



## The Valukas Report on the Lehman collapse and e-discovery: Stratify and CaseLogistix win the day [UPDATED]

Mar 14th, 2010 | By Gregory P. Bufithis, Esq.



*Updated from our original March 13, 2010 post*

Friday saw the release of the 2,200-page report by Anton Valukas on the Lehman Brothers collapse. Valukas was appointed examiner by the U.S. Bankruptcy Trustee probing the reasons for Lehman's failure in September 2008.

*Note: Examiners in bankruptcy cases are appointed to investigate accusations of wrongdoing or misconduct. Their job is to determine whether creditors can recover more money in these cases, and their findings often serve as guides for more lawsuits and even regulatory action. Mr Valukas is a Jenner and Block lawyer who specializes in criminal law and business litigation.*

The report took one year and cost \$38 million and it paints a damning portrait of the role of Wall Street and London's financial center and the off balance-sheet trades used to mask Lehman's true financial condition.

The report is nine volumes and 2,200 pages but downloaded quite quickly to our iPad. We are spending most of weekend reading it.

## *Repo 105*

There is extensive media coverage of the report so we won't labor through all the details, and as we have previously reported there are a large number of civil lawsuits and government investigations underway, all employing a boatload of contract attorneys, accountants and forensics specialists. Preparation of the report required 70+ contract attorneys.

But in summary, the big item is the revelation of a particularly aggressive accounting practice, known internally as "Repo 105" that Valukas said helped the investment bank mask the true depths of its financial woes. Over hundreds of pages (all in [\*Volume 3\*](#) by the way), Valukas details the genesis of and the process behind Repo 105.

Based on standard repurchase agreements (repo) — short-term loans commonly used by many firms for daily financing needs, in which borrowers temporarily exchange assets in return for cash up front — Lehman took a particularly aggressive accounting approach to these transactions. The controversy stems from whether the agreements can be booked as a sale, or whether they should be treated as asset financings. Lehman used repos to temporarily park assets off its books to make its end-of-quarter debt levels look better than they did — while calling them sales instead of loans. So they temporarily removed securities inventory from the 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.

Repo transactions that Lehman (and other investment banks) use are normal to secure short-term financing. But 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. By recharacterizing the Repo 105 transaction as a "sale," Lehman removed the inventory from its balance sheet. So they reduced its publicly reported net leverage and balance sheet. 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. 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. Lehman never publicly disclosed its use of Repo 105 transactions, or its accounting treatment for these transactions.

You can see why Repo 105 would be a tempting thing in the midst of a brewing financial crisis. Leverage had become a focus of the ratings agencies and was widely thought to be an indicator of bank risk, which meant Lehman would have been hell-bent on reducing its leverage — at least publicly. At the same time prices for things like CMBS and subprime loans were falling and/or illiquid – Lehman could not have reduced its balance sheet simply by selling things off without incurring large losses. Hence the repo, which the bank increasingly used between 2007 and 2008 — even breaching its own internal cap on the repo's use (about \$22bn as of summer 2006).

### ***But there was a catch ...***

One catch. According to Valukas, no American law firm would sign off on its use. Enter Linklaters (a highly respected British law firm) who gives Lehman the answer it wanted: so long as the repos were conducted in London through the bank's European arm, and so long as the company took other cosmetic steps to make these transactions appear to be sales instead of financings, Linklaters determined that they would pass regulatory muster.

Linklaters reply to the report findings: the firm was not contacted by Valukas and its legal opinions were not criticized in the examiner's report as wrong or improper.

Valukas deems Richard Fuld (Lehman chairman and chief executive officer) "at least grossly negligent" in his role overseeing Lehman. Fuld's lawyer said my client "did not know what those transactions were — he didn't structure or negotiate them, nor was he aware of their accounting treatment." Although elsewhere in the report there is discussion of emails Fuld received with documents concerning the transactions, Fuld's attorney came up with what will be the #1 excuse for all CEOs going forward: Fuld "did not use a computer" and "he cannot open attachments on his BlackBerry".

### ***The e-discovery elements***

But the most intriguing part of the report we have read concerns the sheer size of the data and the search methodology/software used in examining the documents. Valukas's report was a mammoth task involving e-mails, reports, data sets and interviews. Answering the questions 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 (who took over a large part of Lehman operating units); by the time of the Valukas' 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.

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. It was 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, Valukas directed his financial advisors to identify and acquire an in-depth understanding of the most promising of the systems.

How the review was conducted:

1. 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.
2. Valukas 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, Valukas requested and received hard copy documents from Lehman and both electronic and hard copy documents from numerous third parties and government agencies.

3. 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 electronic form and are maintained on two computerized databases, Stratify and CaseLogistix.
4. 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 Valukus sought and obtained the court's approval to retain contract attorneys. A group of more than 70 contract attorneys, supplemented by Jenner & Block attorneys, conducted first level reviews.
5. All second level (and beyond) reviews were performed by Jenner & Block attorneys or Duff & Phelps professionals. Valukus estimates that he has reviewed approximately 34,000,000 pages of documents in the course of his investigation.
6. The entire body of e-mail in the Stratify database — 4,439,924 documents, approximately 26 million pages— has been reviewed. Approximately 340,000 of the CaseLogistix documents — roughly eight million pages — have been reviewed.
7. Although a large number of the CaseLogistix documents were not reviewed, that database is fully searchable, and Valukus is reasonably confident that the repeated and focused searches applied against that database have discovered most if not all of the most relevant documents.
8. In most cases, documents were produced to Valukus under stipulated protective orders, which are described in Appendix 5 of the report. Subject to those orders, the document databases created remain a resource for the bankruptcy 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.

**Note:** details of the expenses including the cost of contract attorneys and search costs are detailed in the bankruptcy fee filings which will we include in further updates to this post. It will interesting to analyze what cost savings might have been possible had Valukas used such methodologies as Reconnind's predictive coding ([click here](#) and [click here](#)), or perhaps used Index Engines full content/metadata indexing platforms ([click here](#) and [click here](#)) to access each of Lehman's 2,600 software systems.

### ***Valukas smoothes way to legal action***

The Valukas report has armed the regulators and the plaintiff bar with vital information. And we still haven't seen the separate SEC report due out shortly. But there is little doubt his report will make it easier and cheaper for others to build their cases. The SEC and DOJ investigators have already indicated the Valukas' work will speed up the completion of their own report. They can analyse what the evidence shows or proves rather than cope with the burden of simply collecting the evidence — often the hardest task in a case of this size. This will help them to make a concrete determination whether there were false and misleading statements about Lehman's financial condition and whether or who they should charge, either on a civil or criminal basis.

The report may also help determine whether the Lehman bankruptcy estate can sue individuals to recover some of the firm's losses on behalf of its creditors. Litigation specialists suggested that the report might embolden the trustee for Lehman's estate to sue professional firms in an attempt

to recoup losses suffered by creditors. Posse List members will recall that after the 2005 collapse of Refco, an examiner's report helped prompt lawsuits against a number of the defunct commodities broker's legal and accounting advisers, as well as against individuals in the company.

One interesting note: Valukas met the SEC and the two US attorney offices (New York and New Jersey) investigating the case to establish protocols for clearing proposed interviews so as not to interfere with any ongoing investigations.

*Still to come ...*

The report makes fascinating reading on many levels. We are continuing our read. We will amend this post as more information is obtained especially anything we find regarding the e-discovery aspects.

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