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The Labours of Valukas - Document Review and the Lehmans Report

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Abstract: This article considers the immense task faced by those compiling the Valukas Report into the fall of Lehman Brothers. The report published in March 2010 gave a valuable insight into the collapse, examining the potential liability of senior figures both inside and outside Lehman Brothers. Of particular interest in the report were the techniques and methodology used by the investigators in the examination of electronically stored data. The article considers the context of the report, in particular the collapse of Lehman Brother and the aftermath. It explores the findings of the report and then considers how the investigators researched the huge quantity of electronic information. Finally, the article considers the significance of the report for the industry and in terms of broader issues of regulation and governance.

1. Introduction

This article considers the immense task faced by those compiling the Valukas Report on the fall of Lehman Brothers - arguably the most significant event of the recent banking crisis. The report published in March 2010 provides a valuable insight into the collapse, examining the potential liability of senior figures both inside and outside Lehman Brothers. However, the substantive nature of the report is not the primary focus of this article. It considers the techniques and methodology used by the investigators in the examination of electronically stored data. In addition, bearing in mind the extraordinary scale of this report, this article considers what it has actually achieved.

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2. The banking crisis and the fall of Lehman Brothers

Banking and financial crises, it is widely held, are more significant and more serious than crises and failures in other industries. There are a large number of reasons attributed to this, ranging from the pivotal function of banks as providers of liquidity to the far reaching effects that bank crises can have on the wider "real" economy. A full discussion of these reasons is not appropriate here, but one particular peculiarity of banking is highly relevant: the propensity of the failure in one institution to spread problems throughout the industry, causing other institutions to fail or sustain serious losses. This problem is thought to be particularly prevalent where the failing institution is large and/or highly interconnected with other institutions. The failure of the US investment bank Lehman Brothers in 2008 is a recent, and it is suggested, a classic example of this phenomenon.

Lehman Brothers filed for bankruptcy protection on Monday 15th September 2008. This was the largest bankruptcy filing in US corporate history. The subsequent panic in the financial markets and institutions occurred with frightening speed and threatened to bring the entire global financial system down. The system was only saved by unprecedented levels of governmental support. The Valukas report gives a flavour of the fall-out in the USA:

> "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. 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 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."[1]

It is the scale and ferocity of this fall-out that provides the backdrop to the Valukas report. It also explains the importance of the report and the intense interest in its findings.[2] The findings of the report are not central to this article however;[3] it is more concerned with the methodological nature of the report itself and specifically the part played by the treatment of electronically stored data.

3. The Research

The Valukas report was ordered by a bankruptcy court. The purpose of the investigation was therefore to provide ammunition for future claims on behalf of the estate, essentially clawing back as much money as possible for the creditors of Lehman Brothers. From the report it seems that plentiful supplies of ammunition may have been unearthed, principally but not solely relating to Lehman's use of a dubious accounting practice known as Repo 105. This practice is in the form of a contractual agreement to sell assets at the end of one accounting quarter, but also to buy back the same assets at the beginning of the next quarter. Repos 105's are distinctive due to their treatment as sales rather than loans in the accounts. The reason Lehman's entered into these contracts was to make its balance sheets appear more attractive to the rating agencies and therefore to the market as a whole.

Much of the investigation consisted of a rigorous and meticulous study of emails sent within, from and to Lehman Brothers. The fact that electronically created and stored data was central to the investigation is hardly novel. Neither is the fact that the focus of much of the investigation was on email correspondence involving the senior players involved. What is novel, however, is the sheer scale of the investigation.

As the title of this article intimates, the compilation of the Valukas report was a task of herculean proportions. The report itself is over 2200 pages in length – to put this in some sort of context, this is four times the length of the equivalent reports into the Enron scandal in 2002-2003[4]. It is published over five volumes, with another four volumes covering the 24 appendices. The table of contents alone covers 38 pages. The size of the report however is dwarfed by the amount of information actually collected by the compilers of the report. At their disposal, the investigators had a gigantic resource of electronic data:

[1] Valukas Report p. 14 Vol. 1, Sect. 1 (available at http://lehmanreport.jenner.com/ last accessed 28th September 2010)
[2] One of the best ways to view the fall-out is to view one of the media time-lines detailing the events of the days and weeks after Lehman Brothers collapsed (for example the Daily Telegraph at http://www.telegraph.co.uk/finance/financetopics/financialcrisis/6173145/The-collapse-of-Lehman-Brothers.html last accessed 25th October 2010)
[3] Although potentially devastating to several senior executives in Lehman Brothers and elsewhere.
[4] http://www.businessweek.com/news/2010-03-05/lehman-examiner-s-report-should-be-published-investors-say.html

> "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." 5

4. The available universe - how do you search 350 billion pages?

As 350 billion is clearly unmanageable, the investigators contented themselves with collecting 5 million documents, comprising a mere 40 million pages in total. The report estimates further that 34 million pages were fully reviewed in the course of the investigation. Arguably, this reduction is the most impressive feature of the report. Exactly how this was achieved therefore deserves particular attention.

Appendix five details the custodians identified by the examiner for investigation. There were 281 in total, many of whom would have been reasonably obvious "targets"- directors, senior executives, risk managers and audit officers.

In total there were 37 different searches made against these custodians. Within these 37 searches, thousands of different search terms were used. These are carefully documented over 124 pages in appendix five. These were all carefully structured, with full use made of Boolean operators. The search terms are many and varied. Many are couched in complex banking jargon, as one might expect; however, some are much more to the point. Amongst other terms, search 33 contains the following:

> "Shocked or speechless or stupid* or "huge mistake" or "big mistake" or dumb or "can't believe" or "cannot believe" or "serious trouble" or "big trouble" or unsalvageable or "too late" or ((breach or violat*) w/5 (duty or duties or obligation*)) or "nothing we can do" or uncomfortable or "not comfortable" or "I don't think we should" or "very sensitive" or "highly sensitive" or "very confidential" or "highly confidential" or "strongly disagree" or "do not share this" or "don't share this" or "between you and me" or "just between us" or ((can't or cannot or shouldn't or "should not" or won't or "will not") w/5 (discuss or "talk about") w/5 (email or e-mail or computer))[6]

These search terms attracted significant media comment and it is easy to see why. In the modern day world of the sound bite, they provide significantly better or at least more populist copy than the more traditional, prosaic vocabulary of banking and corporate terminology such as securitisations and credit default swaps. However, as has already been pointed out by at least one commentator[7] – these search terms were only used in one search – and only against one custodian – Mark Weber, a risk manager at Lehmans. Nevertheless, at the risk of being accused of going for the populist approach, these particular terms give some indication of the way in which the investigators were thinking.

The choice of such terms is instructive and to a certain extent stems from the nature of email as a form of communication. Plainly the investigators were attempting to identify particular emails, written at times of stress with the writer scribing his instantaneous thoughts on a particular issue. This immediacy of transmission leaving no room for reflection once the heat of the moment has passed. Thus the hastily written email, unlike the letter cannot be removed from the postbag just before the post is dispatched.

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[5] Valukas Report p. 30 Vol. 1, Sect. 1 (available at http://lehmanreport.jenner.com/ last accessed 28th September 2010)
[6] Volume 7 Appendix 5 (At page 124.)
[7] Greg Buckles – Mining the Lehman Mountain (at http://ediscoveryjournal.com/2010/06/mining-the-lehman-mountains-%E2%80%93-searching-3-petabytes/)

Another noteworthy point is – how did the examiner know what to look for? The answer to this is that he did not. It is apparent from the report that the use of Repo 105 in this way had not been suspected. Acting on suggestions from counsel and the regulatory authorities amongst others, the examiner seems to have been initially focussed on such issues as Lehman's attitude to risk and potential breaches of directors' fiduciary duties. Rather surprisingly, given the scale of the calamity, these enquiries drew a blank, partly: it must be said due to the Delaware "business judgment" rule that forbids judicial interference with honest business decisions.

5. What has been achieved by this report?

The first question to ask here is if the report has achieved what it sets out to do: essentially, are there any potential actionable claims against directors or high level associates at Lehmans or at associated firms? It should be noted that the report fall shy of saying that there is liability, even for the Repo 105. The phrase used throughout the report is that of potential "colorable claims" helpfully described in the report as follows:

> "...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."[8]

The examiner, and therefore the report, does not definitively attach liability to anyone. It is purely advisory. Indeed, the report was recently pleaded as part of a due diligence defence by former directors of Lehman Brothers in an ongoing case.

Therefore, although this magnificent document is beautifully researched at enormous expense, it does not, in itself, recoup any money for the creditors of the Lehmans' estate and it remains to be seen whether the reported aim of paying 14 cents in the dollar to every creditor will be achieved. The magnitude of this task is evident. According to the estate there are currently 64,000 claims against it. The estimated value of these claims exceeds $700 million. The best that can be said is that we must wait and see.

6. In a broader context, what lessons are to be learned?

Certainly for the firms, this is another reminder about the problems caused by rogue emails. The report is likely to encourage firms to tighten up there procedures with regard to internal emails and focus on the potential for embarrassing and litigious emails to be unearthed by investigators. This lesson of course has come too late for the Goldman Sachs. Ironically, the publication of the report came shortly before a SEC complaint against the investment bank Goldman Sachs.9

The full details of the complaint are not relevant here, but one of the central players identified in the complaint was the trader Fabrice Touree, who sent several emails that attracted a large amount of media attention.[10] One in particular achieved notoriety:

> "More and more leverage in the system, The whole building is about to collapse anytime now...Only potential survivor, the fabulous Fab[rice Tourre] ... standing in the middle of all

[8] Volume 1, Section 1 (at page 19)
[9] Securities and Exchange Commission, v Goldman Sachs & Co. And Fabrice Tourre, (http://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf last accessed 27th October 2010)
[10] The Daily Telegraph referred to it as follows: On January 23, 2007, Fabrice Tourre sat down to write what is likely to go down in the annals of the financial crisis as one of the most memorable emails to have found its way out of Wall Street. 11:41PM BST 16 Apr 2010 http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/7599970/Goldman-Sachs-Fabrice-Tourre-and-the-complex-Abacus-of-toxic-mortgages.html

> these complex, highly leveraged, exotic trades he created without necessarily understanding all of the implications of those monstrosities!!!"[11]

This was a complaint that was settled with almost embarrassing speed by Goldman Sachs – agreeing to pay the sum of $550 Million in compensation – without accepting liability. There is no way of knowing, but it may suggest that Goldman Sachs may had at the back of their mind the wish to avoid the type of forensic (in every sense of the word) examination that was undertaken with Lehman Brothers.

7. Lessons for regulation and governance

From an academic point of view, the report is a highly insightful study of the collapse of a financial institution, in the form of a blockbuster, and will no doubt have powerful lessons for the regulatory bodies. It also provides an illuminating description of a financial institution's attitude to risk.

These are fairly general issues, but one aspect of regulatory concern may be particularly important regarding the success of electronic discovery in the Valukas report. One of the peculiarities of financial institutions and markets is the inherent problems related to something called information asymmetries, i.e., broadly speaking, the situation where one party has significantly less information than another. The triteness and generic nature of this definition is unavoidable – such circumstances occur in a variety of ways.

Unsurprisingly some of the literature concerning information asymmetries refers to the paradigmatic circumstance where the information asymmetry is between the small depositor (a consumer) and a large high street bank. In this circumstance the consumer, even a relatively well educated and informed one, will be at a serious knowledge disadvantage compared to the bank in which he is depositing his money. This problem can be countered to a certain extent by public information by both the relevant regulator and the bank itself and this is implicitly recognised by the regulatory superstructure of UK Banking. Two of the four regulatory objectives of the Financial Services Authority are after all promoting public awareness and the protection of consumers.[12]

The problem of information asymmetry therefore is clearly a serious issue in terms of consumer protection: if the consumer is not sufficiently informed about the product it is buying (in this instance – the service of the bank account), then how can an informed choice be made? The following insight was made by Lady Hale in the recent overdraft charges litigation:

> "The banks may not be the most popular institutions in the country at present, but that does not mean that their methods of charging for retail banking services are necessarily unfair when viewed as a whole. As a very general proposition, consumer law in this country aims to give the consumer an informed choice rather than to protect the consumer from making an unwise choice."[13]

Information asymmetries, however, are not restricted to consumer retail banking; in this way, the special nature of banking is evident again. The problem also persists with sophisticated non-financial firms and more importantly, for the purposes of systemic risk at least, other financial institutions. In the recent crisis for example, this problem was associated with the multitude of complex interconnected multi-party transactions that investment banks such as Lehmans were involved in, often involving securitised debt based on sub-prime

[11] SEC Complaint against Goldman Sachs. Available at (http://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf last accessed 8th October 2010.
[12] S.2 (b) & (c) Financial Services and Markets Act 2000.
[13] *Per Lady Hale* The Office of Fair Trading (Respondents) *v* Abbey National plc & Others (Appellants) [2009] EWCA Civ 116

mortgage market. If information asymmetries exist, then a bank will be unable to sort good risks from bad ones and they are likely to stop lending completely – which arguably happened in the credit crunch.

But such asymmetries are not restricted to relations outside the firm. They can also promote significant problems between the board and senior management. Interestingly, the Valukas report demonstrates how a methodical examination of corporate emails can go some way to assess the true levels of information asymmetry within a firm. This is important in order to seek methods to reduce similar asymmetries in the future; but there is also another important point.

Without getting into the minutiae of the various cause of action ranged against executives generally- one important factor is in every case, the knowledge of the defendant (for example knowledge of the extent of the use of Repo 105.) Deniability is an important factor here: if the director or senior executive is able to deny knowledge, then liability is unlikely to be found.[14] In any large corporation, the ability of the board of directors to have substantive knowledge of many of the activities of all executive action is inevitably constrained by time and expertise restraints. A detailed forensic account, such as the Valukas report has the potential to test the credibility of any defence that corporate action was a result of *de rigeur* delegation, and the defendant was not aware of the precise details.

8. Conclusion

His labours completed, Anton Valukas relinquished his duties on June 2 2010, having requested and been granted immunity from future lawsuits himself. Thus, in a way, lighting the blue touch paper and retiring to a safe distance. The whole episode has clearly been a major success for Valukas and his firm (being paid approximately $54 million for just over a year's work.) For the creditors of Lehmans and the public at large however, the benefits may come from it but only time will tell.

[14] In terms of deniability it should pointed out that the report states a remarkable assertion by the attorneys' of Dick Fuld when questioned about an attachment, that Mr Fuld did not use a computer, only a blackberry, and he did not know how to open an attachment! (Volume 3, Page 918, Footnote 3520)