

**ROLE OF CORPORATE GOVERNANCE IN THE CASE OF  
LEHMAN BROTHERS**

I tried to write this article or work, let's say masterpiece, by looking through lots of internet website about Lehman Brothers and it's bankruptcy, as well as, by scrutinizing the material that we received in the email from our lecturer. By using my analytical thinking ability, tried as much as I can, to analyze. So, highly recommend reading it, it is a magic story for lovers of corporate governance. Now in the world where big monster corporations are ruling developed economies and their revenue, assets getting even more and more than GDPs of some countries. Today world economy shows that monster corporations and banks are ruling the economy not governments. We are living in world they created. My work consists of two logically connected parts with their glossary at the end: history and reasons of the failure of Lehman Brothers and the reaction and behavior of government, investors, rivals as well as me.

I had assumed that the collapse of Lehman in September 2008 was the consequence of a fatal combination of intricate accounting rules, complex derivatives, greed, excessive leverage and the complacency of rating agencies. It was also the trigger for a chain reaction across other financial institutions which suffered from the panic and liquidity freeze that followed. I have looked through several internet materials about Lehman Brothers scandal and they show instead the amazing similarities between the collapses of Enron in 2001 and Lehman Brothers in 2008. In Enron, the misbehavior of top executives, such as, Ken Lay, Jeff Skilling and Andrew Fastow, was possible because of the inaction of both the board and the auditing firm. By means of the pre-pay transactions, these Enron executives managed to transform increases in leverage into positive cash flows, without any balance sheet impact and with a very simple off-balance sheet structure. The court examiner showed that, in the absence of the pre-pay transactions, Enron's debt-to-assets ratio would have been 45% instead of the reported 38% in 1999<sup>1</sup>.

Lehman's equivalent of the pre-pay transactions is the Repo 105<sup>2</sup>, a fascinating term that is going to become the new example of how to fool analysts and investors. I foresee some cases and articles written on Repo 105. Through these transactions, Lehman Brothers managed to reduce leverage on the right-hand side of the balance sheet and, at the same time, reduce assets on the left-hand side.

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<sup>1</sup> Corporate governance; 1933, Robert A.G. Monks and Nell Minow. – 5<sup>th</sup> edition, p. 145.

<sup>2</sup>[Lehman%20Brothers%20-%20Wikipedia.html](http://Lehman%20Brothers%20-%20Wikipedia.html).

Repo 105 transactions doubled between late 2006 and May 2008, were known inside the company, exceeded the firm's self-imposed limits and typically happened at the end of each quarter, when financial information had to be released. Simply put, the Repo 105 program transformed a financing transaction into an asset disposal. In a typical repo, a financial institution borrows funds using securities (usually treasuries) as collateral. If a bank has securities for \$105, it will borrow \$100 from another institution presenting the securities as a guarantee for the short term loan. The \$5 difference is called "haircut"<sup>3</sup> and is the price for both the liquidity of the bond and its risk. Repo markets are not new – they were born at the beginning of the 20<sup>th</sup> century – and they have served a very legitimate purpose.

However, repo accounting is puzzling, to say the least. The collateral stays on the borrower's books. The cash injection increases the bank's balance sheet, as if assets were duplicated. Naturally, a liability arises for the borrowed amount, because at the maturity of the repo, the borrower returns the cash, plus interest, and gets the securities back. Originally, repos serve a very desirable objective of making money by circulating, lending and investing it. A repo can also be structured as a simple asset disposal, in which a financial institution sells a security for a price. To perfectly replicate the repo, the institution will buy a similar security sometime later, and will have enjoyed the returns on the cash invested during that period. Such a transaction poses several problems. First, the security may be sold at a discounted price either because the market is not liquid enough, or because nobody wants those assets. Second, there is no guarantee that the repurchase of the securities will be possible at favorable prices. However, it has the advantage that, if successful, it allows the financial institution to raise capital which can be used to reduce its leverage, by getting rid of undesirable assets.

Magically, Lehman Brothers used repos reportedly for financing reasons, but accounted for them as asset disposals. In that way, Lehman circumvented the two problems mentioned in the previous paragraph and used the repo proceeds to reduce its leverage right before the disclosure period. These repo proceeds amounted to about \$50 billion by September 2008 – which is more than the amount of General Motors' outstanding bonds when it went bankrupt and is one-tenth of Switzerland's GDP in 2008<sup>4</sup>. Lehman's reported leverage dropped from 13.9 times to 12.1 times in the second quarter of 2008<sup>5</sup>. Sounds like Enron.

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<sup>3</sup> Abid, G. Khan, B. Rafiq, Z. and Ahmad, A. (2014). Theoretical Perspective of Corporate Governance. *Bulletin of Business and Economics*, 3(4), p. 166.

<sup>4</sup> [Case%20Study%20The%20Collapse%20of%20Lehman%20Brothers%20%20Investopedia.html](#).

<sup>5</sup> Corporate Governance: A Summary Review on Different Theory Approaches. *International Research Journal of Finance and Economics*, ISSN 1450-2887 Issue 68 (2011), p. 98.

Problem is it failed to disclose this. And because of the legal constraints in the US on the treatment of repo transactions as asset disposals, Lehman Brothers engineered them through its UK subsidiary. They were clearly used as leverage-reducing transactions because otherwise Lehman could have secured short-term financing at much lower rates — a Repo 105 implies a cost of financing of five percent, plus interest! Enron also used pre-pays to hide leverage. And the question may appear, who knew and what is their responsibility?

The court examiner states that Lehman's CEO Dick Fuld denies "any recollection of Lehman's use of Repo 105 transactions". At the same time, he recognizes that "Fuld's denial of recollection must be weighed by a trier of fact against other evidence". In particular, the confirmation by Bart McDade (Lehman's latest president) that he had specific discussions with Fuld about Lehman's Repo 105 usage in June 2008. Despite their denial, the report also presents evidence against three former Lehman CFOs – Chris O'Meara, Erin Callan and Ian Lowitt. However, with respect to the board of directors it is also clear that "without exception, former Lehman directors were unaware of Lehman's Repo 105 program and transactions". Exactly like Enron.

Finally, there is controversy on the role of Ernst & Young<sup>6</sup> and its knowledge of the Repo 105 program. The lead partner in the auditing firm states that "Ernst & Young did not approve the Accounting Policy it rather became comfortable with the Policy for purposes of auditing financial statements". Interestingly, when the examiner asked the auditor whether Ernst & Young should have considered the possibility that strict adherence to accounting rules could nonetheless lead to a material misstatement in Lehman's publicly reported financial statements, he refrained from comment. It brings back to memory the images of Andersen's auditors shredding incriminating evidence in the Enron scandal. The examiner's conclusion is devastating: "There is sufficient evidence to support a finding that claims of breach of fiduciary duty exist against Fuld, O'Meara, Callan and Lowitt and colorable claim of professional malpractice exists against Ernst & Young". He also adds some evidence of questionable practices by JP Morgan with respect to its requests for collateral.

The weeks that followed after Lehman Brothers filed for bankruptcy, are among the most dramatic in U.S. history. They led to a massive government intervention in the financial system—an intervention that will likely change that system forever. Many people say that letting Lehman fail was the mistake that caused the financial crisis. To them, the lesson is that the government should never allow any "systemically important" financial institution to fail. If only Lehman had

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<sup>6</sup>[Bankruptcy%20of%20Lehman%20Brothers%20-%20Wikipedia.html](http://Bankruptcy%20of%20Lehman%20Brothers%20-%20Wikipedia.html).

been bailed out, the story goes, we could have avoided much of a 45% drop in the S&P 500, a 4% drop in output, the rise in unemployment to 9.7% from 6.2%, and the \$784 billion "stimulus" to top off a \$1.59 trillion deficit<sup>7</sup>. Some competitors of Lehman Brothers think this story is false. They believe that Lehman failure was not an isolated event. It was a movement in a dramatic crescendo of failures. Two weeks prior, on Sept. 7, the government took over Fannie Mae and Freddie Mac, wiping out much of their shareholder equity. On Sept. 16, the government bailed out AIG, lending it \$85 billion. On Sept. 25, Washington Mutual, the nation's sixth-largest bank, was seized by the FDIC. On Sept. 29, Wachovia, the nation's seventh-largest bank, was sold to avoid a similar fate. All this would have happened without Lehman. Meanwhile, the Federal Reserve and the Treasury Department went to Congress to ask for \$700 billion for the Troubled Asset Relief Program (TARP)<sup>8</sup>.

Why? In effect, these speeches amounted to "The financial system is about to collapse. They can't tell you why. We need \$700 billion. We can't tell you what we're going to do with it."<sup>9</sup> That's a pretty good way to start a financial crisis. Subsequent reporting explained why they did it: The Fed and Treasury had felt for months that they needed legal authority to do more bailouts, and a crisis might get Congress to vote for it. But at the time, all the public saw was that US government was in a complete panic. People inferred that the banks must be in much worse trouble than they thought. The ban on short sales of bank stocks the previous week could only reinforce that impression. It did not help that the TARP was such a transparently bad idea. The Fed and Treasury soon figured that out, settling on equity "injections" and a bank-debt guarantee instead. Floating a bad idea does not instill confidence. Would a Lehman bailout have averted a panic? The news would still be that Lehman failed, and markets knew bailouts would not last forever. After all, the Bear Stearns rescue in February had just postponed worse trouble.

More deeply, Lehman's lesson cannot be that the government must always bail out every large financial institution. From the 1984 failure of Continental Illinois bank to the S&L crisis of the late 1980s, the Latin American bond defaults of the 1990s, the 1997 Asian crashes, the 1998 collapse of the Long-Term Capital Management hedge fund and now this mess, financial institutions are taking more and more risks, but their bondholders keep getting rescued. This crisis pushed US government close to its fiscal limits. The next one will be beyond what even US government can contain. The big banks know the government will bail them out, and they are already bigger, more global, more integrated and "systemic" than

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<sup>7</sup>[Case%20Study%20The%20Collapse%20of%20Lehman%20Brothers%20%20Investopedia.html](#).

<sup>8</sup>[Case%20Study%20The%20Collapse%20of%20Lehman%20Brothers%20%20Investopedia.html](#).

<sup>9</sup>[Case%20Study%20The%20Collapse%20of%20Lehman%20Brothers%20%20Investopedia.html](#).

ever. They are making huge trading profits—profits that must someday turn to losses. If brokerage and banking are "systemically important," they cannot be married to proprietary trading. Yet the financial-reform plans do not even talk about breaking up this marriage—they hope simply to regulate the behemoths instead. The blame-it-on-Lehman story leads to a dangerous complacency. If we can persuade ourselves that the fault was just one policy mistake, forced on the feds by silly legal restrictions and not enough bailout power, everything can go back to the cozy way it was before.

This is a convenient story for large banks that dominate the lobbying and communication effort. And it absolves the Fed and Treasury of facing up to their long string of policy mistakes. We don't pretend that we could have done any better. That's the point: A system with so much power vested in so few people, with so few rules, in which crises are managed with 2 a.m. conference calls, cannot possibly do better no matter how well the people at the top. Repeating the Lehman story lets us all ignore the fact that this system cannot go on.

There are several lessons that the Lehman case teaches us. First is that perhaps most of the articles and books that have been published analyzing the 2008 financial crisis and the Lehman collapse in particular have been misguided. Only now we are starting to see that at the bottom of all the bank failures there is — simply — fraud. Which takes me to the second lesson: we do not learn from history. The basic structure and the players in the Lehman collapse resemble too closely some examples from the past (Enron, WorldCom). Finally, Lehman Brothers was not taken down by ill intentioned short sellers and market manipulators. It was bankrupt well before September 2008 and thanks to financial markets it was revealed as the company it truly was.

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## **Glossary**

**Repo** - a contract in which the vendor of a security agrees to repurchase it from the buyer at an agreed price

**Pre-pay** - to pay for in advance

**Cash flow** - the total amount of money being transferred into and out of a business, especially as affecting liquidity

**Balance sheet** - a statement of the assets, liabilities, and capital of a business or other organization at a particular point in time, detailing the balance of income and expenditure over the preceding period

**Off-balance sheet** – it is a statement of the assets, liabilities, and capital of a business that is not detailed balance sheet

**Debt-to-assets** – a dependence or relation of the company's debt towards its assets.

**“Haircut”** - the difference between the rate of interest on funds lent and funds borrowed by a bank.

**Fiscal limits** – expenditure limits.