47-48; transcript of deposition testimony of Steven Berkenfeld, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 6, 2009, at pp. 37-40.

[7846] *See, e.g.*, e-mail from Arthur Bruhmuller, Lazard, to Stephen Campbell, Lazard, *et al.* (Sept. 15, 2008) [LAZ-C-00044714].

[7847] Transcript of deposition testimony of Mark J. Shapiro, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 7, 2009, at pp. 47-48; *see* Lehman, Project Green Working Group List (Sept. 15, 2008) [BCI-CG00001917], attached to e-mail from Elizabeth Dayton, Lehman, to Archibald Cox, Jr., Barclays, *et al.* (Sept. 15, 2008) [BCI-CG00001916].

The parties negotiated through the day Monday and through the night into Tuesday morning, and reached an agreement on a general structure and terms. It then took another day to finish negotiating and drafting the APA.

(2) Structure of Transaction

The principal difference between the failed proposal that had been negotiated prior to LBHI's bankruptcy, and the transaction Lehman and Barclays began negotiating on September 15, was that the pre-bankruptcy proposal called for Barclays' acquisition of the worldwide Lehman enterprise – with the exception of commercial real estate and private equity assets – while the bankruptcy transaction involved the acquisition of only Lehman's United States broker-dealer business. That was reflected, *inter alia*, in the size of the balance sheets of the businesses that Barclays was negotiating to acquire: approximately $600 billion in the pre-bankruptcy proposal, compared to approximately $70 billion in the post-bankruptcy proposal.[7848]

The structure of the post-bankruptcy transaction began to take shape over the course of the afternoon of September 15.[7849] Barclays would acquire the Lehman headquarters building in Manhattan and two data centers in New Jersey, at appraised

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[7848] Lehman, LBI Balance Sheet (Sept. 15, 2008), at p. 1 [LBHI_SECO7940_382574], attached to e-mail from Ryan Traversari, Lehman, to Archibald Cox, Jr., Barclays, *et al.* (Sept. 15, 2008) [LBHI-SEC07940 382573]; Lehman, LBI Summary Balance Sheet (Sept. 17, 2008), at p. 1 [LBEX-DOCID46613], attached to e-mail from James Walker, Barclays, to Martin Kelly, Lehman, *et al.* (Sept. 17, 2008) [LBEX-DOCID 464234]; transcript of deposition testimony of John Varley, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 11, 2009, at p. 27.

[7849] Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at p. 18.

values, and would pay $250 million to acquire the "rights to operate" Lehman's broker/dealer business and the assets and liabilities "directly associated with and necessary to the operation of the business."[7850]

Early in the afternoon of September 15, Diamond e-mailed Varley and Lucas to update them on the negotiation, saying:

> High level numbers
>
> 10,000 people (of 26,000), maybe some separately from Europe and Asia, say 2,000 related to US businesses
>
> 100 b dollar balance sheet (of 600)
>
> Tech, indexes
>
> IBD and M and A staff
>
> Probably lease space, but maybe buy some buildings.
>
> Need US business, broker/dealer capitalized at $5 billion, we have 2 in barcap. So need 3 to 5 billion equity raising I think
>
> Price minimal, we think.[7851]

Witnesses advised the Examiner that the negotiations on Monday, September 15, and Tuesday, September, 16, were arm's length and vigorous negotiations. Ridings, for example, indicated that notwithstanding the LBHI bankruptcy and the fact that Barclays was the only bidder, Lehman nonetheless retained bargaining power in its

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[7850] Transcript of deposition testimony of Michael Klein, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 12, 2009, at pp. 47-53, 54; transcript of deposition testimony of James P. Seery, Jr., *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 3, 2009, at pp. 52-53, 60-61.

[7851] *See* e-mail from Robert E. Diamond, Jr., Barclays, to John Varley, Barclays, *et al.* (Sept. 15, 2008) [BCI-EX-(S)-00025361]; *see also* e-mail from Rich Ricci, Barclays, to Robert Le Blanc, Barclays, *et al.* (Sept. 15, 2008) [BCI-EX-00082251].

negotiations with Barclays. Ridings stated that the negotiations were genuine, in part, because there was a credible threat that the Court would refuse to approve the transaction if "things were not handled appropriately." [7852]

(3) Negotiations Regarding Securities Positions to be Purchased by Barclays

(a) On September 15 and 16, Lehman and Barclays Review Lehman's Securities Positions and Marks

During the negotiations on Monday and Tuesday, "asset experts" from Lehman and Barclays focused on reviewing the various classes of LBI securities positions, and the marks associated with those assets.[7853]

That process began with determining the population of securities positions that was held by LBI and available for transfer.[7854] On Monday afternoon and evening, Lehman assembled information regarding the LBI securities positions available to be

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[7852] Examiner's Interview of Barry W. Ridings, Oct. 1, 2009, at p. 2.

[7853] Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at pp. 24-27; transcript of deposition testimony of Stephen King, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 10, 2009, at pp. 23-24, 26-33; transcript of deposition testimony of Michael Keegan, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 28, 2009, at pp. 25-29; *see* transcript of deposition testimony of Martin Kelly, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 18, 2009, at pp. 34-35 (describing involvement in assembly of information related to assets to be sold to Barclays).

[7854] Transcript of deposition testimony of Stephen King, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 10, 2009, at pp. 23-25; transcript of deposition testimony of Mark J. Shapiro, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 7, 2009, at pp. 97-102. Determining whether a particular securities position on LBI's books was available for transfer to Barclays was an important task, because, LBI held securities in a variety of capacities. LBI did not have the legal right to transfer all of the securities in its possession and control. *See* Section III.C.3.a.1 of this Report, which discusses LBI's holding of securities.

sold, including both long and short positions.[7855] The result was captured in a summary document entitled "Lehman Brother[s] Inc Balance Sheet by GAAP Asset Type 9/12/08."[7856] The document described LBI's total long and short securities positions as follows:

GAAP Asset Class	Net Long Inventory	Net Short Inventory
Total CDs and Other Mon Mkt Instr. Total	$1,014,274,052	$0
Total Corp. Obligations & Spot Total	$5,141,203,903	($2,003,710,797)
Corporate Stocks & Options Total	$8,431,893,804	($6,951,162,769)
Total Derivatives & Other Contr. Total	$4,838,239,449	($4,535,705,348)
Total Governments & Agencies Total	$39,173,255,499	($35,003,084,874)
Total Mortgages & Mortgage Backed Total	$6,556,460,569	($15,959,609)
Grand Total	**$65,155,327,276**	**($48,509,623,397)**

Lehman provided that summary of LBI securities positions to Barclays.[7857] Lehman also provided Barclays with voluminous listings of long and short securities positions as of September 12, 2008.[7858]

[7855] *See, e.g.*, e-mail from Kevin Horan, Lehman, to Gerard M. Reilly, Lehman, *et al.* (Sept. 15, 2008) [LBHI_SEC07940_2543309].

[7856] *See* Lehman, Balance Sheet by GAAP Asset Type (Sept. 12, 2008) [LBEX-DOCID 999276], attached to e-mail from Gerard M. Reilly, Lehman, to Michael Gelband, Lehman (Sept. 15, 2008) [LBEX-DOCID 818160].

[7857] *See id.*; transcript of deposition testimony of Stephen King, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 10, 2009, at pp. 34-37 (testifying that he saw the summary schedule on

Lehman also provided Barclays with an LBI "balance sheet summary" that reflected an estimate of the securities assets and liabilities of the firm as of September 15. That balance sheet summary was provided to Barclays at 9:39 p.m. on September 15; a revised version was provided to Barclays at 10:04 p.m.[7859] The revised LBI balance sheet summary listed estimated total assets as of September 15 of $75.3 billion, consisting of $65.3 billion of securities inventory and cash assets, and $10 billion of "matched book" assets.[7860] The revised balance sheet summary listed total liabilities as of September 15 of $73 billion.[7861] The balance sheet summary is reproduced below:

September 15 and 16); Barclays, Balance Sheet by GAAP Asset Type (Sept. 12, 2008) [BCI-EX-(S)-00074257] (with handwritten notes), attached to e-mail from Jasen Yang, Barclays, to James Walker, Barclays, *et al.* (Sept. 17, 2008) [BCI-EX-(S)-00074256].

[7858] *See* Lehman, LBI long position inventory (Sept. 15, 2008) [LBHI_SEC07940_2547489], attached to e-mail from Michael Garvey, Lehman, to Stephen King, Barclays, *et al.* (Sept. 15, 2008) [LBHI_SEC07940_2547488]; Lehman, LBI short balance sheet detail (excluding equities) as of Sept. 12, 2008 (Sept. 12, 2008) [BCI-EX-(S)-00054319], attached to e-mail from Michael Garvey, Lehman, to Stephen King, Barclays, *et al.* (Sept. 15, 2008) [BCI-EX-(S)-00054317]. Barclays subsequently determined that the total values listed for the categories of securities on the summary chart did not "tie-out" in every instance to the sum of the individual values of the securities in the detail; for example, the summary sheet indicated that the "Total Corp. Obligations & Spot Total" long positions totaled $5,141,203,903, but the securities included in the detailed listing for that category did not sum to that amount. *See* e-mail from Jasen Yang, Barclays, to James Walker, Barclays, *et al.* (Sept. 17, 2008) [BCI-EX-(S)-00074256]; transcript of deposition testimony of Stephen King, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 10, 2009, at pp. 39-40.

[7859] Lehman, Balance Sheet (Sept. 15, 2008) [LBHI-SEC 07940-382490], attached to e-mail from Ryan Traversari, Lehman, to Archibald Cox, Jr., Barclays, *et al.* (Sept. 15, 2008) [LBHI_SEC07940_382489]; e-mail from Ryan Traversari, Lehman, to Archibald Cox, Jr., Barclays, *et al.* (Sept. 15, 2008) [LBHI_SEC07940_382573] and attachment [LBHI_SEC07940_382573] (revised balance sheet).

[7860] Lehman, Balance Sheet (Sept. 15, 2008) [LBHI-SEC 07940-382573] attached to e-mail from Ryan Traversari, Lehman, to Archibald Cox, Jr., Barclays, *et al.* (Sept. 15, 2008) [LBHI_SEC07940_382573].

[7861] *Id.*

LBI		
In US$ billion		
		9/15/2008 estimate
	Cash and Cash Equivalents	1.3
	Cash and Securities Segregated	0.0
	Inventory	64.0
	Matched Book	10.0
	Receivables	0.0
	Investments in Subsidiaries	0.0
	Intercompany Receivables	0.0
Total Assets		75.3
	Short Positions	56.0
	Matched Book	10.0
	Payables	0.0
	Intercompany Payables	0.0
	Subordinated Notes	7.0
Total Liabilities		73.0
	Shareholders Equity	2.3
Total Liabilities & Shareholders Equity		75.3

From Monday evening through early Tuesday morning, the Lehman and Barclays teams discussed the marks associated with LBI's securities portfolio.[7862] McDade testified that there was a "bottoms-up process, albeit in a very quick time period, of establishing a fair market value for the individual assets."[7863] King described

[7862] *See* e-mail from Stephen King, Barclays, to Ryan Babcock, Barclays, *et al.* (Sept. 15, 2008) [BCI-EX-(S)-00054291] (stating, "[n]eed to look just at securities. Do we have line by line pricing on all cusips?"); transcript of deposition testimony of Stephen King, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 10, 2009, at pp. 23-24, 26-33; transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at pp. 25-27; transcript of deposition testimony of Michael Keegan, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 28, 2009, at pp. 25-29; *see also* transcript of deposition testimony of Martin Kelly, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 18, 2009, at pp. 34-35 (describing involvement in assembly of information related to assets be sold to Barclays).

[7863] Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at p. 26.

a process on September 15 and 16 in which Barclays went through the LBI securities and estimated values.[7864]

As the discussions regarding the securities progressed, Martin Kelly and Paolo Tonucci were preparing schedules of assets and liabilities pertaining to the transaction, which were used in the negotiations.[7865] Several versions of the schedules were created.[7866] The last schedule is dated September 16, 2008 at 11:18 a.m., and includes a handwritten notation "9/16/08 Final," with the initials "SB" underneath.[7867] "SB" is Steven Berkenfeld, who made the handwritten notes.[7868] Berkenfeld, head of the Legal, Compliance and Audit Division at Lehman, characterized the schedule as "the final schedule of the estimate of assets and liabilities that would be transferred over" to Barclays.[7869] The final schedule is reproduced below:

[7864] Transcript of deposition testimony of Stephen King, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 10, 2009, at pp. 27-33.

[7865] Transcript of deposition testimony of Steven Berkenfeld, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 6, 2009, at pp. 34-37, 47; *see also* e-mail from James Walker, Barclays, to Martin Kelly, Lehman, *et al.* (Sept. 17, 2008) [LBEX-DOCID 464234] (referring to "attached balance sheet [that] was used by the LEH side in the overnight discussions of Monday"), Schedule (Sept. 16, 2008) [BCI-EX-00115595]; Schedule (Sept. 16, 2008) [BCI-CG00033789].

[7866] E-mail from Patrick Clackson, Barclays, to Bill Castell, Barclays, *et al.* (Sept. 16, 2008) [BCI-EX-(S)-00023848]; Final Schedule (Sept. 16, 2008) [BCI-CG00033742].

[7867] Lehman Final Balance Sheet (Sept. 16, 2008) [BCI-CG00033742]; transcript of deposition testimony of Steven Berkenfeld, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 6, 2009, at p. 48 (explaining why two versions of the schedule bear his initials and the word "final").

[7868] Transcript of deposition testimony of Steven Berkenfeld, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 6, 2009, at pp. 47-48.

[7869] *Id*. at p. 49; *see* transcript of deposition testimony of Ian T. Lowitt, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 20, 2009, at p. 80 (testifying that the schedule was designed to track the assets and liabilities that Barclays would take); transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at pp. 53-

ASSETS		LIABILITIES	
Gov & Ag	$40.0	ST Borrowings	$0.0
Commercial Paper	1.1	Gov & Ag	21.0
Mortgages	2.7	Commercial Paper	0.0
Total Corp Debt	4.9	Mortgages	0.0
Corp Equity	8.8	Corp Debt	2.1
Derivatives	4.5	Corp Equities	6.3
Cash	0.7	Derivatives	4.5
Total	**$62.7**	**Total**	**$33.9**
Collateralized ST Agr	10.0	Collateralized ST Fund	34.5
Receivables	0.0	Payables	0.0
Other Assets	0.0	Deposits	0.0
Inv In Con Subs	0.0	Due to Subs	0.0
Due From Subs	0.0	Sub Notes	0.0
Total	**10.0**	**Total**	**34.5**
		Total	**68.4**
		Cure pmt	2.25
		Comp	2.0
Adj. Total Assets	**$72.65**	**Total**	**$72.65**

Witnesses interviewed by the Examiner have different impressions of whether the sale transaction was supposed to be a "wash" (other than $250 million for the goodwill). For example, Thomas Roberts of Weil described the sale transaction, as closed, as very similar to the transaction contemplated in the APA.[7870] Roberts indicated that both deals entailed (1) Barclays' acquisition of assets and liabilities at a "wash"; (2) the purchase of the 745 Seventh Ave. headquarters and other real estate assets at appraised values; (3) the payment of $250 million for goodwill; and (4) job protection

55 (testifying that the schedule represented a summation of the liabilities that Barclays would assume and the assets it would acquire).

[7870] Examiner's Interview of Thomas A. Roberts, Apr. 28, 2009.

for roughly 10,000 employees for 90 days.[7871] Roberts stated that Barclays eventually bought the assets and liabilities generally at a wash, albeit in a smaller amount than originally contemplated. The "final schedule" of assets and liabilities dated September 16 circulated in connection with the transaction showed an equal amount of financial assets and liabilities being transferred to Barclays,[7872] as did the manila folder used by Michael Klein during the closing weekend to sketch out the terms of the transaction for the Creditors Committee.[7873]

James Seery indicated, however, that the sale transaction was intended to maintain the broker/dealer enterprise value.[7874] In Seery's mind, the transaction did not involve the concept of a "wash" sale or transfer of a balanced book of assets and liabilities; rather, he viewed the transaction to simply involve the purchase of all securities positions (no matter the value) relating to the broker/dealer business.[7875] Seery indicated that when the Debtors and Barclays reached an agreement on Tuesday, September 16, all of the parties understood that the population of long and short positions would change before the transaction closed because, among other things, counterparties were closing out their trades with LBI.[7876] Seery indicated that he did not know, however, whether there was an agreement concerning what would happen if the

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[7871] *Id.*
[7872] Lehman, Final Balance Sheet (Sept. 16, 2008) [BCI-CG00033742].
[7873] Michael Klein, consultant retained by Barclays, Notes on Folder [Deposition Exhibit 338B].
[7874] Examiner's Interview of James P. Seery, Jr., Nov. 12, 2009, at p. 2.
[7875] *Id.*
[7876] *Id.*

approximately $1 billion "spread" between the long and short securities positions identified in the APA increased significantly beyond $1 billion (or vanished).[7877]

(b) Barclays Agrees to Purchase "Long" Securities Positions With a Book Value of "Approximately $70 Billion"

While Lehman and Barclays negotiators were addressing the categories of assets to be conveyed in the deal, Weil and Cleary lawyers were drafting and negotiating the APA. The first draft of the APA was circulated by e-mail shortly before midnight on Monday, September 15,[7878] and the document was finalized early in the morning on Wednesday, September 17.[7879]

In the APA, Barclays agreed to purchase "all of Seller's and its applicable Subsidiaries' right, title and interest in, to and under the Purchased Assets free and clear of all Liens pursuant to Section 363(f) of the Bankruptcy Code."[7880] "Purchased Assets" were defined as "all of the assets of Seller and its Subsidiaries[7881] used in connection with the Business (excluding the Excluded Assets), including:

[7877] *Id.*

[7878] Asset Purchase Agreement [Draft] [BCI-CG00002116], attached to e-mail from Andy R. Keller, Simpson Thacher, to Duane McLaughlin, Cleary Gottlieb (Sept. 15, 2008) [BCI-CG00002115]. That is the first time that a draft of the APA was circulated by e-mail. It is possible that earlier drafts were circulated by hand or otherwise reviewed by the lawyers who were on the 32nd floor of the Lehman headquarters building. Examiner's Interview of Lindsee P. Granfield and Robert Davis, Mar. 3, 2009, at p. 2; Examiner's Interview of Harvey R. Miller, Apr. 23, 2009, at p. 10.

[7879] Asset Purchase Agreement [Finalized Draft] [BCI-CG00008018], attached to e-mail from Lillian Raben, Cleary Gottlieb, to Daniel Chin, Weil, *et al.* (Sept. 17, 2008) [BCI-CG00008016].

[7880] APA, at p. 11 (§ 2.1).

[7881] *See* Section III.C.2.a.c of this Report, which discusses the definition of "Purchased Assets." The definition was amended in the Clarification Letter to provide, among other things, that assets of Subsidiaries were not to be conveyed to Barclays in connection with the transaction. *Id.*

> (a) the Retained Cash;
>
> [. . .]
>
> (d) government securities, commercial paper, corporate debt, corporate equity, exchange traded derivatives and collateralized short-term agreements with a book value as of the date hereof of approximately $70 billion (collectively, "Long Positions");
>
> (e) 50% of each position in the residential real estate mortgage securities;
>
> [. . .]"[7882]

No securities, other than 50% of each position in residential real estate mortgage securities ("RMBS"), were "Excluded Assets."[7883]

In addition, the APA provided that Barclays would assume certain "Liabilities of Seller and its Subsidiaries," including, among other things, "(i) all short positions and 'repos' relating to any securities or interests of the types included in the definition of "Long Positions" with a book value as of the date hereof of approximately $69 billion (collectively, 'Short Positions' and, together with Long Positions, 'Positions')."[7884]

The APA thus provided that Barclays would purchase all of LBI's long securities positions – with the exception of 50% of each position in RMBS – and assume all short

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[7882] APA, at p. 6 (§ 1.1).

[7883] *Id*.

[7884] *Id.* at pp. 12-13 (§ 2.3(i)).

securities positions relating to those long positions.[7885] Presumably, by including both long and short securities positions, Barclays would receive some protection against risks associated with market movement; if the market values of the securities dropped, the value of the long positions would drop, but would be offset by the reduction in the cost of fulfilling Barclays' short obligations.[7886]

The Lehman and Barclays negotiators anticipated that the securities comprising the Long Positions and Short Positions would change between execution of the APA and the closing of the transaction, as LBI unwound its matched book and delivered securities to complete trades.[7887]

[7885] *Id.* at p. 3 (§ 1.1) (definition (k) of "Excluded Assets"), 6 (§ 1.1) (definitions (d) and (e) of "Purchased Assets"), 11 (§§ 2.1, 2.2); *see also* e-mail from Gerard M. Reilly, Lehman, to Eric Felder, Lehman, *et al.* (Sept. 17, 2008) [LBEX-DOCID 070268] (stating that "[t]he only assets that are not going from my understanding which is 2nd hand are 50% of the resi and abs books"); e-mail from Ian T. Lowitt, Lehman, to Gerard M. Reilly, Lehman, *et al.* (Sept. 17, 2008) [LBEX-DOCID 070268] (replying to Gerard M. Reilly e-mail and stating, "That is my understanding. But check with whoever drafted the purchase agreement."); e-mail from Gerard M. Reilly, Lehman, to Martin Kelly, Lehman, *et al.* (Sept. 17, 2008) [LBEX-DOCID 464049] (stating, "[m]y understanding of the deal is that they will purchase our assets that remain in LBI on the closing date which will not be the same as the assets on the 12th."); e-mail from John Mahon, Barclays, to Michael Keegan, *et al.* (Sept. 17, 2008) [BCI-EX-00079087] (stating, "LBI has borrowed and lent stock and securities that were not on the balance sheet we saw on Monday night. . . . The assets we saw, and said we were going to buy, may have been lent out and liabilities we saw would have been covered by borrowing those securities."); e-mail from Stephen King, Barclays, to Patrick Clackson, Barclays, *et al.* (Sept. 17, 2008) [BCI-EX-(S)-00023992] (stating, "[a]lso, can you[] think if there would be any securities which would have been good collateral for the fed facilities which also would have been excluded assets, other than the securities that I excluded? I don't think so but would like to be sure."); e-mail from Patrick Clackson, Barclays, to Stephen King, Barclays, *et al.* (Sept. 17, 2008) [BCI-EX-(S)-00023992] (responding to King e-mail, stating, "The only excluded assets are the ones you excluded, nothing else, so no other collateral."); transcript of deposition testimony of Stephen King, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 10, 2009, at pp. 227-28.

[7886] Examiner's Interview of James P. Seery, Jr., Nov. 12, 2009, at pp. 2-3.

[7887] *Id.* at p. 2; transcript of deposition testimony of Mark J. Shapiro, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 7, 2009, at pp. 97-100; e-mail from Jasen Yang, Barclays, to Charles Spero, Barclays, *et al.* (Sept. 17, 2008) [BCI-EX-(S)-00054403]; e-mail from Gerard M. Reilly, Lehman, to

At issue in the litigation arising from the sale transaction is whether the "approximately $70 billion" in "book value" of Long Positions referenced in the APA reflects a negotiated price below the actual book value of those securities, and whether the transaction included a "buried" discount that was retained through the closing. As explained above, the Examiner is not reaching conclusions regarding those issues, but does set forth below certain facts relating to the negotiations.

At 5:10 a.m. on Tuesday morning, September 16, Kelly sent an e-mail to Lowitt and Tonucci, stating:

> Well it took all night and lots of back and forth but the deal is done and ready for the Board. Final price did not change meaningfully – approx a $5 b all in economic loss versus our marks and $3.6b of resi assets left behind. Assume we can fund this after everything else winds down but Paolo you need to review this. Also, an extra $1b of comp beyond our accrual and assumption of all trade payables in LBI and LBHI. Took 745 for $1b and several data centers for $400mm. Bart reviewed all of it before final agreement . . . .[7888]

On Wednesday, September 17, Gerard Reilly e-mailed Kelly, and said: "My understanding of the deal is that they will purchase our assets that remain in LBI on the closing date which will not be the same as the assets on the 12th. That purchase will be

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Martin Kelly, Lehman, *et al.* (Sept. 17, 2008) [LBEX-DOCID 464049] (stating, "[m]y understanding of the deal is that they will purchase our assets that remain in LBI on the closing date which will not be the same as the assets on the 12th.").

[7888] E-mail from Martin Kelly, Lehman, to Ian T. Lowitt, Lehman, *et al.* (Sept. 16, 2008) [LBEX-DOCID 132844]. When Kelly was asked in his deposition what he meant when he wrote in his e-mail "approx $5b all in economic loss versus our marks," he testified that he "recall[ed] that the 5 billion represents the difference between the negotiated price and the values of those assets on Lehman's books." Transcript of deposition testimony of Martin Kelly, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 18, 2009, at pp. 46; *see also id.* at pp. 66, 143-44, 156, 158-59.

at a fixed discount on the assets that remain to reflect the bulk size of the purchase."[7889] Some of the Lehman participants in the negotiations testified that it was their understanding that Barclays was going to purchase the securities positions from Lehman at a negotiated price that was less than Lehman's book value.[7890]

Other participants in the negotiations, however, described a process in which the negotiated price of the securities reflected an adjustment from Lehman marks from Friday, September 12, which were outdated. For example, McDade testified that the

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[7889] E-mail from Gerard M. Reilly, Lehman, to Martin Kelly, Lehman, *et al*. (Sept. 17, 2008) [LBEX-DOCID 464049]; e-mail from Gerard M. Reilly, Lehman, to Ian T. Lowitt, Lehman (Sept. 17, 2008) [LBHI_SEC07940_383258] (referring to "price haircut," and noting that "[i]f we want conservative marks to reflect block nature we need to know how much and then we can allocate to most logical assets"); Martin Kelly, Lehman, Handwritten Notes (Sept. 17, 2008) [BCI-EX-00115169]; transcript of deposition testimony of Martin Kelly, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 18, 2009, at pp. 221-29 (testifying that $5.25 billion figure in his handwritten notes likely refers to the difference between the book value of the securities and the negotiated price); e-mail from Dirk Haseruck, Lehman, to Eric Felder, Lehman, *et al.* (Sept. 18, 2008) [LBEX-DOCID 182777] (referencing the "gap between current MV and purchase price"); e-mail from Charles Spero, Lehman, to Michael Gelband, Lehman, *et al.* (Sept. 18, 2008) [LBHI_SEC07940_732682] (stating that, "I think they categorized mortgage as all abs, cdo, private label, etc. They view the bulk/liquidity discount as roughly 1.5bln on that half of the total book."); e-mail from Arthur Bruhmuller, Lazard, to Daniel Flores, Lazard, *et al.* (Sept. 17, 2008) [LAZ-C-00048526] (stating, "[w]e are trying to get a sense for how the marks have evolved since Friday. I think the first priority would be to see the inventory of what's being sold, how the marks have evolved and info on the buyer "discount."); Net Asset and Funding Estimates (Sept. 2008) [BCI-EX-00166340] (document from John Varley's files, which includes an apparent reference to a "negotiated discount" of $5 billion); transcript of deposition testimony of John Varley, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 11, 2009, at pp. 155-57.

[7890] *See* transcript of deposition testimony of Ian T. Lowitt, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 20, 2009, at pp. 41-42; transcript of deposition testimony of Martin Kelly, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 18, 2009, at p. 66; transcript of deposition testimony of Paolo R. Tonucci, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at pp. 27-28.

agreed upon price was different from Lehman's book value "because Lehman hadn't marked the books since Friday," September 12.[7891]

(4) Negotiations Regarding Contract Cure and Employee Compensation Liabilities

During the negotiations, Lehman and Barclays also addressed whether Barclays would assume (a) "cure cost" liabilities relating to contracts assigned to Barclays pursuant to Section 365 of the Bankruptcy Code; and (b) compensation liabilities associated with the Lehman employees offered employment at Barclays.

(a) Contract Cure Costs

Shapiro of Lehman addressed the issue of contract cure costs with Cox and Klein of Barclays.[7892] Shapiro insisted that, with respect to contracts that Barclays would designate to be assumed and assigned to it, the APA must provide that Barclays would be responsible for cure costs.[7893]

[7891] Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at pp. 30-31; *see also* transcript of deposition testimony of Barry W. Ridings, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Jan. 15, 2010, at p. 29; transcript of deposition testimony of Stephen King, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 10, 2009, at p. 153 (testifying that Lehman marks "were old, they were what we call stale"); *Id.* at pp. 28-33 (describing process used by Barclays to estimate revised values for Lehman securities); transcript of deposition testimony of Michael Keegan, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 28, 2009, at pp. 25-26 (describing process in which, where Barclays team determined that assets were materially mismarked on Lehman's books, Barclays would present Lehman with proposed revised mark).

[7892] Transcript of deposition testimony of Mark J. Shapiro, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 7, 2009, at pp. 55-57.

[7893] *Id.*

Cox and Klein asked for an estimate of cure costs.[7894] Shapiro asked George Mack and others at Lehman to develop an estimate of cure costs.[7895] The method they used to develop an estimate was to look at a "snapshot" of Lehman's ordinary payables run, and then exclude compensation-related payables in order to develop an estimate.[7896] Shapiro recalled that the process produced an estimate of $1.5 billion.[7897]

In the Sale Motion filed on September 17, the Debtors represented that, in connection with the proposed transaction, Barclays would assume an estimated $1.5 billion of liabilities under assumed contracts.[7898] During the sale procedures hearing on Wednesday, September 17, the Court noted that Barclays was taking on "1.5 billion dollars in cure amounts."[7899]

The summary schedule of assets and liabilities dated September 16 discussed above included a $2.25 billion estimate for cure costs.[7900] Shapiro did not recall why the

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[7894] *Id*. at p. 59.

[7895] *Id*. at pp. 62-65.

[7896] *Id*.; *see also* transcript of deposition testimony of James P. Seery, Jr., *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 3, 2009, at pp. 63-64 (describing how the cure estimate grew out of work done to estimate amount of DIP financing Lehman would need).

[7897] Transcript of deposition testimony of Mark J. Shapiro, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 7, 2009, at pp. 153-55.

[7898] Debtors' Motion to (A) Schedule a Sale Hearing; (B) Establish Sales Procedures; (C) Approve a Break-up Fee; and (D) Approve the Sale of the Purchased Assets and the Assumption and Assignment of Contracts Relating to the Purchased Assets, at p. 6, Docket No. 60, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 17, 2008).

[7899] Transcript of hearing, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 17, 2008, at p. 23.

[7900] Lehman, Final Balance Sheet (Sept. 16, 2008) [BCI-CG00033742] transcript of deposition testimony of Rich Ricci, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 8, 2009, at pp. 92, 282 (explaining that the estimate for cure liability came from Lehman). According to Thomas A. Roberts, the

summary schedule reflected $2.25 billion in those costs, rather than the $1.5 billion estimate.[7901]

The APA provided:

> For a period of 60 days after the Closing, the Purchaser shall have the right upon notice to Seller to designate any contract related to the assets purchased from the Seller by Purchaser or its Affiliates (the "Related Contracts") as either (1) a Purchased Contract or (2) a Contract not designated as a Purchase[d] Contract (a "Rejected Contract"). Until a Related Contract is so designated, Buyer shall be obligated to pay or cause to be paid ordinary course amounts due under such contracts in accordance with the terms thereof. If a Related Contract is designated as a Purchased Contract, such Purchased Contract shall be assigned to the Purchaser and upon such assignment Purchaser shall be obligated to pay or cause to be paid the cure amount in respect of such Purchased Contract. If a Related Contract is designated as a Rejected Contract, Purchaser shall have no further obligations in respect thereof . . . .[7902]

Thus, the actual amount of cure liability for which Barclays would be responsible was dictated by Barclays' decisions about which of Lehman's contracts Barclays determined to assume and assign.

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cure amount of the Sept. 16 balance sheet was calculated by Martin Kelly, and McDade and Lowitt confirmed the cure amount. Examiner's Interview of Thomas A. Roberts, Apr. 28, 2009.

[7901] Transcript of deposition testimony of Mark J. Shapiro, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 7, 2009, at pp. 148-49; *see also* transcript of deposition testimony of James P. Seery, Jr., *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 3, 2009, at pp. 63-64 (testifying that the cure cost estimate he recalled was "in the neighborhood" of the figure in the summary schedule).

[7902] APA, at p. 13 (§ 2.5).

Shapiro does not know whether anyone at Lehman developed a better estimate of Barclays' cure cost liability between September 17 (the date of the Sale Motion) and the September 22 closing.[7903]

Barclays did not expect to incur cure cost liability of the magnitude ($1.5 billion) estimated in the Sale Motion. In an internal Barclays e-mail on Friday, September 19, Clackson stated, "Cure payments are optional and [though] some will be incurred, most will be covered by our ongoing supplier relationships and fall into monthly expenses[.]"[7904] Clackson later testified that Barclays' calculations of its anticipated cure cost liability during the week of September 14 reflected little to no liability because Clackson thought at the time that many of the potential cure liabilities would be minimized through negotiations with Barclays' current suppliers and the synergies from combining Barclays and Lehman.[7905]

[7903] Transcript of deposition testimony of Mark J. Shapiro, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 7, 2009, at pp. 67-68.

[7904] E-mail from Patrick Clackson, Barclays, to Rich Ricci, Barclays (Sept. 19, 2008) [BCI-EX-(S)-00024271].

[7905] Transcript of deposition testimony of Patrick Clackson, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 4, 2009, at p. 101; *see also* Barclays, Long Island Acquisition Summary [Draft] (Sept. 22, 2008) [BCI-EX 00079341], attached to e-mail from Gary Romain, Barclays, to Rich Ricci, Barclays, *et. al* (Sept. 22, 2008) [BCI-EX 00079340] (listing the bonus accrual at $1.7 billion and the cure payment at $800 million); *see also* Barclays, Synopsis of Barclays' "Synergy and Integration Assumptions" (Sept. 18, 2008) [BCI-EX-(S)-0002460], attached to e-mail from Syal Vivek, Barclays, to Rich Ricci, Barclays, *et al*. (Sept. 18, 2008) [BCI-EX-(S)-00024689]. *But see* Barclays Synopsis of Barclays' "Synergy and Integration Assumptions" (Sept. 18, 2008) [BC1-EX-(S)-00024129], attached to e-mail from Syal Vivek, Barclays, to Rich Ricci, Barclays, *et al.* (Sept. 18, 2008) [BCI-EX(S)-00024128].

The Court was not provided with a revised estimate of Barclays' anticipated cure cost liability before the September 19 sale hearing, or before the September 22 sale hearing.

As of July 2009, Barclays had made approximately $220 to $240 million in cure payments.[7906] As explained above, in light of the litigation arising from the sale transaction, the Examiner is not reaching a conclusion regarding whether the Court should have been provided with a revised cure cost estimate.

(b) Compensation Liabilities

Under the APA, Barclays agreed to offer employment to "each active employee employed primarily in connection with the Business."[7907] Barclays further agreed that, with respect to each Lehman employee who accepted Barclays' offer of employment, Barclays would:

> . . . pay each Transferred Employee an annual bonus ("08 Annual Bonuses"), in respect of the 2008 Fiscal Year that, in the aggregate, are

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[7906] Barclays, Aggregate Cure Payments (July 14, 2009) [BCI-EX-00077272] (listing a total of $238 million in cure payments), attached to letter from Jack G. Stern, Boies Schiller, to Robert W. Gaffey, Jones Day, re: Compensation Amounts for Transferred Employees and Aggregate Cure Payments (July 16, 2009); Gary Romain, Barclays, Lehman Acquisition Accounting Interim 2009 Update [Draft] (July 23, 2009), at p. 2 [BCI-EX-00218490] (estimating Barclays' total cure payments at approximately $226 million as of May 29, 2009), attached to e-mail from Gary Romain, Barclays, to Michael Guarnuccio, Price Waterhouse Coopers, *et al*. (July 23, 2009) [BCI-EX-00218489]; *cf*. transcript of deposition testimony of Gary Romain, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 10, 2009, at pp. 133-34 (explaining the cure accrual was approximately $224 million); transcript of deposition testimony of Patrick Clackson, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 4, 2009, at p. 141 (explaining the total cure payments were approximately $220 million).

[7907] APA, at p. 34 (§ 9.1(a)). "Business" was defined as "the U.S. and Canadian investment banking and capital markets businesses of Seller including the fixed income and equities cash trading, brokerage, dealing, trading and advisory businesses, investment banking operations and LBI's business as a futures commission merchant." *Id.* at p. 2 (§ 1.1).

> equal in amount to 100 percent of the bonus pool amounts accrued in respect of amounts payable for incentive compensation (but not base salary) and reflected on the financial schedule delivered to Purchaser on September 16, 2008 and initialed by an officer of each of Holdings and Purchaser (the "Accrued 08 FY Liability"). . . .[7908]

Section 9.1(c) of the APA refers to a "financial schedule delivered to Purchaser on September 16, 2008 and initialed by an officer of each of Holdings and Purchaser."[7909] In connection with litigation arising from the sale transaction, Barclays has asserted that "[t]here was in fact no version of any financial schedule that was initialed by an officer of Barclays, as referenced in Section 9.1(c) of the APA."[7910] Prior to the closing of the sale transaction, however, Lehman's and Barclays' counsel identified the final schedule initialed by Berkenfeld as the document referenced in Section 9.1(c) of the APA.[7911] That final schedule, which is reproduced in Section III.C.6.c.3.a above, includes a line item stating "Comp 2.0 [billion]."

McDade and Kelly testified that the $2 billion compensation accrual for Lehman employees who would be moving to Barclays was a negotiated number.[7912] According

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[7908] APA, at p. 35 (§ 9.1(c)).

[7909] *Id.*

[7910] Memorandum of Barclays Capital Inc. in Opposition to the Rule 60 Motions and in Support of Motion of Barclays Capital Inc. to Enforce the Sale Order and Secure Delivery of All Undelivered Assets, at p. 37 (¶ 92), Docket No. 6815, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Jan. 29, 2010).

[7911] Balance Sheet (Sep. 16, 2008) [STB-LEH 0000682], attached to e-mail from Elizabeth Cooper, Simpson Thacher, to David Leinwand, Cleary Gottlieb, *et al.* (Sept. 19, 2008) [STB-LEH 0000679].

[7912] Transcript of deposition testimony of Martin Kelly, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 18, 2009, at pp. 82-83; transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at pp. 44, 47, 72, 101 (according to McDade, Lehman's compensation accrual by Aug. 1, 2008, was $1 billion, and Barclays used Lehman's compensation data to estimate its compensation liability for the transferred employees and derived $2 billion.).

to McDade and Kelly, that negotiated figure was the result of Barclays adding an additional $1 billion of compensation liability to a $1 billion estimate provided by Lehman, and was reflected in the September 16 summary schedule initialed by Berkenfeld.[7913] Clackson and Ricci, however, testified that it was Lehman that provided the $2 billion compensation figure.[7914]

In the Sale Motion, the Debtors stated that Barclays would assume an estimated $2.5 billion in compensation liability by offering employment to "approximately ten thousand-plus U.S.-based employees of LBI for a period of 90 days" and providing "such employees severance benefits equal to what would have been received under

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[7913] Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.*, No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at pp. 100, 104-05; e-mail from Martin Kelly, Lehman, to Ian T. Lowitt, Lehman, *et al*. (Sept. 16, 2008) [LBEX-DOCID 132844] ("Well it took all night and lots of back and forth but the deal is done and ready for the Board. Also, an extra $1b of comp beyond our accrual . . . ."); transcript of deposition testimony of Martin Kelly, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 18, 2009, at p. 56 ("[T]he liability that Barclays would recognize for all forms of compensation would be a billion dollars more than what Lehman had reflected on its books for certain components of compensation."); transcript of deposition testimony of Philip Kruse, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Dec. 17, 2009, at pp. 203-04 (explaining that there "was real confusion in the record . . . as to whether [the compensation number] was derived by Lehman people . . . or whether it was a negotiated amount"). McDade and Lowitt testified that Lehman's $1 billion figure was an estimate of only the cash portion of Lehman's bonus accrual. Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at p. 286; transcript of deposition testimony of Ian T. Lowitt, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 20, 2009, at pp. 53-54. According to McDade and Lowitt, Lehman paid bonuses through a mix of cash and equity. Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at p. 286; transcript of deposition testimony of Ian T. Lowitt, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 20, 2009, at p. 54.

[7914] Transcript of deposition testimony of Patrick Clackson, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 4, 2009, at pp. 75-77 (stating that Lehman presented Barclays with the $2 billion compensation liability number); transcript of deposition testimony of Rich Ricci, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 8, 2009, at pp. 37, 282 (stating that Lehman presented the $2 billion figure).

LBI's severance policy."[7915] During the September 17 hearing, the Court noted that Barclays was taking on "as much as $2.5 billion dollars in certain employee related severance expenses which may or may not be triggered."[7916]

On Tuesday, September 16, Barclays created various estimates of its assumed compensation liability in connection with the sale, which ranged between $1 billion and $1.3 billion based on the percentage of LBI employees assumed to transfer to Barclays.[7917] That Tuesday, Clackson sent an e-mail to Evans and Ricci, stating: "[t]his is a problem, they have $2bn in the agreement, I was relying on you guys telling me I

[7915] Debtors' Motion to (A) Schedule a Sale Hearing; (B) Establish Sales Procedures; (C) Approve a Break-up Fee; and (D) Approve the Sale of the Purchased Assets and the Assumption and Assignment of Contracts Relating to the Purchased Assets, at p. 6, Docket No. 60, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 17, 2008).

[7916] Transcript of hearing, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 17, 2008, at p. 23.

[7917] E-mail from Mark Kurman, Barclays, to Michael Evans, Barclays (Sept. 16, 2008) [BCI-EX-(S)-00029672]; e-mail from Mark Kurman, Barclays, to Michael Evans, Barclays, *et al*. (Sept. 16, 2008) [BCI-EX-(S)-00029682]. On Wednesday, Barclays' estimates for the compensation liability ranged from $1.3 billion to $1.5 billion. E-mail from Patrick Clackson, Barclays, to Michael Evans, Barclays, *et al*. (Sept. 17, 2008) [BCI-EX-00077621] (listing $1.35 billion for the compensation liability); e-mail from Michael Evans, Barclays, to Patrick Clackson, Barclays, *et al*. (Sept. 17, 2008) [BCI-EX-00077621] (listing an accrued compensation liability of $1.5 billion); Barclays, Long Island Acquisition Summary [BCI-EX-(S)-00023999] (listing a compensation liability of $1.3 billion), attached to e-mail from Gary Romain, Barclays, to Patrick Clackson, Barclays, *et al*. (Sept. 17, 2008) [BCI-EX-(S)-00023997]. On Thursday, a Barclays synopsis of their "synergy and integration assumptions" for the Sale listed its required compensation liability at $1.5 billion, providing a $500 million gain. Barclays, Synopsis of Synergy and Integration Assumptions (Sept. 18, 2008) [BCI-EX-(S)-00024129], attached to e-mail from Syal Vivek, Barclays, to Rich Ricci, Barclays, *et al.* (Sept. 18, 2008) [BCI-EX-(S)-00024128]. In an e-mail on Friday by Clackson, Barclays estimated its compensation liability at $1.35 billion. E-mail from Patrick Clackson, Barclays, to Rich Ricci, Barclays (Sept. 19, 2008) [BCI-EX-(S)-00024707].

needed $1.35bn which gave me $650m of the goodwill but the para[graph] below says we have to pay it to them/can't use[.]")[7918]

On Friday, September 19, Clackson in an e-mail to Ricci explained Barclays' "official line" regarding compensation amounts.[7919] According to Clackson, the difference between Barclays' estimates of its compensation liability and the $2 billion in compensation liability listed in the Sept. 16, 2008 balance sheet was "[s]ome of the comp related to deferred plans so [some compensation] is accounted for over the deferral period."[7920]

At the sale hearing on Friday, September 19, Debtors' counsel explained the changes to the transaction since the September 17 hearing.[7921] Among other things, Debtors' counsel noted that "Barclays is . . . agreeing to the same employee compensation arrangements."[7922] The McDade testimony proffered at the hearing represented that "Barclays [would] also assume exposure for the employees that

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[7918] E-mail from Patrick Clackson, Barclays, to Michael Evans, Barclays, *et al*. (Sept. 17, 2008) [BCI-EX-00077621]; *see also* e-mail from Rich Ricci, Barclays, to Patrick Clackson, Barclays, *et al*. (Sept. 17, 2008) [BCI-EX-00077651] (referring to Section 9.1(c) of the APA, and stating, "[n]ever agreed to it. Archie this is the problem. We can't have this clause I don't think."); e-mail from Michael Evans, Barclays, to Patrick Clackson, Barclays, *et al*. (Sept. 17, 2008) [BCI-EX000077621].

[7919] E-mail from Patrick Clackson, Barclays, to Rich Ricci, Barclays (Sept. 19, 2008) [BCI-EX-(S)-00024271].

[7920] *Id. But see* e-mail from Patrick Clackson, Barclays, to Rich Ricci, Barclays (Sept. 18, 2008) [BCI-EX-00077466] (stating "so it looks like we have to pay them $2bn min bonuses"). Also on Friday, Ricci asked Clackson whether they could "increase comp accrual" because another 300 employees were coming to Barclays. E-mail from Rich Ricci, Barclays, to Patrick Clackson, Barclays (Sept. 19, 2008) [BCI-EX-(S)-00024707]. Clackson responded that if Barclays "get[s] the 2.25 and the 2 and the real bonuses are 1.35[,] I can spare some but otherwise I cant[.]" E-mail from Patrick Clackson, Barclays, to Rich Ricci, Barclays (Sept. 19, 2008) [BCI-EX-(S)-00024707].

[7921] Transcript of hearing, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 19, 2008, at pp. 45-46.

[7922] *Id*. at p. 47.

accept[ed] offers of employment, which [was] estimated to [be] . . . an exposure of approximately two billion dollars."[7923]

By the time of the closing on September 22, Barclays was estimating that it needed to accrue $1.7 billion for bonus payments.[7924] Clackson testified that the estimate was lower than the $2 billion "Comp" entry in the September 16 schedule of assets and liabilities because the $2 billion figure included all compensation, and that in its bonus accrual Barclays was attempting to estimate only the bonus portion of Barclays' $2 billion in compensation liability.[7925]

The use of the $2 billion "Comp" figure in the September 16 schedule, and whether, following the closing, Barclays satisfied its obligations with respect to employee compensation under the APA, are disputed issues in the litigation arising from the sale transaction. In light of the sale litigation pending before this Court, the Examiner is not reaching a conclusion regarding those issues.

[7923] *Id.* at p. 99.

[7924] Barclays, Long Island Acquisition Summary [BCI-EX-00079341] (listing the bonus accrual at $1.7 billion), attached to e-mail from Gary Romain, Barclays, to Rich Ricci, Barclays, *et al*. (Sept. 22, 2008) [BCI-EX-00079340]; *see also* Long Island Acquisition Summary [BCI-EX-(S)-00024690] (listing the bonus accrual at $1.7 billion), attached to e-mail from Gary Romain, Barclays, to Patrick Clackson, Barclays (Sept. 24, 2008) [BCI-EX-(S)-00024689].

[7925] Transcript of deposition testimony of Patrick Clackson, *In re Lehman Bros Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 4, 2009, at pp. 75, 78-79.

d) Consideration and Approval of Transaction Described in APA by LBHI and LBI Boards of Directors

At a joint telephonic board meeting held beginning at 6:00 a.m. on September 16, 2008, the boards of directors of LBI and LBHI approved the terms of the APA and the sale of assets to Barclays.[7926]

The LBHI board members attending the board meeting included Michael L. Ainslie, John F. Akers, Roger Berlind, Thomas Cruikshank (also an LBI board member), Marsha Johnson Evans, Richard S. Fuld, Jr. (also an LBI board member), Sir Christopher Gent, Jerry A. Grundhofer, Roland A. Hernandez, Dr. Henry Kaufman, and John D. Macomber. The LBI board members in attendance (in addition to Cruikshank and Fuld) included Howard Clark, Jr. and Frederick Frank. Lehman personnel who were present included Ian T. Lowitt, Herbert H. McDade, III, Hugh E. McGee, III, Thomas A. Russo, Mark Shafir, and Jeffrey A. Welikson. Michael E. Lubowitz and Thomas A. Roberts of Weil attended the board meeting, as did three Simpson Thacher lawyers: Alvin H. Brown, John G. Finley, and Andrew R. Keller. Also in attendance were Andrew J. Levander of Dechert and Barry Ridings of Lazard.[7927]

Roberts and Shafir advised the board members that the proposed transaction would involve:

[7926] Lehman Brothers Holdings Inc. and Lehman Brothers Inc., Minutes of Meeting of Boards of Directors (Sept. 16, 2008), at pp. 2-5, 6-7 [LBEX-AM 003940].
[7927] *Id.*

- The sale to Barclays of the Lehman headquarters building at 745 Seventh Avenue in Manhattan for its appraised value–estimated at $1 billion;
- The sale to Barclays of two Lehman data centers in New Jersey for their appraised value–estimated at $450 million;
- The transfer of approximately 10,000 Lehman employees to Barclays;
- The payment by Barclays of $250 million for the goodwill of Lehman;
- The transfer of "most assets" of the U.S. broker dealer – LBI – to Barclays; and
- The assumption by Barclays of liabilities, "including employee liabilities and contract cure amounts, basically equivalent to the assets" being transferred to Barclays.[7928]

Roberts also explained that the transaction required that (1) eight specified Lehman employees would enter into employment agreements with Barclays; and (2) a minimum percentage (around 75 percent) of Lehman's top 200 employees would agree to stay at Barclays post-sale.[7929]

The board members were advised that "this transaction would benefit the creditors" of Lehman, would "save the franchise and many jobs" and that "LBI would not be able to fund itself that day without this deal."[7930]

Ridings explained "that the applicable standards for this sale (under Section 363 of the Bankruptcy Code) are to obtain the highest and best price and a price greater than

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[7928] *Id.* at pp. 2-4.
[7929] *Id.* at p. 3.
[7930] *Id.* at p. 2.

liquidation value."[7931] According to Ridings, "it [would] be a close decision for the Bankruptcy Court judge."[7932]

The board members were advised that the APA would be signed that morning, followed by a public announcement of the transaction.[7933] That afternoon, Weil expected to seek Bankruptcy Court approval of the sale procedures.[7934] The sale hearing was expected to occur either that Friday or the following Monday.[7935]

At the end of the meeting, the LBHI and LBI boards approved the APA.[7936]

e) Transaction Described to the Court on September 17

(1) Sale Motion

On Wednesday, September 17, the Debtor filed a motion (the Sale Motion) requesting that the Court, among other things, schedule a sale hearing for Friday, September 19, establish sale procedures and approve a proposed breakup fee.[7937]

In the Sale Motion, the Debtor described the circumstances that led to the proposed sale, including significant liquidity problems, heavily depressed financial

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[7931] *Id.* at p. 4.

[7932] *Id*. *Accord* Examiner's Interview of Barry W. Ridings, Oct. 1, 2009, at p. 4 (explaining that his concern was with the process rather than the sale itself, and whether the Court would approve such a massive sale transaction on less than five days notice).

[7933] Lehman Brothers Holdings Inc. and Lehman Brothers Inc., Minutes of Meeting of Boards of Directors (Sept. 16, 2008), at p. 4 [LBEX-AM 003940].

[7934] *Id.* at pp. 3-4.

[7935] *Id.* at p. 2.

[7936] *Id.* at pp. 6-8.

[7937] Debtors' Motion to (A) Schedule a Sale Hearing; (B) Establish Sales Procedures; (C) Approve a Break-Up Fee; and (D) Approve the Sale of the Purchased Assets and the Assumption and Assignment of Contracts Relating to the Purchased Assets, at p. 1, Docket No. 60, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 17, 2008).

asset prices and credit downgrades,[7938] all of which led to Lehman being unable to maintain normal business operations.[7939] The Debtor stated: "[A]ttempts to pursue strategic alternatives were thwarted by [Lehman's] financial deterioration and lack of support from other entities."[7940]

LBHI and LB 745 represented in the Sale Motion that Barclays would pay approximately "$1.7 billion in cash for the Purchased Assets plus assume other obligations and expenses."[7941] The purchased assets would include "designated assets relating to LBI's business, which [were] owned by LBI as well as certain assets which [were] owned by LBHI and related to the business of LBI."[7942] Barclays would "assume ownership of substantially all operations of LBI, including . . . performance under [the Seller's] obligations as to securities and other transactions."[7943] In addition, "[a]ll remaining customer accounts [would be] transferred to [Barclays]."[7944] The purchased assets would include Lehman's headquarters building in Manhattan, two New Jersey data centers, and the "Lehman" name and associated trademarks.[7945]

The Sale Motion stated that Barclays would, in addition to the cash payment of $1.7 billion, assume an estimated $1.5 billion of liabilities under assumed contracts, an

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[7938] *Id.* at p. 4.
[7939] *Id.*
[7940] *Id.*
[7941] *Id.*
[7942] *Id.* at pp. 4-5.
[7943] *Id.* at p. 5.
[7944] *Id.*
[7945] *Id.* at pp. 5-6.

estimated $2.5 billion in compensation liability relating to LBI's employees, and other liabilities such as transfer taxes and accounts payable in the ordinary course of business.[7946]

LBHI and LB 745 asserted in the Sale Motion that the "proposed sale [would] result in the highest and best recovery for the Debtors."[7947] The Debtor also stated that, although "the financial community [was] well aware that the Purchased Assets were for sale[,] the only serious offeror" was Barclays.[7948] LBHI and LB 745 contended that Barclays was a good-faith purchaser because "[t]he terms and conditions of the Purchase Agreement were negotiated by the Debtors and Purchaser at arm's length and in good faith," and "[e]ach party was represented by sophisticated counsel."[7949]

(2) September 17 Sale Procedures Hearing

An initial hearing on the Sale Motion took place on the afternoon of September 17.[7950]

Debtors' counsel explained that, during the preceding months, Lehman had focused on strategic alternatives "to protect the public customers, preserve values, and assist in avoiding the deterioration of the financial markets."[7951] The Debtors noted that

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[7946] *Id.*
[7947] *Id.* at p. 11.
[7948] *Id.*
[7949] *Id.* at p. 17.
[7950] Transcript of hearing, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 17, 2008, at p. 1.
[7951] *Id.* at p. 18.

the market had known for months that Lehman was for sale (in parts and in its entirety), yet only Barclays had made a bid.[7952]

Debtors' counsel explained that the goal of the Barclays transaction was to "save the value of the franchise, protect the public customers and interest and employees," and provide continued employment for 10,000 to 12,000 Lehman employees for a length of time.[7953]

The Debtors emphasized the importance of quick approval of the proposed transaction.[7954] Lehman was a "wasting asset," and "if the transaction is not consummated the notional cost in connection with the transaction will be in the trillions."[7955] Debtors' counsel advised the Court that witnesses would testify that "if this transaction is not approved, Friday night there will be nobody in the building. And it will just disappear."[7956]

There was a dispute at the hearing over the amount of the proposed breakup fee. The Debtors argued that the proposed breakup fee should be evaluated against a transaction with a fair value of $5.7 billion, consisting of: (1) the $1.7 billion of cash that

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[7952] *Id.* at p. 25.
[7953] *Id.* at pp. 19-20.
[7954] *Id.* at pp. 19-21.
[7955] *Id.*
[7956] *Id.* at p. 26.

was paid to Lehman; (2) Barclays' assumption of $2.5 billion in compensation liability; and (3) Barclays' assumption of $1.5 billion in contract cure liability.[7957]

The SEC advised the Court that it strongly supported the proposed transaction,[7958] and emphasized the importance that the deal be completed by week's end.[7959] The FRBNY urged that it was vital for the transaction "to go forward as quickly as possible in order to preserve financial stability."[7960]

The Creditors Committee objected to the timing and sought a continuance of the Sale Hearing. Earlier in the hearing, the Court had expressed some concern "as to the adequacy of notice as to the substance of the transaction for purposes of basic constitutional due process . . . ."[7961] In response, the Debtors reiterated that Lehman was a "quickly wasting asset,"[7962] which would have little value remaining if a normal sale process was followed.[7963] Debtors' counsel advised the Court that "[t]he consensus among all the business people . . . and the professionals was there would be nothing to sell in two weeks."[7964]

[7957] *Id.* at pp. 23-24.
[7958] *Id.* at pp. 65-66.
[7959] *Id.* at p. 67.
[7960] *Id.* at p. 65. The Commodity Futures Trading Commission supported the positions of the SEC and the FRBNY. *Id*. at p. 69. The United States Trustee expressed her support for the position of the Debtors and the regulatory agencies. *Id.* at p. 67.
[7961] *Id.* at p. 27.
[7962] *Id.* at p. 29.
[7963] *Id*.
[7964] *Id.*

After taking judicial notice of the packed courtroom, the experience and sophistication of counsel and the availability of many of the proposed deal's terms and conditions in the media, the Court concluded that due process was satisfied.[7965]

The Court, recognizing the "critical timing imperative," approved the bid procedures and the breakup fee, subject to adjustments needed to harmonize the bidding procedures with changes announced during the hearing.[7966] The Court explained that Barclays appeared to be the logical purchaser for the assets and expressed doubt that another bidder would emerge.[7967]

f) Between September 17 and 19, the Securities Positions Being Acquired by Barclays Change

(1) The "Replacement Transaction"

As described above in Section III.C.6.b.2, on Sunday, September 14, the FRBNY agreed to provide LBI with financing through the PDCF in order to facilitate an "orderly unwind of [LBI's] trading positions."[7968] Although the FRBNY advised Lehman that it was willing to fund the broker/dealer for up to two weeks following LBHI's bankruptcy, the FRBNY was concerned about its exposure to LBI as a result of the extension of overnight financing.[7969]

[7965] *Id.* at pp. 31-32.
[7966] *Id.* at p. 72.
[7967] *Id.* at p. 73.
[7968] Leventhal Decl. ¶ 6. At that time, LBI already was receiving financing through two other FRBNY programs, the TSLF and OMO. A&M's Interview of James W. Hraska, Oct. 8, 2008, at p. 1.
[7969] Examiner's Interview of Shari D. Leventhal, Apr. 30, 2009, at p. 5.

On Tuesday, September 16, the FRBNY contacted Barclays to request that Barclays "step into the shoes" of the FRBNY with respect to overnight financing of LBI.[7970] The FRBNY advised Barclays that the FRBNY's September 14 agreement to allow LBI to access the PDCF to obtain overnight financing had been based on the assumption that the FRBNY was facilitating an orderly wind-down of the broker-dealer.[7971] The FRBNY explained that, if Barclays wanted the FRBNY to continue funding LBI during the week of September 15 to facilitate an orderly transition of the broker/dealer assets to Barclays, the FRBNY needed Barclays to "take out" the FRBNY's exposure to LBI prior to the closing of the transaction.[7972]

Tuesday evening, September 16, Barclays and Lehman representatives met at the FRBNY to discuss how Barclays would "step into the shoes" of the FRBNY.[7973] The FRBNY advised Barclays that it could use the PDCF to finance the LBI securities that

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[7970] *Id.*; transcript of deposition testimony of Rich Ricci, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 8, 2009, at pp. 133-34 (testifying that Barclays received a call from Thomas C. Baxter, Jr., General Counsel of the FRBNY); Leventhal Decl. ¶ 7; *see* transcript of deposition testimony of Gerard LaRocca, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 19, 2009, at pp. 28-29 (testifying that Jonathan Hughes, Global General Counsel for Barclays Capital, had advised him on Monday, September 15 that the FRBNY had contacted Barclays to advise that the FRBNY wanted to have Barclays help with LBI's financing with the FRBNY's financing of LBI); transcript of deposition testimony of David Petrie, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 26, 2009, at pp. 53, 67-68; transcript of deposition testimony of Michael Keegan, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 28, 2009, at pp. 33.

[7971] Leventhal Decl. ¶ 6.

[7972] *Id.*

[7973] Transcript of deposition testimony of Gerard LaRocca, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 19, 2009, at p. 30; transcript of deposition testimony of David Petrie, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 26, 2009, at pp. 80-88; *see also id*. at p. 53; David Petrie, Barclays, Handwritten Notes of David Petrie (Sept. 16, 2008) [BCI-EX-00115847] (notes of meeting at FRBNY).

Barclays would receive as collateral in the transaction, because the FRBNY anticipated that it would take Barclays time to find third party financing sources.[7974] Barclays advised the FRBNY that Barclays believed it could finance the collateral through the triparty repo market within two weeks.[7975]

Barclays and the FRBNY, and their respective counsel, worked Tuesday evening and the following morning to document an agreement under which Barclays would "step into the shoes" of the FRBNY (the "Replacement Transaction").[7976] On Wednesday, September 17, Barclays and the FRBNY signed a letter agreement governing their respective obligations under the Replacement Transaction.[7977] The letter agreement provided, among other things, that:

> By not later than the opening of business on Monday, September 22, 2008 (or, if the Court extends the date of the Sale Hearing beyond

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[7974] Transcript of deposition testimony of Gerard LaRocca, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 19, 2009, at pp. 31-32; transcript of deposition testimony of David Petrie, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 26, 2009, at pp. 88-89; e-mail from Lucinda M. Brickler, FRBNY, to Bill Dudley, FRBNY, *et al.* (Sept. 17, 2008) [FRBNY to Exam. 003415].

[7975] Transcript of deposition testimony of David Petrie, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 26, 2009, at pp. 84-86.

[7976] *E.g.*, e-mail from Hydee R. Feldstein, Sullivan & Cromwell, to Jay W. Clayton III, Sullivan & Cromwell, *et al.* (Sept. 17, 2008) [BCI-SC00009285] (referencing conference call at 9:30 a.m. on September 17 regarding letter agreement, and forwarding e-mail attaching draft of letter agreement); letter agreement [Draft] [BCI-EX-0078810], attached to e-mail from David Aman, Cleary Gottlieb, to Hydee R. Feldstein, Sullivan & Cromwell, *et al.* (Sept. 17, 2008) [BCI-EX-00078818]; e-mail from Hydee R. Feldstein, Sullivan & Cromwell, to James Bergin, FRBNY, *et al*. (Sept. 17, 2008) [BCI-EX-00078990] (indicating that Barclays was in process of executing letter agreement as of 1:49 p.m.); *see also* transcript of deposition testimony of Gerard LaRocca, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 19, 2009, at p. 32. After the meeting with the FRBNY, Barclays also met with the DTCC to discuss the transfer of assets under the Replacement Transaction that would require use of the DTCC wire. *See* Transcript of deposition testimony of David Petrie, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 26, 2009, at pp. 84-87.

[7977] *See* letter agreement among Barclays and the FRBNY (Sept. 17, 2008) [FRBNY to Exam 000043]; Leventhal Decl. ¶ 7.

> September 19, 2008, the earlier of September 29, 2008 (or such later date as may be designated by the FRBNY in its sole discretion) and the business day following the date on which an order (which has not been stayed) approving a Successful Bidder has been entered (the "Take-Out Date"), Barclays agrees (i) to purchase from the FRBNY, without recourse, the entirety of the FRBNY's position under all of the Agreements [under which the FRBNY had been providing financing to LBI] . . . and (ii) simultaneously cause the release or termination of the FRBNY's obligations under all Agreements. Upon receiving such purchase price and release or termination, the FRBNY shall deliver all LBI Collateral to Barclays. Alternatively, at Barclays' option, each of the Agreements outstanding immediately prior to the filing of any petition under Title 11 of the United States Code with respect to LBI shall be novated to substitute Barclays (or one of its affiliates) in place of the FRBNY thereunder.[7978]

The letter agreement thus provided that, in return for taking over FRBNY's financing position with respect to LBI, Barclays would receive the LBI securities that had been pledged to the FRBNY.[7979] Those pledged LBI securities, however, included

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[7978] Letter agreement between Barclays and the FRBNY (Sept. 17, 2008) [FRBNY to Exam 000043] at p. 2. The letter agreement also provided that, "[a]t the hearing before the Court on the [Sale] Motion, the FRBNY shall support the Motion."

[7979] *See id.*; *see also* Declaration of Gerard LaRocca in Support of the Trustee's Motion for Entry of an Order Approving a Settlement Agreement, ¶ 9, *In re Lehman Bros. Inc.*, No. 08-01420 (Bankr. S.D.N.Y. Dec. 5, 2008) (the "LaRocca Decl."), attached to Motion Under 11 U.S.C. §§ 105 and 363 Fed. R. Bankr. P. 9019(a) for Entry of an Order Approving Settlement Agreement, Docket No. 387, *In re Lehman Bros. Inc.*, No. 08-01420 (Bankr. S.D.N.Y. Dec. 5, 2008); e-mail from John N. Palchynsky, Lehman, to James W. Hraska, Lehman, *et al.* (Sept. 18, 2008) [LBEX-DOCID 459816]; e-mail from Lucinda M. Brickler, FRBNY, to Bill Dudley, FRBNY, *et al.* (Sept. 17, 2008) [FRBNY to Exam. 017511]; e-mail from Ian T. Lowitt, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Sept. 17, 2008) [LBEX-DOCID 70146]; e-mail from John N. Palchynsky, Lehman, to Sindy Aprigliano, Lehman, *et al.* (Sept. 18, 2008) [LBEX-DOCID 77086]; e-mail from Michael Keegan, Barclays, to Archibald Cox, Jr., Barclays (Sept. 19, 2008) [BCI-EX-00077814]; transcript of deposition testimony of David Petrie, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 26, 2009, at pp. 39-41, 67-68, 93, 132; transcript of deposition testimony of John Rodefeld, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 27, 2009, at p. 24.

residential mortgage-backed securities ("RMBS") that Barclays was not purchasing under the APA.[7980]

Wednesday evening, September 17, Barclays, Lehman, JPMorgan, BNYM and FRBNY representatives met to prepare for implementation of the Replacement Transaction on Thursday, September 18.[7981] Shortly after midnight on Thursday, September 18, Lehman sent an e-mail to Barclays, BNYM and JPMorgan that "outlined . . . the key tasks necessary to move the collateral currently being used to support the three Fed programs (TSLF, OMO, and PDCF) from Lehman to Barclays on Thursday, 9/18."[7982] The Lehman e-mail stated that "[t]he end of day collateral files for each of the above mentioned programs are being provided on Wednesday night, 9/17, to both Barclays and BNYM . . . [t]he collateral files will be cross referenced versus the list of excluded cusips that was provided by Barclays to remove positions not intended

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[7980] *See* APA, at p. 6 (§ 1.1) (definition (e) of "Purchased Assets") (defining "Purchased Assets" to include "50% of each position in the residential mortgage securities"); Excluded Mortgage Assets 09-17-2008.xls [BCI-EX-00000735], attached to e-mail from David Aronow, Lehman, to Richard Policke, Lehman, *et al.* (Sept. 17, 2008) [BCI-EX-0000732] (e-mail body addressed to Lehman, BNYM and Barclays stating that "[a]ttached are the cusips associated with the book that we were told on the call will be excluded from the movements tomorrow. These cusip[s] should not be part of the pledge to [BNYM] according to our earlier conversation").

[7981] *See* e-mail from Lucinda M. Brickler, FRBNY, to Bill Dudley, FRBNY, *et al*. (Sept. 17, 2008) [FRBNY to Exam. 003416]; e-mail from David Aronow, Lehman, to John Haley, Barclays, *et al.* (Sept. 18, 2008) [BCI-EX-(S)-00037617] (referring to meeting); transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at pp. 62-63 (discussions of the mechanics of the Replacement Transaction started on Sept. 17 and continued into the early morning on Sept. 18).

[7982] E-mail from David Aronow, Lehman, to John Haley, Barclays, *et al.* (Sept. 18, 2008) [BCI-EX-(S)-00037617].

to be transferred."[7983] The Lehman e-mail did not address whether the parties intended to substitute any collateral that had been pledged to the FRBNY, but which appeared on Barclays' list of excluded collateral.[7984]

To effect the Replacement Transaction, on Thursday morning, September 18, JPMorgan advanced cash to the FRBNY, and the FRBNY's financing of LBI under the three FRBNY programs was unwound.[7985] JPMorgan advanced $46.22 billion to the FRBNY, and the LBI collateral was delivered by the FRBNY to LBI's clearance box at JPMorgan.[7986]

The parties then began to implement the second stage of the Replacement Transaction, a repo transaction between LBI and Barclays under which Barclays would send $45 billion in cash to JPMorgan for the benefit of LBI, and Lehman would pledge securities to Barclays.[7987] Barclays planned to wire the $45 billion cash to JPMorgan in $5 billion components,[7988] and Barclays (actually, Barclays' triparty custodian bank, BNYM) would receive collateral to secure each $5 billion cash transfer.[7989]

[7983] E-mail from Richard Policke, Lehman, to David Aronow, Lehman, *et al.* (Sept. 18, 2008) [BCI-EX-00007640] (forwarding, shortly after midnight on Sept. 18, lists identifying the LBI securities that had been pledged to the FRBNY).

[7984] *Id.*

[7985] *See* e-mail from Christopher R. Burke, FRBNY, to Lucinda M. Brickler, FRBNY, *et al.* (Sept. 18, 2008) [FRBNY to Exam. 017484]; Leventhal Decl. ¶ 10.

[7986] Leventhal Decl. ¶¶ 9-10.

[7987] *See* e-mail from Lucinda M. Brickler, FRBNY, to Bill Dudley, FRBNY, *et al.* (Sept. 17, 2008) [FRBNY to Exam. 017569]; e-mail from Ian T. Lowitt, Lehman, to Paolo R. Tonucci, Lehman, *et al.* (Sept. 17, 2008) [LBEX-DOCID 70146].

[7988] *See* e-mail from Lucinda M. Brickler, FRBNY, to Christopher R. Burke, FRBNY, *et al.* (Sept. 18, 2008) [FRBNY to Exam. 017483]; e-mail from Gerard LaRocca, Barclays, to Stephanie A. Heller, FRBNY, *et al.*

Shortly after noon on Thursday, Barclays wired the initial $5 billion of cash to JPMorgan for the benefit of LBI.[7990] LBI then released collateral to be transferred to Barclays,[7991] but only approximately $1.5 billion of that collateral initially made it to BNYM for the benefit of Barclays.[7992] Barclays advised Lehman that Barclays was unwilling to send additional cash until it received sufficient collateral to secure the $5 billion already wired to JPMorgan.[7993] A dispute arose between Barclays and JPMorgan over whether JPMorgan would deliver repo collateral with a marked value equivalent to the cash Barclays had advanced, or would send that collateral plus additional

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(Sept. 26, 2008) [BCI-EX-00082581]; transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at pp. 77-78; transcript of deposition testimony of John Rodefeld, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 27, 2009, at p. 28.

[7989] *See* e-mail from Neal Ullman, Lehman, to David Aronow, Lehman, *et al.* (Sept. 18, 2008) [LBEX-DOCID 091226]; e-mail from James W. Hraska, Lehman, to Daniel J. Fleming, Lehman, *et al.* (Sept. 18, 2008) [LBEX-DOCID 459816]; transcript of deposition testimony of John Rodefeld, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 27, 2009, at pp. 27-28.

[7990] *See* Fedwire Transfer Receipt (Sept. 18, 2008) [FRBNY to Exam. 021198]; *see also* e-mail from Gerard LaRocca, Barclays, to Stephanie A. Heller, FRBNY, *et al.* (Sept. 26, 2008) [BCI-EX-0082581]; transcript of deposition testimony of David Petrie, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 26, 2009, at p. 100; transcript of deposition testimony of John Rodefeld, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 27, 2009, at p. 28.

[7991] *See* e-mail from Neal Ullman, Lehman, to Alastair Blackwell, Lehman, *et al.* (Sept. 18, 2008) [LBEX-DOCID 077879] (stating, at 12:22 p.m., that "Releases for 5b are loaded").

[7992] *See* e-mail from Gerard LaRocca, Barclays, to Stephanie A. Heller, FRBNY, *et al.* (Sept. 26, 2008) [BCI-EX-0082581]; e-mail from Lucinda M. Brickler, FRBNY, to Bill Dudley, FRBNY, *et al.* (Sept. 18, 2008) [FRBNY to Exam. 017510]; transcript of deposition testimony of David Petrie, *In re Lehman Bros. Holdings Inc.,* No. 08-13555, Bankr. S.D.N.Y., Aug. 26, 2009, at pp. 99-100; transcript of deposition testimony of John Rodefeld, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 27, 2009, at pp. 28-29.

[7993] *See* e-mail from David Aronow, Lehman, to Peter Hadington, Lehman, *et al.* (Sept. 18, 2008) [LBEX-DOCID 091226]; e-mail from James W. Hraska, Lehman, to Daniel J. Fleming, Lehman, *et al.* (Sept. 18, 2008) [LBEX-DOCID 459816]; transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at p. 80.

collateral sufficient to provide Barclays a margin.[7994] Ricci testified that a senior executive from JPMorgan then contacted Diamond, and asked Barclays to send the $40 billion in cash all at once to expedite the process.[7995] According to Ricci, the JPMorgan executive provided Diamond with assurances that, if Barclays sent the $40 billion in cash, JPMorgan would follow up promptly in delivering the remaining collateral.[7996] Early Thursday evening, Barclays wired the remaining $40 billion in cash.[7997]

Barclays did not receive $49.6 billion in securities that evening. Although both the FRBNY and DTCC kept their securities transfer facilities open long after their usual closing times,[7998] by 11:00 p.m. on Thursday evening, September 18, Barclays had received collateral with a marked value of only approximately $42 billion.[7999]

[7994] Examiner's Interview of Stephanie A. Heller, July 8, 2009.

[7995] Transcript of deposition testimony of Rich Ricci, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 8, 2009, at pp. 135-36.

[7996] *Id.; see* e-mail from Gerard LaRocca, Barclays, to Stephanie A. Heller, FRBNY, *et al.* (Sept. 26, 2008) [BCI-EX-0082581] (asserting that "senior executives at [Barclays] ask for and receive an oral commitment from [JPMorgan] that $49.6 billion of collateral would be delivered" to Barclays).

[7997] *See* e-mail from Gerard LaRocca, Barclays, to Stephanie A. Heller, FRBNY, *et al.* (Sept. 26, 2008) [BCI-EX-0082581]; Fedwire Transfer Receipts (Sept. 18, 2008) [FRBNY to Exam. 021198]; *see also* Leventhal Decl. ¶ 11 (stating that "[b]y early evening, the entire sum of $45 billion in cash had been transferred by Barclays to LBI"); e-mail from John Haley, Barclays, to Jai Westwood, Barclays (Sept. 18, 2008) [BCI-EX-(S)-00088051]; transcript of deposition testimony of David Petrie, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 26, 2009, at pp. 103-04; transcript of deposition testimony of John Rodefeld, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 27, 2009, at pp. 29-30, 80-81.

[7998] *See* e-mail from Lawrence P. Servidio, Lehman, to James W. Hraska, Lehman, *et al.* (Sept. 18, 2008) [LBEX-DOCID 110339]; transcript of deposition testimony of David Petrie, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 26, 2009, at pp. 103-05; transcript of deposition testimony of John Rodefeld, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 27, 2009, at pp. 29-30; transcript of deposition testimony of Nancy Denig, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 21, 2009, at pp. 54-55.

[7999] E-mail from Gerard LaRocca, Barclays, to Stephanie A. Heller, FRBNY, *et al.* (Sept. 26, 2008) [BCI-EX-0082581]; e-mail from Jonathan Hughes, Barclays, to Stephanie A. Heller, FRBNY (Oct. 1, 2008) [FRBNY to

There appear to be a number of reasons why Barclays did not receive all of the collateral that LBI had pledged to the FRBNY. First, some of the securities LBI had pledged to the FRBNY had been obtained by Lehman through the GCF Repo dealer-to-dealer triparty repo program. As a result of daily settlement activity, a significant portion of the securities that LBI had pledged to the FRBNY was transferred out of LBI's clearance boxes at JPMorgan.[8000]

Second, some of the RMBS that were Excluded Assets under the APA (and that Barclays also had requested be excluded from the Replacement Transaction), were included in the securities that the FRBNY had been financing the night before, and were delivered to Barclays on Thursday.[8001] By 7:40 p.m. on Thursday evening, BNYM had identified and returned to Lehman $371 million of RMBS that Barclays had identified

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Exam. 015344]; e-mail from Paolo R. Tonucci, Lehman, to Gerard M. Reilly, Lehman, *et al.* (Sept. 20, 2008) [LBEX-DOCID 69255]; e-mail from Daniel J. Fleming, Lehman, to David Aronow, Lehman (Sept. 21, 2008) [LBEX-DOCID 77821]; e-mail from John Haley, Barclays, to Teri Scott, Barclays (Sept. 19, 2008) [BCI-EX-(S)-00088070] (stating that collateral was still moving to Barclays); e-mail from Gerard LaRocca, Barclays, to Stephanie A. Heller, FRBNY, *et al.* (Sept. 26, 2008) [BCI-EX-0082581]; Leventhal Decl. ¶ 14 (noting that although the DTC and FRBNY "remained open for several hours past their normal closing times . . . operational issues interfered with the ability to transfer all of the intended securities to Barclays"); transcript of deposition testimony of David Petrie, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 26, 2009, at p. 105; transcript of deposition testimony of John Rodefeld, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 27, 2009, at pp. 29-30; transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at pp. 40-41, 46; transcript of deposition testimony of Nancy Denig, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 21, 2009, at p. 54; transcript of deposition testimony of Alastair Blackwell, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 7, 2009, at p. 59.

[8000] Transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at pp. 71-73; e-mail from Alastair Blackwell, Lehman, to Ian T. Lowitt, Lehman (Sept. 18, 2008) [LBEX-DOCID 77882].

[8001] Transcript of deposition testimony of Michael Keegan, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 28, 2009, at pp. 32-33, 107.

for exclusion, $366 million of which had been pledged to the FRBNY Wednesday night and returned to LBI's clearance box at JPMorgan on Thursday morning.[8002] By 9:15 p.m. that evening, BNYM identified an additional $289.4 million in RMBS that Barclays had identified for exclusion, and which had been included in the securities it received; although some were sent back, Barclays retained $289 million of those RMBS.[8003] $75 million of that collateral had been pledged to the FRBNY Wednesday night.[8004]

Third, a large volume of pending securities orders were in queue, including orders from customers who had directed that LBI move their accounts to other firms. [8005] When the LBI securities that had been pledged to the FRBNY were delivered to LBI's clearance boxes at JPMorgan, or attempted to be delivered to Barclays through DTCC clearing entities, some of those securities were automatically used to satisfy pending orders or netted against offsetting positions.[8006]

The end result was that, when the securities transfer and clearing facilities shut down on late Thursday evening, Barclays had delivered $45 billion in cash for LBI's benefit, but had received securities with a marked value of only $42 billion. Barclays requested that Lehman deliver $7 billion to Barclays until the remaining securities could

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[8002] *See* e-mail from John Haley, Barclays, to Gerard LaRocca, Barclays, *et al.* (Sept. 29, 2008) [BCI-EX-(S)-00034913].

[8003] *See* e-mail from John Haley, Barclays, to Gerard LaRocca, Barclays, *et al.* (Sept. 29, 2008) [BCI-EX-00080299].

[8004] *See* e-mail from John Haley, Barclays, to Gerard LaRocca, Barclays, *et al.* (Sept. 29, 2008) [BCI-EX-(S)-00034913].

[8005] *See* transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at pp. 75-76.

[8006] *Id*.

be delivered.[8007] Shortly after midnight on Friday, September 19, JPMorgan credited an account with $7 billion for the benefit of Barclays, and recorded an LBI "box loan" for that amount.[8008]

(2) $15.8 Billion Repo

In addition to the overnight financing LBI received from the FRBNY, from Monday, September 15, through Wednesday, September 17, Barclays also provided overnight funding to Lehman via a triparty repo, with JPMorgan acting as the triparty agent.[8009] Michael Keegan of Barclays testified that Barclays extended the triparty repo financing to LBI at the request of JPMorgan.[8010] According to Keegan, on Monday, September 15, JPMorgan asked Barclays to provide overnight financing for a portion of

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[8007] *See id.* at pp. 59-60; transcript of deposition testimony of Gerard LaRocca, *In re Lehman Bros. Holdings Inc.*, No. 08-13555, Bankr. S.D.N.Y., Aug. 19, 2009, at pp. 42-43; transcript of deposition testimony of Rich Ricci, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 8, 2009, at pp. 136-37.

[8008] *See* e-mail from James W. Hraska, Lehman, to Alastair Blackwell, Lehman (Sept. 18, 2008) [LBEX-DOCID 077930]; e-mail from John Haley, Barclays, to Teri Scott, Barclays, *et al*. (Sept. 19, 2008) [BCI-EX-(S)-00038010]; e-mail from Robert Azerad, Lehman, to Martin Kelly, Lehman, *et al.* (Sept. 20, 2008) [LBEX-DOCID 069255]; transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at pp. 52-53; Leventhal Decl. ¶¶ 15-16; LaRocca Decl. ¶ 8. On Friday, September 19, Barclays sent a notice of termination of the repo agreement relating to the Replacement Transaction. Letter from Michael Montgomery, Barclays, to Robert H. Bing, Lehman, *et al.*, re: Notice of Termination (Sept. 19, 2008) [BCI-EX-00109164]. The legal effect of this notice is in dispute in the Barclays sale litigation.

[8009] *See* e-mail from Teri Scott, Barclays, to Jonathan Stone, Barclays, *et al.* (Sept. 18, 2008) [BCI-EX-(S)-00038010]; transcript of deposition testimony of David Petrie, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 26, 2009, at pp. 53-55; transcript of deposition testimony of Nancy Denig, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 21, 2009, at pp. 135-36; transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at pp. 96-97; transcript of deposition testimony of Michael Keegan, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 28, 2009, at pp. 44-45.

[8010] Transcript of deposition testimony of Michael Keegan, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 28, 2008, at pp. 44-45.

the securities that Barclays would be purchasing from Lehman, and Barclays agreed to do so.[8011]

Thursday morning, September 18, the Barclays repo with Lehman from Wednesday night – under which Barclays had advanced $15.8 billion – unwound. JPMorgan wired $15.8 billion in cash to BNYM Barclays, and Barclays returned the securities that had been pledged under the repo to LBI's clearance box at JPMorgan.[8012]

When the $15.8 billion repo unwound on Thursday morning, JPMorgan understood that Barclays would renew the repo Thursday evening. On Thursday morning, in an e-mail to JPMorgan regarding the unwinding of the $15.8 billion repo, Jim Beckenhaupt of Barclays stated: "[Can] we get these funds returned ASAP and we'll let you know what the new amount is going to be for today."[8013] JPMorgan e-mailed Barclays wire instructions to renew the triparty repo with Lehman Thursday evening.[8014] Lehman also was assuming that Barclays would renew the $15.8 billion repo that evening, and was considering increases to the amount of the repo.[8015]

[8011] *Id.*

[8012] *See* e-mail from Marco Brandimarte, JPMorgan, to Keith Kochie, Barclays, *et al.* (Sept. 18, 2008) [JPM-EXAMINER00000669] (e-mail exchange reflecting (1) Barclays' request for the $15.8 billion triparty repo to be unwound, with Barclays' funds wired to Barclays account at BNYM and (2) JPMorgan's acknowledgment that Barclays' funds had been released).

[8013] *See* e-mail from Jim Beckenhaupt, Barclays, to Keith Kochie, Barclays, *et al.* (Sept. 18, 2008) [JPM-EXAMINER00000669].

[8014] *See* e-mail from Marco Brandimarte, JPMorgan, to Keith Kochie, Barclays, *et al.* (Sept. 18, 2008) [JPM-EXAMINER00000669].

[8015] *See* e-mail from Ian T. Lowitt, Lehman, to Alastair Blackwell, Lehman (Sept. 18, 2008) [LBEX-DOCID 077881]; *see also* transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.*,

Late Thursday afternoon, however, Barclays made the decision not to renew the $15.8 billion repo. At 4:00 p.m., Teri Scott of Barclays circulated an e-mail within Barclays regarding the $15.8 billion repo that stated: "[W]ho is making the decision on whether we would extend financing? Is there a move to ensuring that what we are financing is collateral that we have agreed, as a part of the asset purchase, to buy?"[8016] Keegan testified that, on Thursday afternoon at around 4:00 p.m., Rich Ricci asked him to come over to Lehman to review the securities positions that Barclays was receiving in connection with the Replacement Transaction.[8017] According to Keegan, after he arrived, Jerry del Missier asked him to review the securities associated with the $15.8 billion repo, and recommend whether Barclays should renew the repo.[8018] Keegan testified that he "got the list of collateral that was in repo and there was a $5 billion security. I have no idea what it was but I know we didn't purchase any $5 billion notional amount of security. So I advised Jerry this is not what we agreed on Monday night. It was not what we purchased . . . [a]nd . . . my recommendation would be not to roll a repo with JPMorgan."[8019]

Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at pp. 98-99 (stating that "Lehman believed at the time that [the repo] was also rolling").

[8016] E-mail from Teri Scott, Barclays, to Kevin Walker, Barclays, *et al.* (Sept. 18, 2008) [BCI-EX-(S)-00037993].

[8017] Transcript of deposition testimony of Michael Keegan, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 28, 2008, at pp. 21-22.

[8018] *Id.* at p. 45.

[8019] *Id.* Barclays had received the list of securities associated with the $15.8 billion repo shortly after midnight on Thursday, September 18. *See* e-mail from Richard Policke, Lehman, to David Aronow, Lehman, *et al.* (Sept. 18, 2008) [BCI-EX-00007640].

At 5:38 p.m., LaRocca sent an e-mail to Ricci that stated (in the subject line): "JPM will BE ANNOYED with several billion of collateral tonight that we will not finance."[8020] At 5:48 p.m., LaRocca sent an e-mail to Diamond and Ricci that said (in the subject line): "Urgent WE NEED TO TALK, JPM IS GOING TO BE MORE ANNOYED WITH WHAT I HAVE PLANNED THAT WILL SAVE BARCLAYS SIZE."[8021]

Thursday night, Barclays did not wire the funds to renew the $15.8 billion repo.[8022] Late Thursday evening and into Friday morning, JPMorgan booked a hold-in-custody (HIC) repo transaction for Lehman.[8023] Friday morning, JPMorgan changed the beneficiary of the HIC transaction to itself, essentially providing Lehman with a box loan to cover the overdraft.[8024]

[8020] E-mail from Gerard LaRocca, Barclays, to Rich Ricci, Barclays (Sept. 18, 2008) [BCI-EX-00077444].

[8021] E-mail from Gerard LaRocca, Barclays, to Robert E. Diamond, Barclays, *et al.* (Sept. 18, 2008) [BCI-EX-00077441].

[8022] Transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at pp. 97-99; transcript of deposition testimony of Nancy Denig, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 21, 2009, at pp. 135-36; transcript of deposition testimony of Michael Keegan, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 28, 2009 at pp. 45-47.

[8023] Transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at pp. 98-100. *See* e-mail from Angelo Gabriele, Lehman, to John Feraca, Lehman (Sept. 19, 2008) [LBEX-DOCID 53093] (explaining that a $15.8 billion HIC trade was conducted Thursday night); transcript of deposition testimony of Daniel J. Fleming, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 28, 2009, at pp. 177-79 (explaining that JPMorgan booked a HIC repo to cover the overdraft); transcript of deposition testimony of Alastair Blackwell, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 7, 2009, at p. 260.

[8024] Transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at pp. 98-102; e-mail from John N. Palchynsky, Lehman, to Neal Ullman, Lehman, *et al*. (Sept. 19, 2008) [LBEX-DOCID 3331072]; transcript of deposition testimony of Nancy Denig, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 21, 2009, at pp. 143-44; transcript of deposition testimony of Daniel J. Fleming, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 28, 2009, at pp. 178-79.

Rather than financing approximately $58 billion of LBI securities ($42 billion in securities under the Replacement Transaction plus a $15.8 billion repo), by not renewing the repo Barclays limited its LBI securities financing exposure to approximately $42 billion in LBI's securities. This was significant because, with a SIPA proceeding looming for LBI, the parties that financed LBI collateral on Thursday evening would very likely end up owning the financed securities after LBI commenced a SIPA proceeding.

On Friday morning, September 19, JPMorgan froze LBI's clearing accounts and prevented LBI from accessing JPMorgan's dealer securities trading systems because of the overdrafts in LBI's accounts.[8025] Until the situation was resolved, LBI was unable to access its clearing accounts at JPMorgan, or to settle outstanding trades and collateral movements.[8026] JPMorgan's actions also eliminated LBI's visibility into the JPMorgan

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[8025] E-mail from Edward J. Corral, JPMorgan, to Murray Pozmanter, DTCC (Sept. 19, 2008) [JPM-EXAMINER00000493] (explaining that JPMorgan shut Lehman out of JPMorgan's system because of a $15.8 billion overdraft by Lehman); e-mail from Daniel J. Fleming, Lehman, to Alastair Blackwell, Lehman, *et al.* (Sept. 19, 2008) [LBEX-DOCID 077808] ("Chase will not do anything until we resolve the 15.8bn problem from last night"); transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at p. 52; e-mail from John N. Palchynsky, Lehman, to Neal Ullman, Lehman, *et al.* (Sept. 19, 2008) [LBEX-DOCID 3331072]; transcript of deposition testimony of Alex Kirk, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 31, 2009, at pp. 54-55, 63.

[8026] E-mail from Daniel J. Fleming, Lehman, to Alastair Blackwell, Lehman, *et al.* (Sept. 19, 2008) [LBEX-DOCID 077808] (explaining that JPMorgan's action prevented Lehman from funding the DTC settlements); e-mail from John N. Palchynsky, Lehman, to Neal Ullman, Lehman, *et al.* (Sept. 19, 2008) [LBEX-DOCID 3331072] (describing the impact of JPMorgan's decision to freeze LBI); transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at p. 52.

BDAS system used by LBI,[8027] and prevented LBI from reconciling its trades and bank accounts.

Between Friday, September 19 and Monday, September 22, Barclays believed that the $7 billion in cash that JPMorgan had advanced to provide Barclays additional collateral under the Replacement Transaction was in a Barclays account at JPMorgan.[8028] At some point, however, JPMorgan, without advising Barclays, removed the $7 billion from the account, and transferred it to LBI's clearance account at JPMorgan, where it was applied against JPMorgan's outstanding box loan to LBI.[8029]

(3) September 19 Agreement to Transfer Additional Assets

On Friday morning, September 19, Rich Ricci instructed Michael Klein to investigate whether additional unencumbered Lehman assets existed, and to demand

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[8027] JPMorgan's counsel represented to the Examiner that the only way to limit LBI's ability to transfer securities was to eliminate LBI's access to the BDAS system. While "read-only" access was feasible, JPMorgan's counsel represented that it would have taken an estimated two days to establish. E-mail from Amy Wolfe, Wachtell, to Vincent E. Lazar, Examiner's Counsel, *et. al.* (Jan. 28, 2010).

[8028] *See* Leventhal Decl. ¶¶ 19-21 (stating that Barclays first learned that it did not have the $7 billion cash on or about September 23); e-mail from Jonathan Hughes, Barclays, to Stephanie A. Heller, FRBNY (Oct. 1, 2008) [FRBNY to Exam. 015346]; e-mail from Gerard LaRocca, Barclays, to Stephanie A. Heller, FRBNY, *et al.* (Sept. 26, 2008) [BCI-EX-0082581]; transcript of deposition testimony of Gerard LaRocca, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 19, 2009, at p. 79; transcript of deposition testimony of John Rodefeld, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 27, 2009, at pp. 73-74 (testifying that Barclays received statements on Friday, September 19 and Monday, September 22 indicating that the $7 billion remained in a Barclays account at JPMorgan).

[8029] Examiner's Interview of Shari Leventhal, Apr. 30, 2009, at p. 6; Leventhal Decl. ¶ 16 (stating that the $7 billion in cash was transferred to an LBI account at JPMorgan); LaRocca Decl. ¶¶ 11-12; e-mail from James W. Hraska, Lehman, to John N. Palchynsky, Lehman, *et al.* (Sept. 19, 2008) [LBEX-DOCID 77721]; e-mail from Jonathan Hughes, Barclays, to Stephanie A. Heller, FRBNY (Oct. 1, 2008) [FRBNY to Exam. 015346].

those assets for Barclays in order to provide what Ricci described as a sufficient "cushion [for Barclays] given the uncertainties in the market."[8030]

That morning, Klein, Cox, Ricci and Keegan met with McDade, Kirk, Lowitt and Tonucci.[8031] The Barclays team expressed discomfort with the assets Barclays had received in connection with the $45 billion Replacement Transaction, asserted that they were concerned that Barclays might be undercollateralized, and demanded additional assets.[8032] McDade concluded that Lehman needed to provide more value in order to close the deal, and directed Kirk, Lowitt and Tonucci to lead an effort to identify more assets for Barclays.[8033]

[8030] Transcript of deposition testimony of Rich Ricci, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 8, 2009, at p. 155.

[8031] Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at pp. 165-67; transcript of deposition testimony of Ian T. Lowitt, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 20, 2009, at p. 102.

[8032] Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at pp. 162-65; transcript of deposition testimony of Ian T. Lowitt, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 20, 2009, at p. 60; transcript of deposition testimony of Rich Ricci, *In re Lehman Bros. Holdings Inc.*, No. 08-13555, Bankr. S.D.N.Y., Sept. 8, 2009, at p. 165; transcript of deposition testimony of Paolo R. Tonucci, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at p. 55.

[8033] Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.*, No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at pp. 165-66, 169-70; transcript of deposition testimony of Ian T. Lowitt, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 20, 2009, at p. 60; transcript of deposition testimony of Paolo R. Tonucci, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at pp. 50-51, 55 (explaining that his instructions came from Ian T. Lowitt); transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Jan. 15, 2010, at pp. 67-69 (explaining that Tonucci requested via Alastair Blackwell that Hraska and others find additional assets that could be delivered to Barclays); *see* e-mail from Ian T. Lowitt, Lehman, to Herbert H. McDade, III, Lehman (Sept. 19, 2008) [LBEX-DOCID 138017] (reporting the results of his search for additional assets to McDade).

Several Lehman witnesses stated that a specified amount of additional assets were needed.[8034] Barclays witnesses, however, testified that Barclays did not seek particular additional assets or specify the amount of additional assets.[8035] According to Ricci, he "felt [he] needed as much as [he] could get to protect the firm" and "wasn't sure what Lehman had left."[8036]

At a second meeting on the afternoon of September 19 among Ricci, Keegan, McDade and Kirk, Barclays explained that, without additional assets from Lehman, the transaction could not take place.[8037] Lehman then identified two additional assets:

[8034] Transcript of deposition testimony of Alex Kirk, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 31, 2009, at p. 103 (explaining that the amount of additional assets needed was between $2 and $5 billion); transcript of deposition testimony of James P. Seery, Jr., *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 3, 2009, at pp. 188-89 (explaining that Barclays was looking for a particular amount of additional assets although he could not recall the specific amount); transcript of deposition testimony of Ian T. Lowitt, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 20, 2009, at pp. 62-63 (explaining that McDade gave him a target of $3 to $4 billion in addition value); transcript of deposition testimony of Nancy Denig, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 21, 2009, at pp. 64-65 (explaining that Hraska said the goal was $1.9 billion in unencumbered collateral); transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Jan. 15, 2010, at pp. 68-69 (explaining that Tonucci was responsible for the instruction to find at least $1.9 billion of clearance box assets); transcript of deposition testimony of Alastair Blackwell, *In re Lehman Bros. Holdings Inc.,* No. 08-13555, Bankr. S.D.N.Y., Aug. 7, 2009, at p. 144.

[8035] Transcript of deposition testimony of Rich Ricci, *In re Lehman Bros. Holdings Inc.,* No. 08-13555, Bankr. S.D.N.Y., Sept. 8, 2009, at pp. 156-57; transcript of deposition testimony of Michael Klein, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 12, 2009, at pp. 97-98; transcript of deposition testimony of Michael Keegan, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 28, 2009, at pp. 35-36.

[8036] Transcript of deposition testimony of Rich Ricci, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 8, 2009, at pp. 156-57.

[8037] Transcript of deposition testimony of Michael Klein, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 12, 2009, at p. 95; transcript of deposition testimony of Alex Kirk, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 31, 2009, at p. 100 (explaining Barclays' view that, without additional assets the transaction could not take place). In Ricci's deposition, he could not recall if he said the transaction would not go through without additional assets, although he "certainly [had] those thoughts." Transcript of deposition testimony of Rich Ricci, *In re Lehman Bros.*

(1) excess amounts in 15c3-3 customer reserve accounts, estimated to have a value of approximately $750 million, and (2) certain unencumbered securities (sometimes referred to as the "bag of hammers") estimated to have a value of $1.9 billion.[8038]

(a) Excess 15c3-3 Assets

As explained above, after Barclays met with Lehman on Friday morning, September 19, McDade directed Kirk, Lowitt and Tonucci to lead an effort to identify more assets that might be available for transfer to Barclays.[8039] As part of that process, Lowitt and his team worked to quantify the amount of assets in LBI's 15c3-3 accounts (over and above the amounts required to be held for the benefit of customers) that

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Holdings Inc., Case No. 08-13555, Bankr. S.D.N.Y., Sept. 8, 2009, at p. 157. McDade understood that "in order to transact the deal, we had to find more in the way of ideas that would provide value . . . . both of which I've just mentioned to you, [unencumbered assets in the clearance boxes and the 15c3]." Transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at p. 165.

[8038] Transcript of deposition testimony of Alex Kirk, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 31, 2009, at pp. 105-13; transcript of deposition testimony of Ian T. Lowitt, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 20, 2009, at p. 60; transcript of deposition testimony of Michael Klein, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 12, 2009, at pp. 107-09; transcript of deposition testimony of Rich Ricci, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 8, 2009, at pp. 164-65; transcript of deposition testimony of Paolo R. Tonucci, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at pp. 54-57; transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at p. 175.

[8039] *See* e-mail from Ian T. Lowitt, Lehman, to Herbert H. McDade, III, Lehman (Sept. 19, 2008) [LBEX-DOCID 138017] (reporting the results of his search for additional assets to McDade); transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.,* No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at pp. 165-66, 169-70; transcript of deposition testimony of Ian T. Lowitt, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 20, 2009, at p. 60; transcript of deposition testimony of Paolo R. Tonucci, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at pp. 50-51, 55 (explaining that his instructions came from Ian T. Lowitt); transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Jan. 15, 2010, at pp. 67-69 (explaining that Tonucci requested via Alastair Blackwell that Hraska and others find additional assets that could be delivered to Barclays).

might be available to transfer to Barclays.[8040] LBI had difficulty, however, determining the precise amount of excess assets in its 15c3-3 accounts. LBI's estimates of the excess assets varied with the changing market conditions, customer withdrawals and the identification of numerous "breaks" in customer clearing transactions.[8041]

The first e-mails reflecting LBI's efforts to determine the amount and transferability of excess 15c3-3 assets were sent shortly after the September 19 meeting discussing additional assets to be transferred to Barclays. At approximately 10:15 am on September 19, Anna Yu of Lehman e-mailed Tonucci and Kelly, among others, to report that "[t]he 15c3-1 seg cash remaining is currently $1 bn. Tony is waiting on the answer back from the SEC regarding the transferability of seg cash funds from Lehman to Barclays."[8042] Later that day, at 2:27 p.m., Lowitt reported to McDade that over $1.3 billion in 15c3-3 assets were available.[8043]

That afternoon and evening, the parties appeared before the Court for the hearing on the Sale Motion. At the hearing, Debtors' counsel told the Court that, since

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[8040] SEC Rule 15c3-3, known in the industry as the Customer Segregation Rule or the Customer Protection Rule, requires broker-dealers to maintain a reserve account for the exclusive benefit of customers (also known as an "EBOC Account") that is used to hold assets for the benefit of customers. As the amount of customer assets fluctuates, so does the amount the broker must hold in that reserve account. *See* 17 C.F.R. § 240.15c3-3(e); *see also* Affidavit of Daniel McIsaac, at p. 5 (¶ 14), Docket No. 1867, *In re Lehman Bros. Holdings Inc.,* No. 08-01420 (Bankr. S.D.N.Y. Oct. 5, 2009).

[8041] *See* transcript of deposition testimony of Daniel J. Fleming, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, S.D.N.Y., Aug. 28, 2009, at pp. 189-90.

[8042] E-mail from Ann Yu, Lehman, to Kristie Y. Wong, Lehman, *et al.* (Sept. 19, 2008) [LBEX-DOCID 4572388].

[8043] E-mail from Ian T. Lowitt, Lehman, to Herbert H. McDade, III, Lehman (Sept. 19, 2008) [LBEX-DOCID 138017].

the initial presentation of the APA to the Court on Wednesday, "there ha[d] been some major changes in the transaction."[8044] Debtors' counsel told the Court that the agreement had been finalized only about 30 minutes before the hearing began, and a letter agreement was being drafted to memorialize the new agreement.[8045] There was no mention at the hearing that Barclays was to receive any excess cash or securities held in LBI's 15c3-3 accounts.

During the weekend, Lehman employees continued to attempt to identify excess 15c3-3 assets that might be available for transfer. An estimate from Saturday, September 20, placed the excess 15c3-3 assets at between $700 and $800 million.[8046] By that evening, Lehman had reverted to its earlier estimate that $1 billion in excess 15c3-3 assets were available for transfer to Barclays.[8047]

On Sunday evening, Azerad sent Kelly, Tonucci and Christopher M. O'Meara a PowerPoint presentation describing LBI's available, excess 15c3-3 assets for transfer to Barclays, as follows:

> We last calculated the 15c3 lockup on Wednesday, September 17. The amounts segregated on that date were $1.769 billion for the customers and $492 million for the PAIB. During this weekend, we recalculated the lockup as of Friday, September 19. The amounts to be segregated as of

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[8044] *Id.*

[8045] Transcript of hearing, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 19, 2008, at p. 43.

[8046] Transcript of deposition testimony of Robert Azerad, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Aug. 17, 2009, at pp. 101-04.

[8047] *See* e-mail from Brett Beldner, Lehman, to Martin Kelly, Lehman, *et al.* (Sept. 21, 2008) [LBEX-DOCID 456031].

> Friday were $1.011 billion for the customers and $97 million for the PAIB – i.e., a reduction of $1.123 billion, which can be immediately transferred to Barclays.[8048]

On Sunday, Barclays estimated it would receive $1 billion of excess 15c3-3 assets.[8049]

As explained in Section III.C.6.h.2 of this Report, the transfer of excess 15c3-3 assets to Barclays was the subject of negotiations with the Creditors Committee on Sunday, September 21. The Clarification Letter executed on the morning of the sale closing provided that Barclays was to receive, "to the extent permitted by applicable law," $769 million in excess 15c3-3 securities, or "securities of substantially the same nature and value,"[8050] while LBI retained an estimated $1 billion in excess 15c3-3 cash as a compromise.[8051] The $1 billion in estimated excess 15c3-3 cash and $769 million in excess securities specified in the Clarification Letter matched Lehman's Friday estimate of the amount in its reserve lock-up as of Wednesday the 17th.[8052]

The eventual transfer of excess 15c3-3 securities required SEC approval.[8053] On September 20, Tonucci e-mailed Michael A. Macchiaroli of the SEC regarding the need for quick SEC approval for the transfer of 15c3-3 securities:

[8048] Lehman Brothers: The 15c3 Lockup (Sept. 21, 2008), at p. 1 [LBEX-DOCID 57002], attached to e-mail from Robert Azerad, Lehman, to Martin Kelly, Lehman, *et al.* (Sept. 21, 2008) [LBEX-DOCID 69281].

[8049] *See* Long Island - Acquisition Summary [Draft] [BCI-EX-(S)-00052479], attached to e-mail from Samantha J. King, Barclays, to Iain Mackinnon, Barclays (Sept. 21, 2008) [BCI-EX-(S)-00052478].

[8050] Clarification Letter, at p. 4 (¶ 8).

[8051] Examiner's Interview of Saul Burian, Sept. 29, 2009, at p. 6; transcript of deposition testimony of Saul Burian, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Dec. 17, 2009, at pp. 307-09.

[8052] E-mail from Joel Potenciano, Lehman, to Joseph Abate, Lehman (Sept. 19, 2008) [BCI-CG00033812].

[8053] E-mail from Paolo R. Tonucci, Lehman, to Daniel J. Fleming, Lehman, *et. al.* (Sept. 20, 2008) [LBHI_SEC07940_562928]; e-mail from William Burke, Lehman, to Anthony Stucchio, Lehman, *et al.*

> We may need your quick response to a rerun of the 15c3 calc as of Friday. We expect that there will be a further reduction in the requirement because of the transfer of clients and continued reduction in client exposures.
>
> Consequently we hope to release some cash which would become part of the sale. This has been documented in the bankruptcy filing.
>
> . . . It would be great if you could review, or have your team review, quickly when the calc is completed.[8054]

The SEC ultimately gave its approval for the transfer of the 15c3-3 securities.[8055]

The propriety of the transfer of excess 15c3-3 securities to Barclays is the subject of pending litigation involving the Debtors, the SIPA Trustee, the Creditors Committee and Barclays. Because this issue is the subject of active, pending litigation before this Court with respect to which discovery is not complete, the Examiner has limited this section of the Report to setting out a short record of the facts he has developed on this issue.

(b) Additional Securities

In addition to the excess 15c3-3 assets, on Friday Lehman also identified a mix of additional securities that could be transferred to Barclays. Barclays asserted that it believed that the true value of the additional assets, and in particular the unencumbered

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(Sept. 23, 2008) [LBEX-DOCID 056115]; transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, S.D.N.Y., Sept. 2, 2009, at pp. 282-83.

[8054] E-mail from Paolo R. Tonucci, Lehman, to Michael A. Macchiaroli, SEC (Sept. 20, 2008) [LBEX-DOCID 457721].

[8055] E-mail from Paolo R. Tonucci, Lehman, to Daniel J. Fleming, Lehman, *et. al* (Sept. 20, 2008) [LBHI_SEC07940_562928]; *see* transcript of deposition testimony of Daniel J. Fleming, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, S.D.N.Y., Aug. 28, 2009, at pp. 167-68.

assets, was questionable.[8056] Ricci expressed his discomfort with the amount available.[8057] Kirk explained that there was nothing left to give Barclays,[8058] and Ricci responded that he "did not want to be a pig."[8059] With the additional assets, Ricci acknowledged that Barclays was willing to proceed with the transaction.[8060]

That weekend, Lehman continued to identify unencumbered securities that could be transferred to Barclays, and updated its valuations of the unencumbered securities that could be delivered to Barclays.[8061] On Saturday, September 20, estimates of the value of the additional securities ranged from $1.6 billion[8062] to $2.18 billion.[8063]

[8056] Transcript of deposition testimony of Alex Kirk, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 31, 2009, at pp. 106-10 (explaining that Michael Keegan considered the additional assets even harder to value than the assets in the Replacement Transaction); transcript of deposition testimony of Michael Keegan, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 28, 2009, at pp. 87-89.

[8057] Transcript of deposition testimony of Rich Ricci, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 8, 2009, at p. 158.

[8058] *Id*.

[8059] *Id.;* e-mail from Alex Kirk, Lehman, to Herbert H. McDade, III, Lehman (Sept. 19, 2008) [Deposition Exhibit 326] ("Rich Richie just told me he won't blow up this trade by being a pig").

[8060] Transcript of deposition testimony of Michael Klein, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 12, 2009, at pp. 110-11; transcript of deposition testimony of Rich Ricci, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 8, 2009, at p. 158; transcript of deposition testimony of Alex Kirk, *In re Lehman Bros. Holdings Inc.,* No. 08-13555, Bankr. S.D.N.Y., Aug. 31, 2009, at pp. 111-12; transcript of deposition testimony of Herbert H. McDade, III, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 2, 2009, at pp. 177-78.

[8061] Transcript of deposition testimony of Michael Klein, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 12, 2009, at pp. 107-09; transcript of deposition testimony of James W. Hraska, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 14, 2009, at pp. 212-13, 221-22, 227-28; *see* e-mail from Ian T. Lowitt, Lehman, to Monty Forrest, Lehman, *et al.* (Sept. 20, 2008) [LBEX-DOCID 77857] (reflecting Lehman's attempts to find additional securities to transfer to Barclays).

[8062] *See* e-mail from Monty Forrest, Lehman, to Alastair Blackwell, Lehman, *et al.* (Sept. 20, 2008) [LBEX-DOCID 463886].

[8063] E-mail from Monty Forrest, Lehman, to Alastair Blackwell, Lehman, *et al.* (Sept. 20, 2008) [LBEX-DOCID 463886]; transcript of deposition testimony of Nancy Denig, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Aug. 21, 2009, at pp. 190-91.

(c) OCC Margin

The OCC[8064] requires that each of its clearing members post collateral (margin) sufficient to secure its obligations to the OCC.[8065] The minimum required OCC margin consists of an amount equal to (1) the mark-to-market value of the member's positions, plus (2) a risk component to cover roughly two days of market movement.[8066] The OCC also requires that clearing members post a clearing deposit based on the size of their positions.

LBI was one of the top ten to fifteen clearing members at the OCC, typically maintaining $2 - 3 billion dollars in net positions and associated margin.[8067] LBI usually provided margin somewhat in excess of what the OCC required.[8068] LBI also maintained a clearing deposit at the OCC.[8069]

From September 15 through September 19, 2008, LBI's options positions at the OCC were in the aggregate "short," and the market generally declined during the week following LBHI's bankruptcy, so LBI's positions at the OCC moved in LBI's favor

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[8064] The OCC is the clearing organization for most domestic exchange-traded commodities options, as well as futures on financial assets such as stocks and currencies. It clears options for a number of exchanges. Examiner's Interview of John Fennell and Jean Cawley, Dec. 18, 2009, at p. 2.

[8065] *Id.* at pp. 2-3.

[8066] In general, increased market volatility means that clearing members must post more margin (collateral). *Id.* at p. 2.

[8067] *Id*.

[8068] *Id*.

[8069] Declaration of Craig L. Jones, at p. 3 (¶ 7), *In re Lehman Bros. Holdings Inc.*, No. 08-13555, (Bankr. S.D.N.Y. Jan. 8, 2010) (the "Jones Decl."), attached as Ex. 354 to Memorandum of Barclays Capital Inc. in Opposition to the Rule 60 Motions and in Support of Motion of Barclays Capital Inc. to Enforce the Sale Order and Secure Delivery of All Undelivered Assets, Docket No. 6815, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Jan. 29, 2010).

during this period.[8070] As a result, the collateral LBI had posted at the OCC prior to LBHI's bankruptcy was sufficient to meet the OCC's typical margin requirements, and the OCC did not make any special margin calls upon LBI.[8071] However, the OCC did not permit LBI to access any "excess" margin that was being created as a result of market movements. Instead, that week the OCC insisted that all excess margin remain on deposit at the OCC.[8072]

Beginning on Friday, September 19, in connection with its review of whether additional assets might be available for transfer to Barclays, LBI reviewed its exchange-traded positions. That day, Lehman estimated the amount of excess OCC margin at $401 million.[8073] On Sunday, Fleming emailed Tonucci with a higher amount: "The statement from the OCC reflects a large excess position in house and customer. House has excess of $444mm and customer $244. I do not know how accessible this is."[8074]

It is not clear whether the magnitude of the excess OCC margin was clearly communicated to Barclays prior to the closing. As of Monday, internal Barclays' e-mails were complaining about the lack of information about LBI's positions at the

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[8070] Examiner's Interview of John Fennell and Jean Cawley, Dec. 18, 2009, at pp. 2-3.

[8071] *Id*.

[8072] *Id*.

[8073] Declaration of Sharon Blake, Ex. 1, *In re Lehman Bros. Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Jan. 8, 2008), attached as Ex. 350 to Memorandum of Barclays Capital Inc. in Opposition to the Rule 60 Motions and in Support of Motion of Barclays Capital Inc. to Enforce the Sale Order and Secure Delivery of All Undelivered Assets, Docket No. 6815, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Jan. 29, 2010).

[8074] E-mail from Daniel J. Fleming, Lehman, to Paolo R. Tonucci, Lehman (Sept. 21, 2008) [Deposition Exhibit 161A].

OCC: "It is clear lb has absolutely no idea what its occ risk position is. We know it is between 2bn short and 4bn long. They do not know what has been booked to what entity. We cannot see. We are now 4 days into making zero progress on this with them."[8075]

The OCC did not actively participate in negotiations between Barclays and Lehman.[8076] However, the OCC made clear that it would not continue clearing LBI's accounts post-sale unless Barclays assumed LBI's obligations to the OCC: "OCC's willingness to transfer the LBI accounts to Barclays is conditioned upon obtaining Barclays' signature on the 'Transfer and Assumption Agreement' among OCC, the [SIPA] Trustee and Barclays."[8077] The OCC proposed to implement the transfer by simply renaming "the LBI accounts as accounts of Barclays and it would then be Barclays obligation to make settlement in respect of those accounts on Monday [September 22, 2008] morning."[8078]

On Monday, September 22, the OCC, the SIPA Trustee and Barclays executed the Transfer and Assumption Agreement referenced in the OCC's e-mail.[8079] The agreement provided that LBI transferred to Barclays "(ii) all margin deposits held by OCC with

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[8075] E-mail from Stephen King, Barclays, to Elizabeth James, Barclays, *et al.* (Sept. 22, 2008) [BCI-EX-(S)-00110544].

[8076] Examiner's Interview of John Fennell and Jean Cawley, Dec. 18, 2009, at p. 7.

[8077] E-mail from James R. McDaniel, Sidley Austin, to Edward J. Rosen, Cleary Gottlieb (Sept. 21, 2008) [BCI-CG00064703].

[8078] E-mail from James R. McDaniel, Sidley Austin, to Ronit J. Berkovich, Weil (Sept. 20, 2008) [BCI-CG00023904].

[8079] Transfer and Assumption Agreement among LBI, THE OCC and Barclays (Sept. 19, 2008), at p. 1 (§ 1(a)).

respect to the Account; (iii) all settlement obligations with regard to transactions in cleared contracts; and (iv) all rights and obligations in respect of exercises of option contracts. . . ."[8080] In exchange, Barclays assumed and agreed to perform "each obligation arising out of or to be performed with respect to the activity in the Account."[8081] In the agreement, the SIPA Trustee authorized JPMorgan to transfer "all rights in securities, cash, and other property ("Collateral") pledged by LBI to [the OCC] and held for OCC's benefit at" JPMorgan.[8082]

As of the close of business on Friday, September 19, the OCC's aggregate margin requirements across all LBI accounts (customer and house) was $1,693,367,422.[8083] The OCC estimates that LBI's posted collateral, including the clearing fund deposit, had a value of $2,301,351,807,[8084] consisting of $1,081,685,547 in cash (including $80,797,001 in proceeds from letters of credit that had been drawn upon by the OCC earlier that week); securities with an estimated market value of $967,466,259[8085] and undrawn letters of credit in the aggregate face amount of $252 million. Thus, the OCC calculates that LBI's collateral at the OCC (including drawn and undrawn letters of credit) exceeded

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[8080] *Id*.

[8081] *Id.* at p. 2 (§ 1(b)).

[8082] *See* letter agreement among Barclays, LBI and JPMorgan (Sept. 19, 2008) [BCI-CG00063905].

[8083] Letter from William J. Nissen, Sidley Austin, to Vincent E. Lazar, Examiner's Counsel, re: The Options Clearing Corporation (Jan. 13, 2010); Jones Decl. Ex. 1.

[8084] E-mail from William J. Nissen, Sidley Austin, to Vincent E. Lazar, Examiner's Counsel (Feb. 1, 2010).

[8085] OCC, Collateral Inventory by CMO: Government Securities (GS & GE) (Sept. 19, 2008) [LBEX-OCC 000001].

the OCC's margin requirements by $607,984,385 ($355,784,385 excluding undrawn letters of credit).[8086] Barclays values the collateral somewhat differently.[8087]

The propriety of the transfer of OCC margin (including excess margin) to Barclays and its subsequent actions, including Barclays' subsequent liquidation of options positions attributable to LBI and its affiliates,[8088] is the subject of pending litigation involving the Debtors, the SIPA Trustee, the Creditors Committee and Barclays. Because this issue is the subject of active, pending litigation before this Court with respect to which discovery is not complete, the Examiner has limited this section of the Report to setting out a short record of the facts he has developed on this issue.

g) The Court's Consideration and Approval of the Proposed Transaction

(1) September 19, 2008 Sale Hearing

On September 19 at approximately 4:30 p.m., the sale hearing commenced.[8089] At the beginning of the hearing, Debtors' counsel requested a recess to explain to those in attendance how the deal had changed since the APA was filed with the Court. The

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[8086] E-mail from William J. Nissen, Austin, to Vincent E. Lazar, Examiner's Counsel (Feb. 1, 2010).

[8087] Jones Decl. Ex. 1.

[8088] The margin deposits transferred to the OCC included margin associated with LBI positions attributable to at least one LBHI Affiliate, LOTC. The options positions associated with LOTC's accounts at LBI were subsequently liquidated by Barclays. Declaration of Daniel Dziemian, at pp. 2-5 (¶¶ 7-10), *In re Lehman Bros. Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Jan. 8, 2008), attached as Ex. 352 to Memorandum of Barclays Capital Inc. in Opposition to the Rule 60 Motions and in Support of Motion of Barclays Capital Inc. to Enforce the Sale Order and Secure Delivery of All Undelivered Assets, Docket No. 6815, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Jan. 29, 2010).

[8089] Transcript of hearing, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 19, 2008, at p. 1.

Court granted the request, and Debtors' counsel spent approximately an hour describing the changes to those in the courtroom.[8090]

When the hearing recommenced, Debtors' counsel advised the Court that the precipitous drop in the markets in the preceding days had reduced the value of the securities that would be conveyed in the transaction;[8091] and because of the LBIE insolvency proceeding in the United Kingdom, LBI was unable to deliver to Barclays the intended assets pursuant to the APA.[8092]

With respect to the securities to be transferred, Debtors' counsel stated:

> [Lehman was] selling assets that had a value of seventy -- approximately seventy billion dollars. And today, Your Honor, [Lehman is] only selling assets that have a value of 47.4 billion dollars.
>
> Barclays is assuming liabilities, however, of 45.5 billion dollars in connection with those assets. So that has not changed from the original transaction.[8093]

Debtors' counsel also informed the Court that: "Barclays basically stepped into the shoes of the Federal Reserve in connection with the Primary Dealer Credit Facility as to the 45.5 billion dollars Lehman borrowed last Monday and received the collateral that Lehman had posted therewith."[8094]

[8090] *Id.* at p. 45.
[8091] *Id.* at p. 46.
[8092] *Id.* at pp. 63-65.
[8093] *Id.* at p. 47.
[8094] *Id.* at p. 63.

Debtors' counsel informed the Court that the changes in the proposed transaction did not fundamentally alter the basic agreement set forth in the APA,[8095] pointing to the cash consideration, the $250 million payment and the sale of the building at 745 Seventh Avenue and the two New Jersey data centers as evidence of the general continuity of the deal.[8096] Counsel noted, however, that the cash consideration would change somewhat due to new appraisals of the real estate assets.[8097]

Following a brief description by Debtors' counsel of the RMBS that were included in the assets to be transferred to Barclays, the DTCC described how the treatment of the $6 billion in RMBS in the proposed transaction had changed.[8098] As explained by the DTCC, under the original proposal LBI and Barclays were to split the RMBS 50/50[8099] under the revised proposal, Barclays would take all of the RMBS and pledge them to the DTCC to secure clearing.[8100] DTCC's counsel indicated that Barclays already had posted the RMBS as collateral to the DTCC that morning, and that DTCC was using the RMBS to protect itself as it settled trades to effect the transfer of LBI accounts to Barclays.[8101] According to the DTCC, trading would have stopped had

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[8095] *Id.* at p. 64.
[8096] *Id.*
[8097] *Id.* at pp. 64-65.
[8098] *Id.* at pp. 49-51.
[8099] *Id.* at pp. 51-52.
[8100] *Id.* at pp. 51-53.
[8101] *Id.* at pp. 51-52. During the Examiner's interview of Isaac Montal from DTCC, DTCC's counsel Sheldon Hirshon indicated that he recalled making the statement but did not recall the source of this information, and in hindsight believes that he may have been incorrect and simply speculating that the RMBS already had been moved to DTCC. Examiner's Interview of Isaac Montal, May 19, 2009 at p. 2.

collateral not been posted.[8102] The DTCC further explained that the First Amendment to the APA provided that after LBI's accounts at the DTCC were settled, fifty percent of the remaining RMBS would be returned to LBI.[8103]

The Creditors Committee's counsel explained that the Creditors Committee neither supported nor objected to the proposed transaction.[8104] The Creditors Committee indicated that it had insufficient time to conduct a proper due diligence review of the proposed transaction, but did not see a viable alternative.[8105]

The Court concluded: "I have to approve the transaction because it's the only available transaction."[8106] The Court explained that if it did not approve the transaction "[t]he harm to the debtor, its estates, the customers, creditors, generally, the national economy and the global economy could prove to be incalculable."[8107] The Court noted that its approval of the transaction would save 9,000 jobs for at least ninety days.[8108]

[8102] *Id.* at p. 52.

[8103] *Id.* at pp. 52-53; First Amendment to the Asset Purchase Agreement among Lehman Brothers Holdings Inc., Lehman Brothers Inc., LB 745 LLC, and Barclays Capital Inc. (Sept. 19, 2008), at p. 1. These provisions in the First Amendment to the APA were deleted by the Clarification Letter. Clarification Letter, at p. 3 (¶ 4(d)).

[8104] Transcript of hearing, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 19, 2008, at p. 67.

[8105] *Id.*

[8106] *Id.* at p. 248.

[8107] *Id.* at p. 250.

[8108] *Id.*

(2) The Sale Order

On September 20, 2008, the Court entered the Sale Order authorizing the sale of the Purchased Assets to Barclays.[8109] The Sale Order for the most part conformed to the proposed form of order LBHI had attached to its Sale Motion.

In the Sale Order, the Court found:

- LBHI and its debtor subsidiaries would suffer irreparable harm without the sale;[8110]
- "Good and sufficient reasons" were given to satisfy the Court that the sale was in the best interests of the debtors;[8111]
- The debtors demonstrated both (1) good business judgment, and (2) compelling reasons to authorize the sale outside the ordinary course of business under Bankruptcy Code section 363(b) (namely, that it was necessary to maximize the value of the Purchased Assets);[8112]
- The Purchase Agreement was negotiated at arms length and in good faith; Barclays was not an "insider" of the debtors, and no party engaged in conduct that could cause the Purchase Agreement to be avoided under Bankruptcy Code section 363(n). "Specifically, the Purchaser has not acted in a collusive manner with any person and the purchase price was not controlled by any agreement among bidders;"[8113]

[8109] At the time of the sale hearing, the final version of the Clarification Letter had not been drafted, and it was not presented to the Court.

[8110] Order Under 11 U.S.C. §§ 105(a), 363, and 365 and Federal Rules of Bankruptcy Procedure 2002, 6004 and 6006 Authorizing and Approving (A) the Sale of Purchased Assets Free and Clear of Lines and Other Interests and (B) Assumption and Assignment of Executory Contracts and Unexpired Leases at p. 3, Docket No. 258, *In re Lehman Bros. Holdings Inc.,* No. 08-13555 (Bankr. S.D.N.Y., Sept. 20, 2008) ("Sale Order").

[8111] *Id.* at p. 5.

[8112] *Id.* at p. 6.

[8113] *Id.* at pp. 5-6.

- Barclays "is a good faith Purchaser of the Purchased Assets within the meaning of Bankruptcy Code section 363(m) and is, therefore, entitled to all of the protections afforded thereby;"[8114]

- The Purchase Agreement was the highest and best offer for the Purchased Assets, and LBHI's determination of that is "a valid and sound exercise of the Debtors' business judgment;"[8115] and

- The Purchase Agreement must be consummated "promptly in order to preserve the viability of the businesses subject to the sale as going concerns, to maximize the value of the estates. Time is of the essence in consummating the Sale."[8116]

Based on these findings, the Court ruled:

- "The Debtors are hereby authorized and directed to (1) execute the Purchase Agreement,[8117] along with any additional instruments or documents that may be reasonably necessary or appropriate to implement the Purchase Agreement, provided that such additional documents do not materially change its terms; (2) consummate the Sale in accordance with the terms and conditions of the Purchase Agreement and the other agreements contemplated thereby; and (3) take all other and further actions as may be reasonably necessary to implement the transactions contemplated by the Purchase Agreement."[8118]

- "The Purchase Agreement and any related agreements, documents or other instruments may be modified, amended or supplemented by the parties thereto, in a writing signed by such parties, and in accordance with the terms thereof, without further order of the Court, provided that any such modification, amendment or supplement does not have a material adverse

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[8114] *Id.*

[8115] *Id.* at p. 6.

[8116] *Id.* at p. 11.

[8117] The Sale Order defines the Purchase Agreement as the: "Asset Purchase Agreement, dated Sept. 16, 2008, among the Debtors, Lehman Brothers Inc. . . . and Barclays . . . , collectively with that First Amendment Clarifying Asset Purchase Agreement dated September 19, 2008 and that letter agreement clarifying and supplementing the Asset Purchase Agreement dated September 20, 2008 (as may be subsequently modified or amended or clarified . . . ." *Id.* at p. 1.

[8118] *Id.* at p. 12.

effect on the Debtors' estates and has been agreed to between the Committee, the Debtors and the Purchaser.[8119]

h) Transaction Closing

(1) JPMorgan/Barclays Disputes

Over the closing weekend, significant disputes arose between JPMorgan and Barclays. According to several parties, those disputes consumed much of the weekend and threatened to derail the transaction.[8120]

JPMorgan objected to Barclays' decision on Thursday, September 18, not to renew its $15.8 billion triparty repo with Lehman. JPMorgan's position was that Barclays had agreed to buy all of LBI's securities, including the securities associated with the $15.8 billion repo.[8121] On Saturday, September 20, JPMorgan threatened to lock down all of LBI's accounts at JPMorgan and apply the cash and securities in LBI's

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[8119] *Id.* at p. 21. On September 20, 2009, Bay Harbour, an LBIE creditor, appealed the Sale Order and a related order entered in LBI's SIPA proceedings. Bay Harbour argued that there was insufficient evidence for the Bankruptcy Court to find that Barclays was a good faith purchaser, that the Bankruptcy Court's decision violated the Due Process Clause because Bay Harbour was not afforded a sufficient opportunity to be heard, and that the Bankruptcy Court erred in finding that Barclays took LBI's assets free and clear of any interests third parties had in those assets.

The District Court affirmed the Sale Order, holding that there was sufficient evidence to find that Barclays was a good faith purchaser, that under Section 363(m) of the Bankruptcy Code any challenge to the sale, other than to Barclays' status as a good faith purchaser, was moot, and that because Bay Harbour did not seek and receive a stay pending its appeal, Section 363(m) precluded it from challenging anything other than whether Barclays was a good faith purchaser. *See generally In re Lehman Bros. Holdings Inc.*, 415 B.R. 77, 84 (S.D.N.Y. 2009).

[8120] Examiner's Interview of Harvey R. Miller, Lori Fife and Thomas Roberts, Feb. 3, 2009; Examiner's Interview of Saul Burian, Sept. 29, 2009, at p. 5.

[8121] *See* letter from Jamie Dimon, JPMorgan, to John Varley, Barclays, re: Settlement Discussion (Oct. 11, 2008) [BCI-CG-00059720].

accounts against LBI's obligations to JPMorgan.[8122] Barclays was not yet aware that JPMorgan had applied the $7 billion JPMorgan had advanced for Barclays' benefit in connection with the Replacement Transaction against LBI's box loan.

On Sunday, September 21, negotiations between Barclays and JPMorgan reached a breaking point.[8123] To resolve the dispute, the FRBNY hosted a conference call beginning around 3 p.m., which included, among others, the FRBNY, Lehman, the Creditors Committee, DTCC, the SEC, JPMorgan and Barclays, as well as numerous counsel and financial advisors.[8124] The conference call continued on-and-off through most of the night.

During the call, Heidi Miller of JPMorgan spoke of a "problem" involving $7.4 billion.[8125] Stephanie Heller of the FRBNY told the Examiner that the FRBNY and Barclays' representatives participating in the call understood that Miller was referring to the $7 billion that JPMorgan had deposited into an account for the benefit of Barclays on Friday, September 19, in connection with the Replacement Transaction.[8126] According to Heller, she later concluded that there was a misunderstanding: Miller was

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[8122] *See* e-mail from Philip Mindlin, Wachtell, to James W. Giddens, SIPA Trustee, *et al.* (Sept. 20, 2008) [BCI-CG00025435].

[8123] Examiner's Interview of Stephanie A. Heller, July 8, 2009; *see* e-mail from Archibald Cox, Jr., Barclays, to Rich Ricci, Barclays, *et al.* (Sept. 21, 2008) [BCI-EX-00081149] (stating that there was a major issue with JPMorgan).

[8124] Examiner's Interview of Stephanie A. Heller, July 8, 2009; e-mail from Alastair Blackwell, Lehman, to Jennifer Becker, Lehman (Sept. 21, 2008) [LBEX-SIPA 005309] ("I am in a room with fed/dtc/sec/jp morgan and barcap. Sucks soooooo bad. This deal is coming down to clearing."); Examiner's Interview of Harvey R. Miller, Apr. 23, 2009, at p. 14.

[8125] Examiner's Interview of Stephanie A. Heller, July 8, 2009.

[8126] *Id.*

referring to a $7.4 brokered loan between JPMorgan and Lehman that JPMorgan wanted Barclays to assume, rather than the $7.0 billion relating to the Replacement Transaction.[8127]

During the early morning hours of Monday, Barclays and JPMorgan reached an apparent resolution of their disputes, which was memorialized in a Services and Settlement Agreement dated as of September 22, 2008.[8128] The Services and Settlement Agreement provided that JPMorgan would continue to clear and settle transactions for LBI in order to facilitate the SIPA Trustee's liquidation of the broker/dealer.[8129] The Services and Settlement Agreement also provided that Barclays would have no interest in cash, securities or other property in LBI's clearance and other accounts at JPMorgan.[8130] Earlier drafts of the Services and Settlement Agreement had provided that Barclays would pay JPMorgan $7.4 billion for LBI securities that JPMorgan asserted were worth $8.55 billion.[8131] The final version of the Services and Settlement Agreement

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[8127] *Id.*; *see also* e-mail from Stephanie A. Heller, FRBNY, to Gerard LaRocca, Barclays, *et al.* (Sept. 25, 2008) [BCI-EX-00077452] (explaining her belief that there was a misunderstanding between Barclays and JPMorgan).

[8128] *See* Services and Settlement Agreement among JPMorgan Chase Bank, N.A., Barclays Capital, Inc., James W. Giddens as Trustee for the Liquidation of Lehman Brothers Inc., the Securities Investor Protection Corporation, and Lehman Brothers Holdings Inc. (Sept. 22, 2008) (the "Services and Settlement Agreement").

[8129] *Id.* § 1.

[8130] *Id.* § 2.

[8131] *Compare* Services and Settlement Agreement [Draft] (Sept. 22, 2008) [BCI-CG00027059] *with* Services and Settlement Agreement [Draft] (Sept. 22, 2008) [BCI-CG00027292] and Services and Settlement Agreement [executed]; *see also* e-mail from Nathaniel Hartley, Barclays, to Stephen King, Barclays, *et al.* (Sept. 22, 2008) [BCI-EX-(S)-00039229] (providing description of the $8.55 billion of securities that Barclays would purchase, which included RACERS).

did not include a purchase of securities by Barclays, apparently because Barclays had determined that part of the $8.55 billion was the RACERS security position with a marked value of $5 billion, which Barclays did not believe was worth $5 billion, and did not want.[8132]

Early in the morning on September 22, Don Donahue, CEO of the DTCC, received a call from either the SEC or the FRBNY.[8133] Donahue was informed that JPMorgan and Barclays had resolved their dispute, and JPMorgan would continue to settle LBI's trades. However, the $6 billion in RMBS were no longer available for the DTCC to use as collateral for its clearing activities.[8134] Donahue was told that the DTCC would only receive $250 million in cash to secure clearing. DTCC nonetheless decided to clear LBI's trades through Wednesday, September 24, which gave the parties enough time to consummate the sale transaction.[8135]

(2) The Committee's Role

What the Creditors Committee was told about the sale transaction and the changes to the transaction between the APA and the sale closing, and whether the Creditors Committee consented to the transaction that closed on Monday, September 22, are disputed issues in the ongoing litigation relating to the sale transaction. As

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[8132] Transcript of deposition testimony of Harvey R. Miller, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Jan. 7, 2010, at p. 27.

[8133] Examiner's Interview of Isaac Montal, May 19, 2009, at p. 7.

[8134] *Id.*

[8135] *Id.*

explained above, the Examiner is not reaching any conclusions regarding those factual disputes, but sets forth below facts pertinent to the Creditors Committee's role in the sale transaction.

On Thursday, September 18, Seery, Shapiro, Miller and Richard P. Krasnow (a partner at Weil) met with Burian, Bradley Geer, Eric Siegert and Michael Fazio of Houlihan, and Michael C. Eisenband and other representatives of FTI, another financial advisory firm retained by the Creditors Committee.[8136]

Seery testified that, during the meeting, the participants discussed "the deal, . . . [t]he risk in the market, . . . [t]he transfer of assets."[8137] According to Seery, "it was a diligence meeting on their part where they asked a lot of questions."[8138]

Burian described the September 18 meeting to the Examiner as a "big picture" meeting.[8139] Burian stated that he came to the meeting with a prepared list of questions regarding the transaction.[8140] According to Burian, Krasnow walked the group through the transaction.[8141] Burian advised the Examiner that very little explanation was provided regarding the securities positions to be transferred, apart from a "balance

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[8136] Transcript of deposition testimony of James P. Seery, Jr., *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 3, 2009, at pp. 119-20; Examiner's Interview of Saul Burian, Sept. 29, 2009, at p. 2; transcript of deposition testimony of Saul Burian, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Dec. 17, 2009, at pp. 15, 198.

[8137] Transcript of deposition testimony of James P. Seery, Jr., *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 3, 2009, at p. 120.

[8138] *Id.*

[8139] Examiner's Interview of Saul Burian, Sept. 29, 2009, at p. 2.

[8140] *Id.*

[8141] *Id.*

sheet" document that was distributed that included totals of $70 billion on one side and $68 billion on the other, and included contract cure and employee cost estimates.[8142]

Burian testified that although the Houlihan team asked specific questions during the meetings, it did not receive sufficient details.[8143] In addition, Burian advised the Examiner that, during the September 18 meeting, there was no discussion of modification of the transaction to convey securities to Barclays through a repo transaction (*i.e.*, the Replacement Transaction).[8144]

On Friday, September 19, prior to the sale hearing, Seery participated in a call with Creditors Committee advisors from Houlihan and Milbank.[8145] Seery testified that during the call, he discussed with the Creditors Committee advisors several aspects of the sale transaction, including: (1) the structure of the Replacement Transaction and using the transaction as a mechanism to transfer assets to Barclays;[8146] (2) that the repo with Barclays would be terminated at the closing, leaving Barclays with the securities

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[8142] *Id.;* transcript of deposition testimony of Saul Burian, *In re Lehman Bros. Holdings Inc.,* Case. No. 08-13555, Bankr. S.D.N.Y., Dec. 17, 2009, at pp. 198-04. Seery testified that "[t]here was definitely discussion of assets," but did not recall specifics. Transcript of deposition testimony of James P. Seery, Jr., *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 3, 2009, at pp. 121-22.

[8143] Transcript of deposition testimony of Saul Burian, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Dec. 17, 2009, at pp. 203-04; Examiner's Interview of Saul Burian, Sept. 29, 2009, at p. 3.

[8144] Examiner's Interview of Saul Burian, Sept. 29, 2009, at p. 3. Seery testified that he did not recall whether the Replacement Transaction was discussed during the September 18 meeting. Transcript of deposition testimony of James P. Seery, Jr., *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 3, 2009, at p. 122.

[8145] Transcript of deposition testimony of James P. Seery, Jr., *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 3, 2009, at p. 126.

[8146] *Id.* at pp. 126, 128-29. Seery testified that, as of the conference call on September 19, the Committee already was aware that Barclays had "stepped into the shoes" of the FRBNY through a repo, although he did not know how they knew. *Id.* at p. 127.

that had been pledged as collateral;[8147] (3) the haircut on the repo collateral (the difference between what Barclays advanced in cash and the market value of the securities pledged under the repo);[8148] and (4) that Barclays was concerned about the value of the securities that had been received under the repo, and that Lehman was attempting to identify additional assets to transfer to Barclays.[8149]

Burian's notes from the September 19 call appear to refer to a "Collateralized Repo of Barclays Fed Loan," and to "$50.65 billion Assets" and "Total extension $45.5 B."[8150] Those notes, however, were crossed out.[8151] Burian testified that he was told either on that call or in a follow up call on September 19, that the information contained in that portion of his notes was incorrect.[8152] Burian's notes from another subsequent call refer to "45.5 Long" and "Loan @ $45.5."[8153]

Shortly after midnight on September 20, the Court entered the Sale Order.[8154] The Sale Order provided, in part:

[8147] *Id.* at pp. 130-31.

[8148] *Id.* at p. 131.

[8149] *Id.* at pp. 114, 126-27, 132.

[8150] Transcript of deposition testimony of Saul Burian, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Dec. 17, 2009, at pp. 226-40; Saul Burian, Houlihan, handwritten notes of Saul Burian (Sept. 19, 2008), at p. 3 [Deposition Exhibit 472B].

[8151] Transcript of deposition testimony of Saul Burian, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Dec. 17, 2009, at pp. 226, 240.

[8152] *Id.* at pp. 237, 239-42; Saul Burian, Houlihan, handwritten notes of Saul Burian (Sept. 19, 2008), at p. 4 [Deposition Exhibit 472B].

[8153] Examiner's Interview of Saul Burian, Sept. 29, 2009, at p. 4; transcript of deposition testimony of Saul Burian, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Dec. 17, 2009, at pp. 239-42.

[8154] Order Under 11 U.S.C. §§ 105(a), 363, and 365 and Federal Rules of Bankruptcy Procedure 2002, 6004 and 6006 Authorizing and Approving (A) the Sale of Purchased Assets Free and Clear of Liens and Other

> The Purchase Agreement and any related agreements, documents or other instruments may be modified, amended or supplemented by the parties thereto, in a writing signed by such parties, and in accordance with the terms thereof, without further order of the Court, provided that any such modification, amendment or supplement does not have a material adverse effect on the Debtors' estates and has been agreed to between the Committee, the Debtors and the Purchaser.[8155]

There were a limited number of meetings among the Creditors Committee, Lehman and Barclays on Saturday, September 20, and there does not appear to be any significant disagreement about any of the communications that occurred that day.

Seery testified that, on Sunday, September 21, he "spent a lot of time" with the Creditors Committee advisors and Weil.[8156] According to Seery, they discussed the marked value of the assets that were being transferred to Barclays in connection with the Replacement Transaction, and how that marked value compared to the amount of cash that Barclays advanced.[8157] Seery testified that the difference between the marked value they discussed on the call and the $45 billion Barclays paid in connection with the Replacement Transaction was a "significant amount of money."[8158]

Burian advised the Examiner that on Sunday, he was told that there was not enough value in the securities that had been transferred to Barclays in connection with the Replacement Transaction, and that additional "B-list" assets therefore were being

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Interests and (B) Assumption and Assignment of Executory Contracts and Unexpired Leases, Docket No. 258, *In re Lehman Bros. Holdings Inc.,* No. 08-13555 (Bankr. S.D.N.Y. Sept. 20, 2008).

[8155] *Id.* at p. 21 (¶ 25).

[8156] Transcript of deposition testimony of James P. Seery, Jr., *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 3, 2009, at pp. 147-49.

[8157] *Id.*

[8158] *Id.* at pp. 149-50.

identified to "fill up" Barclays.[8159] Burian also advised the Examiner that on Sunday evening, he demanded from Miller a complete description of the transaction.[8160] Miller called in Klein, and Klein provided Burian with an explanation of the deal, in part by writing on a manila folder.[8161] Roberts and Fazio also participated in that discussion.[8162]

Burian advised the Examiner that Klein stated that what he sketched on the folder "was the deal," and that "none of the details mattered."[8163] According to Burian, Klein said that the securities and cash transferred to Barclays in connection with the Replacement Transaction were marked as of Friday at $49.9 billion, but that the marked value as of Sunday was between $44 billion and $45 billion, and that the $45 billion mark was "charitable." Burian also advised the Examiner that Klein stated that additional assets totaling $1.9 billion, which were not originally contemplated to be transferred, were now included in the transaction, and that the additional $1.9 billion in assets brought the total assets being transferred to about $47 billion.[8164] According to Burian, Klein said that Barclays would "forgive" Lehman's $45 billion in "repo debt"

[8159] Examiner's Interview of Saul Burian, Sept. 29, 2009, at p. 6.

[8160] *Id.* at p. 7.

[8161] *Id.;* Michael Klein, consultant retained by Barclays, Manila Folder [Deposition Exhibit 3388]; *see also* transcript of deposition testimony of Saul Burian, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Dec. 17, 2009, at pp. 138, 244; transcript of deposition testimony of Michael Klein, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 12, 2009, at pp. 161-63.

[8162] Examiner's Interview of Saul Burian, Sept. 29, 2009, at p. 7; transcript of deposition testimony of Saul Burian, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Dec. 17, 2009, at pp. 138-39, 254-55.

[8163] Examiner's Interview of Saul Burian, Sept. 29, 2009, at p. 7.

[8164] *Id.* at pp. 7-8; transcript of deposition testimony of Saul Burian, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Dec. 17, 2009, at p. 255.

and assume $4.25 billion in additional liabilities, bringing the total liabilities to $49.75 billion.[8165] Burian further advised the Examiner that Klein stated that this deal was $2 to $2.5 billion better for Lehman than the original deal.[8166]

On Sunday, September 21, according to Burian, he also learned that the Debtors planned to transfer excess 15c3-3 cash and securities to Barclays.[8167] Burian indicated that he was upset by this information and demanded that Miller and Krasnow explain what, if any, excess 15c3-3 assets were going to Barclays.[8168] During their discussion, Krasnow told Burian that Barclays was to receive some excess 15c3-3 assets from Lehman.[8169] Burian indicated that he demanded to see the terms of the purchase agreement, became frustrated and told Miller that he would not sign off on the deal.[8170] Burian explained that Miller informed him that he would propose a compromise with Barclays in which Lehman would retain all the excess 15c3-3 cash, and Barclays would get the excess 15c3-3 securities.[8171] According to Burian, he did not learn until the

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[8165] Examiner's Interview of Saul Burian, Sept. 29, 2009, at p. 8; transcript of deposition testimony of Saul Burian, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 12, 2009, at pp. 135-37 (explaining that he was told the $7 billion in cash was included in the transaction as a substitute for securities that, for whatever reason, did not transfer to Barclays).

[8166] Transcript of deposition testimony of Michael Klein, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Sept. 12, 2009, at pp. 161-63.

[8167] Examiner's Interview of Saul Burian, Sept. 29, 2009, at p. 6.

[8168] *Id.*

[8169] *Id.* at p. 6; transcript of deposition testimony of Saul Burian, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Dec. 17, 2009, at pp. 307-09.

[8170] Examiner's Interview of Saul Burian, Sept. 29, 2009, at p. 6.

[8171] *Id.* at p. 6.

following morning, after the sale had closed, that this compromise had worked its way into the final sale transaction.[8172]

Dennis C. O'Donnell, in his capacity as a Rule 30(b)(6) witness for Milbank, testified that Milbank was provided with a draft of the "clarification letter" on Saturday afternoon, and while Milbank may have seen subsequent drafts on Sunday night and early Monday morning, "primarily [Milbank] had access to only the draft provided on Saturday."[8173] Burian testified that he received a draft letter on "Saturday night and Sunday morning."[8174]

Late Sunday and into Monday morning, the Creditors Committee's advisors, Lehman and Weil discussed whether (a) it was necessary for the Creditors Committee to consent to the deal as set forth in the draft Clarification Letter; and (b) the Creditors Committee would provide that consent. The recollections of those involved in those communications diverge.

Miller testified that, in his view, the Clarification Letter represented in substance the deal that the Court approved on Friday evening, September 19, and that therefore there was no need to return to the Court for approval.[8175] He stated that there was a

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[8172] *Id.* at p. 6.

[8173] Transcript of deposition testimony of Dennis C. O'Donnell, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Jan. 6, 2010, at p. 58.

[8174] Transcript of deposition testimony of Saul Burian, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Dec. 17, 2009, at p. 80.

[8175] Transcript of deposition testimony of Harvey R. Miller, *In re Lehman Bros. Holdings Inc.,* Case No. 08-13555, Bankr. S.D.N.Y., Jan. 7, 2010, at p. 33; *see also* transcript of deposition testimony of Saul Burian, *In re*

discussion among Weil lawyers either late Sunday night or Monday morning about whether it was necessary to take the letter back to Judge Peck for further approval, and that they concluded it was not necessary to do so, because the letter did not change the deal that was presented to the Court.[8176]

Miller also testified that the Creditors Committee consented to the transaction that closed on Monday, September 22.[8177] According to Miller, as the Creditors Committee's legal and financial advisors left Weil between 3:00 a.m. and 5:00 a.m. on Monday, September 22, Burian advised him that: "[e]verything's fine, and going forward, if it's okay with you, it's okay with us," and Despins said, "[i]f you guys are satisfied with it, we're satisfied.[8178]

Burian advised the Examiner that, following a conference call with the Creditors Committee late on Sunday night, the Creditors Committee advisors left Lehman.[8179] Burian stated that as they left, he and Despins approached Miller, and Burian advised

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Lehman Bros. Holdings Inc., Case No. 08-13555, Bankr. S.D.N.Y., Dec. 17, 2009, at pp. 327-29 (testifying that Miller advised him that he did not need Creditors Committee consent).

[8176] Transcript of deposition testimony of Harvey R. Miller, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Jan. 7, 2010, at p. 49; *see also* transcript of deposition testimony of James P. Seery, Jr., *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Sept. 3, 2009, at p. 156 (testifying that the Creditors Committee's advisors approved the transaction).

[8177] Transcript of deposition testimony of Harvey R. Miller, *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555, Bankr. S.D.N.Y., Jan. 7, 2010, at pp. 29, 101-02.

[8178] *Id.*

[8179] Examiner's Interview of Saul Burian, Sept. 29, 2009, at p. 8.

Miller that the Creditors Committee was not signing off on the deal, even though everything Burian had heard "sounded okay."[8180]

Despins also advised the Examiner that the Creditors Committee never consented to the transaction that closed on Monday.[8181] According to Despins, in the early morning hours of Monday, the Creditors Committee legal and financial advisors departed Lehman's offices following a conference call with the Creditors Committee.[8182] Despins advised the Examiner that, as the Creditors Committee advisors left Lehman, they made it very clear to Miller and Roberts that the Creditors Committee was not consenting to the transaction.[8183] Despins explained that the advisors deliberately left the closing to prevent their presence from being interpreted as consent.[8184]

Over the early morning hours on Monday, Barclays, Lehman, JPMorgan and the SIPA Trustee reached sufficient consensus to close the sale and finalize the remaining sale documents, including the Services and Settlement Agreement and the Clarification Letter.[8185] The Clarification Letter modified the agreement between Barclays and Lehman in several ways. The Clarification Letter deleted from the definition of "Purchased Assets" the approximately $70 billion in "Long Positions" and added:

[8180] *Id.*

[8181] Examiner's Interview of Luc Despins, Nov. 23, 2009, at p. 2.

[8182] *Id.*

[8183] *Id.*

[8184] *Id.*

[8185] E-mail from Michael Klein, consultant retained by Barclays, to Rich Ricci, Barclays, *et al.* (Sept. 22, 2008) [BCI-EX-00080663]; Examiner's Interview of Harvey R. Miller, Apr. 23, 2009, at p. 14.

(1) the securities specified on "Schedule A," which were the securities that had been transferred to Barclays in connection with the Replacement Transaction,[8186] (2) $1.9 billion in unencumbered assets specified on "Schedule B,"[8187] (3) exchange-traded derivatives and collateralized short term agreements,[8188] (4) LBI's customer accounts and related assets,[8189] (5) $769 million of LBI's excess 15c3-3 securities,[8190] (5) the equity of Lehman Brothers Canada, Inc., Lehman Brothers Sudamerica SA and Lehman Brothers Uruguay SA,[8191] and (6) the prime brokerage business and accounts.[8192] In addition, the Clarification Letter terminated the repo agreement executed in connection with the Replacement Transaction.[8193]

The sale transaction between Barclays and Lehman closed around 8:00 a.m. on Monday morning.[8194] Sometime before 8:00 a.m., the deed to 745 Seventh Avenue was recorded. Barclays wired the money for the buildings to Lehman, and wired $250 million to DTCC to collateralize Lehman trades that were in the process of clearing.[8195]

[8186] Clarification Letter, at p. 1 (¶ 1(a)(ii)(A)).
[8187] *Id.* at pp. 1-2 (¶ 1(a)(ii)(B)).
[8188] *Id.* at p. 2 (¶ 1(a)(ii)(C)).
[8189] *Id.* at p. 4 (¶ 8).
[8190] *Id.*
[8191] *Id.* at p. 2 (¶ 1(a)(iii)).
[8192] *Id.* at p. 2 (¶ 1(a)(iv)).
[8193] *Id.* at p. 5 (¶ 13).
[8194] Examiner's Interview of Harvey R. Miller, Apr. 23, 2009, at p. 14; Examiner's Interview of Lindsee P. Granfield and Robert Davis, March 3, 2009, at p. 4.
[8195] *Id.*

(3) December 2008 Settlement Between Trustee, Barclays and JPMorgan

Following the closing of the sale transaction, Barclays discovered that JPMorgan had moved the $7 billion advanced in connection with the Replacement Transaction and applied it against LBI's box loan. Barclays and JPMorgan engaged in an intense series of discussions, mediated in part by the FRBNY, and in December 2008, reached a settlement of their disputes. That settlement was memorialized in a Settlement Agreement among Barclays, JPMorgan and the SIPA Trustee.[8196] The Settlement Agreement provided that JPMorgan would deliver to Barclays: (1) the LBI securities that had been pledged to the FRBNY on Wednesday evening, September 17, and which JPMorgan retained when it locked down LBI's accounts on Friday, September 19 (those securities were identified on Annex A to the Settlement Agreement); and (2) $1.25 billion in cash from LBI's account at JPMorgan to compensate it both for undelivered FRBNY program securities that had been liquidated by JPMorgan, and the decline in the value of the undelivered securities that JPMorgan did not liquidate.[8197]

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To assist the parties and the Court, the Examiner has set forth this narrative of the facts he has developed relating to the sale transaction. However, in light of the pending litigation between the Debtors, the SIPA Trustee and the Creditors Committee,

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[8196] Settlement Agreement among JPMorgan, Barclays, and the SIPA Trustee, at pp. 2-3, Docket No. 387, *In re Lehman Bros. Inc.*, No. 08-01420 (Bankr. S.D.N.Y. Dec. 5, 2008).
[8197] *Id.*

on the one hand, and Barclays on the other, relating to the sale transaction, including the extensive discovery still underway, the Examiner has not reached any conclusions regarding whether LBHI or LBI have colorable claims arising from the acts and events relating to the sale transaction. The Examiner expects that in the course of that litigation the parties will continue to develop additional facts pertinent to this narrative.

Respectfully Submitted,

Anton R. Valukas

Examiner

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