Deconstructing the use of REPO 105 and Repo 108 Transactions Under SFAS 140: the Case of Lehman Brothers Holding Inc. and the Liability of Ernst & Young

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Abstract

Prior to filing for bankruptcy in 2008, Lehman Brothers Holding Inc., [LBHI] relied upon select repurchase agreements denominated "Repo 105" and "Repo 108" for the purpose of re-casting its balance sheet to meet net leverage ratios required by money markets. SFAS 140, as then existing without the 2011 amendment, provided a mechanism to treat "ordinary borrowings" as "asset sales". LBHI used SFAS 140 to justify Repo 105 and Repo 108 transactions to engineer its balance sheet. The accounting treatment resulted in the publication of misleading quarterly and annual Financial Statements relied upon by external users to make investment decisions.[1] In 2011 and 2012, the Southern District of New York issued opinions in the consolidated LBHI litigation. The finding that LBHI correctly applied the criteria of SFAS 140 to justify "borrowings" as "asset sales" under Repo 105 and Repo 108 is fundamentally flawed. During the period 2000 until 2008, Ernst & Young [E&Y] served as the outside auditor of LBHI. Legal principles governing the obligations of auditors support a finding that E&Y committed professional malpractice by issuing unqualified audit opinions knowing that LBHI failed to disclose its liabilities to repurchase transferred securities under Repo 105 and Repo 108 transactions. Economic analysis of non-contractual obligations [tort] supports a reformulation of the legal standard governing auditor liability to external users of audited financial statements containing materially misleading information. The reformulated standard allocates incentives to take precautions both to the audit firm and to the external user to achieve an efficient allocation of the cost of harm ensuing from defective information products.

Keywords: Lehman Brothers; audit failure; Repo 105 and Repo 108; Ernst & Young; misleading financial statements.

[1] In 2011, the Financial Accounting Standards Board issued ASU No. 2011-03 "Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements, removing from the assessment of "effective control" the criterion of requiring the transferor to have the ability to fund the repurchase or redeem the financial assets underlying the transaction. Contractual obligation to repurchase the transferred assets meets the control test. Had SFAS 140 as amended been in effect during the period 2001-08, LBHI could not availed itself of this accounting standard.

The Case Study

LBHI was an investment bank founded upon a business model of high risk and high leverage.[2] The asset side of the balance sheet was long term and the liability side of the balance sheet was short term. Hence, LBHI required daily infusions of short term financing in amounts ranging from tens to 100 billions of dollars to stay open for business.[3] The confidence of its counterparties was critical to its business model; LBHI depended upon debt financing to conduct ordinary operations. Rating agencies, creditors, and analysts required that LBHI have a favourable net leverage ratio compared to its peers in the investment banking industry, ranging from 10 to 16 percent.[4] That metric was the *sine qua non* of market confidence. LBHI delivered that metric by engineering its balance sheet at period end to meet quarterly expectations. The engineering of the balance sheet created an illusion of liquidity by using transactions coded "Repo 105" and "Repo 108" never disclosed in its periodic and annual reports. Reliance upon off-balance sheet transactions proved unsustainable in the long run.

Three events led to the collapse of LBHI. In 2000, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 140 that, subject to mandatory criteria, permitted firms to recharacterise ordinary "repo" transactions as "asset sales" with a forward purchase agreement.[5] Second, in 2006, LBHI undertook an aggressive "countercyclical growth strategy" spending capital to acquire Collateralised Mortgage Backed Securities [CMBS] and Retail Mortgage Backed Securities [RMBS] thereby expanding geometrically its holdings in the distressed commercial and retail real estate market. "The total illiquid positions on Lehman's balance sheet increased from $41 billion in 2006 to 115$ and $120 billion in the first quarter of 2008".[6] Third, LBHI, relying upon SFAS 140, progressively undertook an aggressive accounting strategy to lower its net leverage to meet market expectations, as its portfolio of assets deteriorated in quality and effectively became illiquid. "Lehman failed [precisely] 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".[7]

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[2] "Lehman maintained approximately $700 billion in assets, and corresponding liabilities, on capital of approximately $25 billion". Bankruptcy Examiner's Report [BER] prepared by Anton R. Valukas, Examiner consisting of nine volumes plus appendices, Vol. 1, Introduction at 3. The factual data contained in this article related to Repo 105 and Repo 108 transactions is drawn primarily from the BER, specifically Vol. 3, Section III.A.4: Repo 105. The full Report plus Appendices is found at: https://web.stanford.edu/~jbulow/Lehmandocs/menu.html, last visited 15 November 2018.

[3] Id.

[4] "Net leverage is the ratio of debt/equity of a company" to asses its strength to repay borrowings. In re Lehman Brothers Securities And Erisa Litigation, 799 F. Supp. 2d 258, 268 (S.D.N.Y. 2011); numerous additional lawsuits were against Lehman Brothers, not relevant for purposes of this article.

[5] Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, Financial Accounting Standards Board (2000), (SFAS 140) available at http://www.gasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820919404&blobheader=application%2Fpdf, last visited 10 May 2010.

[6] BER, *supra* note 2 at 836.

[7] Id at 16.

The precipitous decline in value of LBHI stock during the first nine months of 2008 depicts the degradation of the firm's financial condition and the failure of its business model. "On January 29, 2008, [LBHI] reported record revenues of nearly $60 billion for it fiscal year ending November 30, 2007".[8] In January 2008, the stock traded as high as $65.73 per share, "implying a market capitalisation of over $30 billion".[9] Prior to filing for bankruptcy protection on 12 September 2008, the stock of LBHI closed under $4 per share, a decline of 95% in less than eight months. The illusion of liquidity imploded and the illiquidity of its assets blocked a loan large enough to save it from collapse.[10] The following chart identifies landmark dates in the declining market value of LBHI stock during the year 2008.

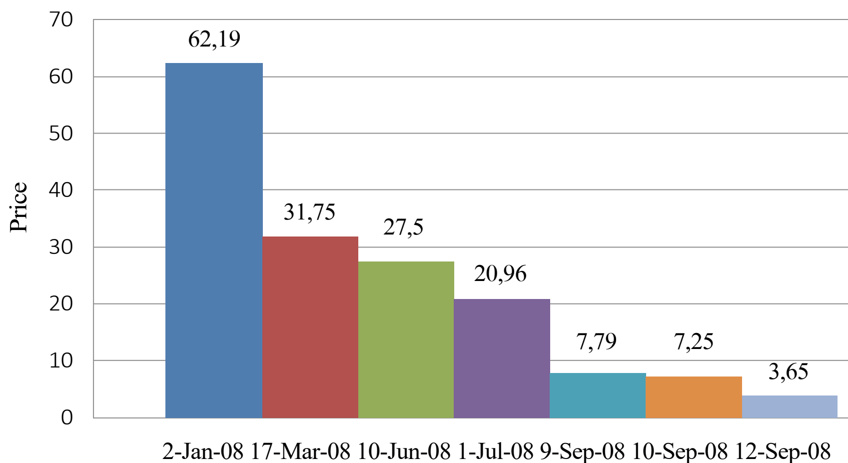

Figure 1. Decline of LBHI Share Price in 2018[11]

Repo 105 and 108 transactions obfuscated for significant periods the financial condition of LBHI and prolonged its inevitable collapse producing substantial losses for external users of its financial statements.

Anatomy of LBHI Repo 105 and Repo 108 Transactions [Accounting]

LBHI started its Repo 105 program in 2001 when SFAS 140 entered into effect.[12] For the purpose of executing Repo 105 transactions, LBHI developed an internal Accounting Policy first to cover Repo 105 [fixed income securities] and later to cover Repo 108 [equity securities] transactions[13] under SFAS 140. The policy was applied firm wide.[14]

[8] Id at 2.

[9] Id.

[10] "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)". *See*, BER, *supra* note 2 at 2 n.4.

[11] Source: BER (Banruptcy Examiner Report)

[12] BER, *supra* note 2, Vol. 3 at 765.

[13] Id. at p. 766.

[14] Id. at p. 765.

LBHI vetted the concept of SFAS 140 repo transactions with its outside auditor, Ernst & Young, before adopting the Repo 105 policy and engaging in Repo 105 transactions.[15]

"A repurchase agreement (repo) involves a temporary transfer of assets (often fixed income or equity securities) to a counterparty for cash accompanied by a simultaneous agreement to repurchase the same (or equivalent assets) at a specified price at a later date".[16] The later date is short, usually a week or ten days. The lender returns the securities to the borrower and the borrower repays the loan with interest in cash. "The substance of the transaction is a short term loan". [17]

By contrast, Repo 105 transactions, though similar to ordinary repo transactions, were markedly different in accounting treatment as they were deemed "asset sales", not short-term loans. In spite of the different accounting treatment reserved for Repo 105 transactions, LBHI used the same documentation to effect both Repo 105 and ordinary repo transactions, and these transactions were conducted with the same collateral and sometimes with the same counterparties. Like an ordinary repo transaction, in a Repo 105 transaction, Lehman transferred securities to a repo lender to obtain short-term financing.[18] Additionally, like an ordinary repo transaction, LBHI, in a Repo 105 transaction, was obligated to "repurchase" the securities posted as collateral (to repay the cash borrowing) upon the maturity date designated in the repo agreement.[19]

Similarly, during the term of a Repo 105 transaction, like an ordinary repo, LBHI received the stream of income (the coupon payments) from the securities transferred in the Repo 105 transaction.[20] In addition, like an ordinary repo, LBHI was charged interest on the cash borrowing.[21] LBHI paid the interest separately upon the completion of a Repo 105 transaction (*i.e.*, when the term expired), just as LBHI would pay interest due on all ordinary repo transactions.[22] Accordingly, Lehman would debit an "interest expense" on the income statement.[23]

The alchemy used to transform an ordinary "borrowing" into an "asset sale" derived from LBHI's use of SFAS 140. Under SFAS 140, "A transfer of financial assets in which the transferor surrenders control over those financial assets is accounted for as a

[15] Id.

[16] Chao-Shin Liu and Thomas F. Schaefer, *Asset Sales or Loans: The Case of Lehman Brother's Repo 105*, The Accounting Educator's Journal, Volume XXI, pp.79-88 (2011).

[17] *Id*. at 80.

[18] BER, supra note 2, Vol. 3 at 771.

[19] Id.

[20] Id.

[21] Id.

[22] Id. at p. 772

[23] Id.

sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange."[24] The key criterion is " surrender of control". SFAS 140 provides that the transferor surrenders control only when three criteria are collectively met: (1) the assets are presumptively placed beyond the reach of the transferor and its creditors, even in bankruptcy, (2) the lender has the absolute right to pledge or exchange the transferred assets without any conditions imposed by the borrower, and (3) the borrower has no contractual obligation to purchase the assets prior to the date of maturity or lacks the ability to require the return of specific assets from the lender, except through a "cleanup call". [25] Paragraphs 47 through 49, 217, and 218 of SFAS 140 contain the relevant discussion of "control."[26]

LBHI structured ordinary repurchase agreements to meet the requirements of SFAS 140 by means of arbitrarily selected "over-collateralisation". The euphemisms "Repo 105" and "Repo 108", unconventional nomenclature in the market, referred to LBHI'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.[27] 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 LBHI faced in an ordinary repo transaction involving treasury- securities, approximately 2%.[28] LBHI deliberately over-collateralised Repo 105 and Repo 108 transactions to avail itself of SFAS 140 by depicting an inability to fund fully the repurchase of the transferred assets, despite a contractual obligation to buy back the assets from the lender.

The Underlying Rational of Repo 105 Transactions

LBHI was concerned with its net leverage ratio to maintain its credit rating and to retain access to the money markets to borrow money at interest rates consistent with its competitors. LBHI measured gross net leverage by taking total assets and dividing them by total stockholders' equity. Deducting the value of collateralized agreements from total assets and dividing by total stockholders' equity resulted in net leverage ratio. LBHI used Repo 105 and Repo 108 transactions to reduce net leverage ratios when periodic reports were made public as required by government regulation and stock exchange rules. LBHI reduced its net leverage ratio by whole numbers thereby depicting a false picture of the financial strength of the firm to repay debt from current assets.

An illustration taken from the BER depicts the mechanics of the two steps required in a Repo 105 transaction to achieve the desired net leverage ratio metric.

[24] Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities, *supra* note 5 at 4

[25] Id. at 9.

[26] SFAS 140, ¶¶ 47-49, 217-218.

[27] Id.

[28] Id.

Assume LBHI executes $50 billion of Repo 105 transactions. The transaction is characterized as a sale and $50 billion of financial instruments, considered sold, are removed from the balance sheet. LBHI receives $50 billion in cash; so total assets are unchanged. "Lehman records no liability to return the cash borrowing so likewise liabilities remain unchanged thereby leverage is unaffected" as the following illustration taken directly from the BER demonstrates[29]:

Assets [millions]		Liabilities and OE	
Cash	57,500[29]	Short-term borrowings	200,000
Financial Instruments	300,00	Collateralised Financings	325,000
Collateralised Agreement	350,000	Long term borrowings	150,000
Receivables	20,000	Payables	98,000
Other	72,500	OE	27,000
Total	800,000		800,000
Gross Leverage	30		
Net Leverage	17		

Table 1. Balance Sheet Before Repo Transaction: Net Leverage Ratio[31]

If this were the result, LBHI would not have engaged in such a transaction. However, LBHI immediately used the cash to pay down short-term borrowings, such as other repo transactions, and thereby achieved its goal of reducing leverage as the next illustration taken from the BER demonstrates[32]:

Assets [millions]		Liabilities and OE	
Cash	7,500	Short-term borrowings	200,000
Financial Instruments	300,00	Collateralised Financings	275,00
Collateralised Agr.	350,000	Long term borrowings	150,000
Receivables	20,000	Payables	98,000
Other	72,500	OE	27,000
Total	750,000		750,000
Gross Leverage	28		
Net Leverage	15		

Table 2. Balance Sheet After Repo Transaction Showing a reduced Net Leverage Ratio[33]

[29] BER, supra note 2, Vol. 3 at 754.

[30] Prior to the transaction cash was 7,500; likewise, financial instruments were 350,000.

[31] Source: BER, *supra* n. 2.

[32] BER, supra note 2, Vol. 3 at 750.

[33] Source: BER

When the repo matured, LBHI borrowed funds to repay the Repo 105 borrowing plus interest, and the securities were returned to its inventory. "Accordingly, total assets and liabilities increased".[34]

A Reconstruction of an LBHI Repo 105 Transaction

Repo 105 and Repo 108 rarely took place within the jurisdiction of the United States. A Repo 105 transaction typically proceeded as follows. Lehman Brothers Special Finance [LBSF] group and a "street" counterparty would enter into a purchase/sale contract whereby LBSF purchased for cash, in the amount of $105, government debt carrying the identical value [USD 105]. LBSF then would enter into an intercompany repo with Lehman Brothers International Europe [LBIE], a wholly owned subsidiary of LBHI located in London, whereby LBSF, without any over-collateralisation, transferred the government debt having a value of $105 in return for LBIE providing a loan of an identical amount. The intercompany repo clearly did not constitute a sale under SFAS 140 because the cash received was sufficient to fund fully the repurchase of the transferred financial instruments. Subsequently, LBIE would carry out the Repo 105 transaction by transferring debt securities with a value of $105 with a European counterparty, usually a UK bank, in return for cash in the amount of $100. The transaction in Europe purportedly justified treating the repo as a sale rather than a borrowing. In addition, LBHI would transfer cash in the amount of $5 to LBIE that then was booked as a derivative asset to be applied to the forward purchase agreement. The diagramme below depicts the structure deployed by LBHI to report lower leverage ratios and to meet formally the rule requirements of SFAS 140[35].

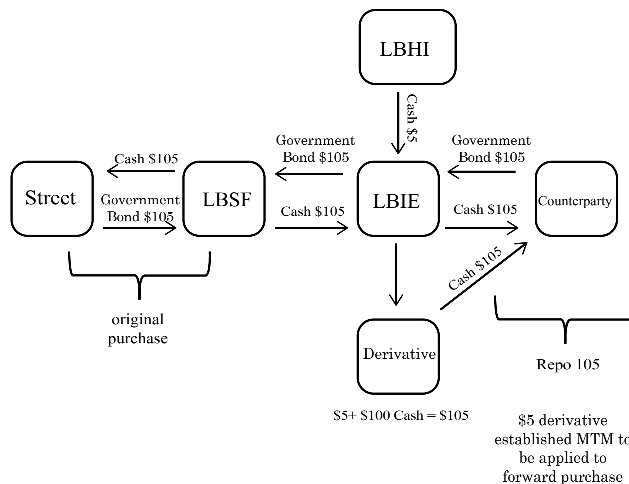

Figure 2. How LBHI structured Repo 105 Na Repo 108 with its UK subsidiary LB International Europe to avoid violation of US law[36]

[34] BER, *supra* note 2, Vol. 3 at 760.

[35] Author has drawn diagramme.

[36] Source: Author

The structure of this transaction provides overwhelming justification for the Examiner's conclusion that the transaction was hollow in economic substance and used solely for the purpose of balance sheet manipulation as LBHI provided consolidated financial statements.

The Misuse of SFAS 140 by LBHI

While there is nothing wrong *per se* by reclassifying a "repo transaction" as a sale with a forward agreement to repurchase under SFAS 140, there were many things wrong with LBHI's use of this accounting standard. First, the transactions lacked economic substance or business purpose. The primary purpose of engaging in Repo 105 or Repo 108 transactions at the near-end of each quarter was to remove securities from the balance sheet, use cash to pay down short-term liabilities, and, contrary to reality, report lower net leverage ratios. Second, SFAS 140 requires firms to obtain a letter from a law firm to attest that the transfer is a "true sale" in law. LBHI could not obtain such a letter from any U.S. law firm. Hence, it requested, and obtained, a "true sale" opinion from the UK firm of Linklaters on behalf of its UK subsidiary LBIE. The Linklaters "true sale" opinion was premised upon UK law and applied solely to LBIE trading with firms located in the European Union.[37] The Linklaters opinion did not address the question of using securities originating in the United States, followed by an intercompany repo to transfer the securities to LBIE, enabling the London subsidiary to "sell" the securities to a European bank, and then, at the time of repurchase, enter into a second intercompany repo to transfer the securities back to LBHI in New York. Third, the over-collateralisation was an artifice. The Bankruptcy Examiner noted, that LBHI "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".[38] Further support for this conclusion is found in the testimony of LBHI officers and personnel interviewed by the Examiner. The examiner concluded, "[T]he 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". [39]

Fourth, LBHI deliberately adopted the Repo 105 and Repo 108 policy knowing that the purported sale was actually a short-term loan. Numerous documents from LBHI'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

[37] *Id*. at 23.

[38] Id. at 746.

[39] Id.

repo transaction.[40] Fifth, LBHI classified transferred assets as SFAS "sales" to coincide with its mandatory financial reporting obligations under United States law. In 2007 and 2008, a substantial volume of LBHI's firm-wide Repo 105 transactions occurred at each quarter-end and involved assets originating from a United States-based LBHI entity.[41]

Specifically: fourth quarter 2007: $8.3036 billion[42]; first quarter 2008: $14.889 billion[43]; and second quarter 2008: $13.6307 billion.[44] The following diagramme depicts the "timing" of the Repo 105 and Repo 108 transactions:

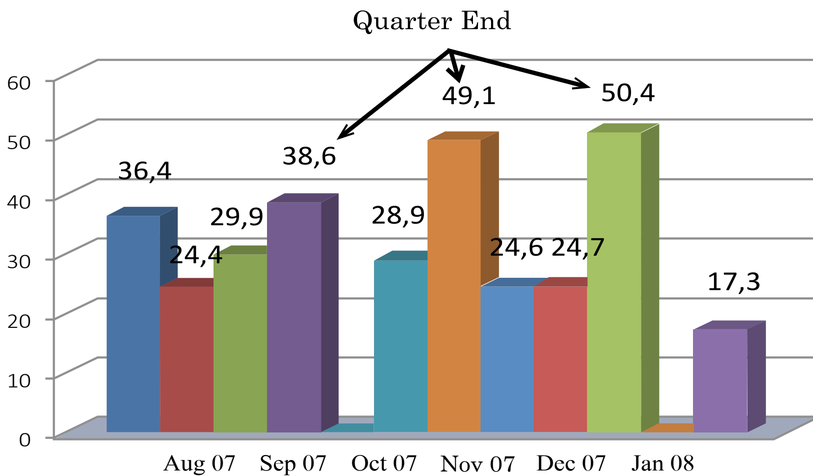

Figure 3. Depiction of timing of LBHI use of Repo transactions preceding quarterly reports[45]

The Flawed Reasoning of the Southern District of New York Respecting LBHI Compliance with SFAS 140 [Law]

The collapse of LBHI spawned "litigation across the country". The LBHI litigation was consolidated under the United States District Court for the Southern District of New York. On 27 July 2011, the United States District Court for the Southern District of New York issued its opinion in *In re Lehman Brothers Equity/Debt Securities Litigation* [*E/D Class Action*].[46] The plaintiffs were "pension funds, companies, and individuals each of which purchased Lehman common stock or other Lehman securities, including structured products like principal protection notes (PPN's) issued pursuant to Offering

[40] Id. at p. 790.

[41] Id. at p. 792.

[42] Id. at p. 793.

[43] Id.

[44] Id.

[45] Source: BER, *supra* n. 2.

[46] 799 F. Supp. 2d 258 (S.D.N.Y. 2011)

Materials".[47] The defendants fell into four categories, one of which was E&Y, LBHI's outside auditor. The Court granted in part and denied in part extensive motions to dismiss contained in the Third Amended Complaint [TAC], but did not decide any substantive questions of law. On 15 October 2012, the Southern District of New York issued a second opinion in In re: Lehman Brothers Securities And Erisa Litigation [*Securities/ERISA Class Action*], originating from "eight consolidated securities actions brought by seven California public entities and a California-based insurance company".[48] The *Securities/ERISA Class Action*, like its predecessor, based its claims contained in the consolidated first amended complaint [*CFAC*] primarily upon the Bankruptcy Examiner's Report. The Court granted in part and denied in part extensive motions to dismiss. The TAC and CFAC were predicated upon violations of federal securities law, specifically the Securities Exchange Act of 1933 and the Securities Exchange Act of 1934.

The following analysis is cabined to Judge Kaplan's determination in the *E/D Class Action* that LBHI's use of Repo 105 transactions complied with SFAS 140. "Under SFAS 140, whether a transferred asset properly is accounted for as a sale or a financing is dependent on the degree of control that the transferor has over the asset".[49] SFAS 140 provides that the transferor has surrendered control over assets 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 … it received, and no condition both constrains the transferee (holder) from taking its 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 and redeem them before their maturity or (2) the ability to unilaterally cause the holder to return specific assets, other than through a clean-up call.[50]

Plaintiffs claimed that the LBHI accounting for Repo 105 transactions failed to comply with the requirements of SFAS 140 on three grounds: (1) LBHI was obligated contractually to repurchase the Repo 105 assets; (2) the transactions lacked economic substance, and (3) LBHI was unable to secure a "true sale at law" opinion from a US law firm. Judge Kaplan found that these three grounds were insufficient to make out a

[47] *Id*. at 2.

[48] Id. At 3.

[49] *Id*. at 27.

[50] SFAS 140, *supra* note 5 at 9.

violation of SFAS 140. His reasoning focused primarily upon the meaning of "control" within the context of SFAS 140.

Appendix A: Implementation to Guidance of SFAS 140 delineates the meaning of "maintain effective control over transferred assets" when the transferor is obliged to repurchase the transferred assets[51]. Paragraph 47 of the Guidelines provides that a transfer must be accounted for as a secured borrowing if all of the following conditions are met:

- The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 48).
- The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 49).
- The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
- The agreement is entered into concurrently with the transfer.

Paragraph 49 of the Guidelines further provides: "To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund *substantially all* of the cost of purchasing replacement assets from others". [Emphasis added] Judge Kaplan relied principally upon paragraph 47(b) as elaborated by paragraph 49 to find that LBHI did not maintain control over the transferred assets. Judge Kaplan found that because the Repo 105 transactions were over-collateralised by 5%, LBHI did not receive proceeds from the transactions sufficient to fund "substantially all" of the cost of replacing the assets it had transferred to its counter-party.

This argument fails on three grounds: (1) Judge Kaplan ignored the fact that the Guidelines state clearly that "isolation of assets" depends upon all facts and circumstances taken as a whole, (2) assets in the amount of 95% of the assets transferred in Repo 105 transactions come within the literal meaning of the term "*substantially all*", and (3) the court opinion omits an essential premise: the Linklaters true sale opinion letter was based on English sale law and not upon SFAS 140. First, Judge Kaplan ignored the Guidelines' admonition to review all pertinent facts and circumstances surrounding the "sale". LBHI and LBIE were affiliated parties and the repo transactions were not the product of an arm's length transaction. The intercompany repo between LBHI and LBIE was valued at 100% without any application of a "haircut". The transferred securities originated in the United States and these US originated securities served as the object of the Repo 105 transaction carried out by LBIE with European Counterparties, mainly English banks. In addition, LBHI was contractually obligated through its subsidiary

[51] *Id*. at par. 47.

LBIE to repurchase the entire value of transferred assets under the forward purchase agreement at the date of maturity. The Examiner found that the complex structure of the repo was designed solely for the purpose of removing assets from the balance sheet of LBHI. According to the BER, "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".[52] Judge Kaplan's finding that SFAS 140 does not require "economic substance" fails to take into account the mandate of the FASB to make certain that firms report accurate financial statements. Technical compliance cannot be countenanced to permit LBHI to falsely represent its financial condition for the purpose of raising capital

Second, Judge Kaplan never explains why 95% of cash obtained by means of the Repo 105 is insufficient to fund *substantially all* of the cost of repurchasing replacement assets from others.[53] The first canon of interpretation of a legal rule or standard is to give words their ordinary meaning. The Oxford English Language Dictionary defines the adverb "substantially" to mean "to a great or significant extent". 95% of a specific quantity is an amount equal to a specific extent; in this case, LBHI had the ability to fund *substantially all* of the cost of repurchasing replacement assets from others. The term "substantially all" does not require a sum equal to 100%; such an interpretation renders the term "substantially all" meaningless.

Third, Judge Kaplan's view that SFAS 140 does not require a firm to obtain a "true sale at law" letter from a US firm is not only questionable but also leads to absurd results. The Linklaters letter was addressed to LBIE, analysed repo transactions under the 1995 or 2000 version of a Global Master Repurchase Agreement under English law, provided that the opinion was not to be used by any other entity except LBIE, and did not contain any analysis of GAAP or SFAS 140.[54] Judge Kaplan's conclusion that a "true sale at law" letter ostensibly may be provided by any non-US legal firm fails to adhere to the implicit requirement of SFAS 140: that the "true sale at law" letter requires an examination of SGAS 140 and the mandates of the FASB.[55] Taken to its logical consequence, Judge Kaplan's ruling leads to an absurd result: a multi-national firm obligated to report under US law may obtain legal assurance from a legal entity established under any jurisdiction without regard to an understanding of FASB standards and GAAP.

[52] BER, supra note 2, Vol. 3 at 7.

[53] *In re Lehman Brothers Securities and ERISA Litigation, supra* note 41 at 34

[54] BER, *supra* note 2, Vol. III at 784-786.

[55] Judge Kaplan's attempt to justify his conclusion by noting that "our legal system sprung from the English one" is unpersuasive. *In re ED/Class Action, supra* note 41 at 116. The origin of the US legal system is related to the UK common law, but the two systems are not equivalent, particularly given the significant transfer of sovereignty to the European Union and the UK's obligation to adhere to the decisions of the Court of Justice of the European Union and the legislative dictates of the Council and Parliament of the EU.

While Judge Kaplan found that LBHI used SFAS 140 correctly to reclassify select repurchase agreements as "asset sales", Judge Kaplan found that LBHI had a duty to disclose Repo 105 transactions based on its statements regarding net leverage ratio. The omission to disclose material information in its "Offering Materials" and its financial statements had the capacity make these statements materially misleading, since "the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information available".[56] The Court upheld the claim that LBHI registration and financial statements during the period of 2007 and 2008 arguably violated GAAP. Quoting *United States v. Ebbers*, Judge Kaplan stated, "GAAP itself recognizes that technical compliance with particular GAAP rules may lead to misleading financial statements, and imposes an overall requirement that the statements as a whole accurately reflect the financial status of the company".[57] This finding established the basis to hold that E&Y, with the requisite *scienter*, "made a false or misleading statement in Lehman's 2Q08 in that it professed ignorance of facts warranting material modifications to Lehman's balance sheet".[58] E&Y knew that "Lehman used Repo 105 transactions to remove temporarily from its balance sheet $50 billion of inventory thereby "casting into doubt the balance sheet's consistency with GAAP". [59]

The Legal Liability of Auditors to External Users of Misleading Financial Statements

Extant legal paradigms governing auditor liability to external users for misleading financial statements of a publicly listed company range from federal securities law, contract, and a wide variety of non-contractual obligation models.[60] Federal securities law dominates the field and pre-empts inconsistent state law. However, with the exception of Section 11 of the Securities Exchange Acts of 1933, that imposes strict liability upon firms and their auditors provided the registration statement contains a materially misleading statement, federal securities law requires that defendants meet *scienter* requirements approaching fraudulent conduct. The seminal case of auditor liability outside the framework of federal securities law is the 1931 Benjamin J. Cardozo decision, in *Ultramares v. George A. Touche, et al*. Cardozo found that the auditors were negligent in the audit of the firm's financial statements on four counts. However,

[56] *In re ED/Class Action, supra* note 41 at 283.

[57] *Id*. at 279, quoting *United States v. Ebbers*, 458 F. 3d 110, 126 (2nd Cir. 2006)

[58] *Id* at 304. The term "scienter", as used in actions brought under Exchange Act Claims, requires evidence that defendants acted "with intent to deceive, manipulate or defraud". 15 U.S.C. §78u-4(b)(2); *Tellabs, Inc. v. Makor Issues & Rights, Ltd*., 551 U.S. 314 (2007). "An extreme departure from the standard of ordinary care … to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it" – are sufficient. *In re ED/Class Action, supra* note 41 at 294

[59] *Id*.

[60] John JA Burke, *Auditor Liability to External Users of Misleading Financial Statements of Publicly Listed Companies: Two Normative Propositions*, 39 Syracuse J. Int'l L. & Commerce 138 (2011.)

Cardozo refused to extend standing to the creditors relying upon the audited reports because they were not in contractual "privity" with the audit firm.[61]

Cardozo's argument to restrict auditor liability based on "privity" to the client is factually and conceptually unsound. The rationale conflicts with the commercial reality that the audit industry knows that financial statements are not made for the use or benefit of the client but for use by external users. While the client prepares the financial statements, the audit function is to ascertain, without guaranteeing, that the firm has produced the financial statements consistent with applicable accounting standards and that the financial statements depict a non-misleading portrait of a firm's financial position. External users rely upon audited financial statements to make credit and investment decisions, and credit agencies, government regulators, and securities analysts use the statements to report information to the market. The failure of *Ultramares*, and its UK counterpart *Caparo,* to reflect commercial reality is sufficient to render them to the "dustbin of history". [62]

Subsequent to the decision in *Ultramares*, tort law began to relax the "privity" requirements. Most states now have adopted the Restatement (Second of Torts) ß 552 test [*Restatement*] based upon a doctrine of "limited foreseeability". The *Restatement* test expands standing to a "limited group of persons for whose benefit and guidance [the auditor] … knows that the recipient intends to supply [the audit information]".[63] The *Restatement* test constitutes a compromise between the *Ultramares* "privity" doctrine, and the aggressive, but ultimately rejected, "foreseeability test" that extended standing to all foreseeable external users of audited financial statements.

The decision in *Bily v. Arthur Young & Co*. aptly captures the incoherence of the *Restatement* test. [64]In denying a remedy to investors that relied upon the audited financial statements of Osborne Computer Corporation, the Court relied upon the auditor's primary duty to the client, reminiscent of the *Ultramares* doctrine, and the requirement that the audit firm must foresee the specific identity of external users of the financial statements.[65] In addition, the Court also found that investors who bought Osborne warrants were "sophisticated", thereby shifting responsibility from the auditor to the investor. The Court stated: "A supplier of information is liable for negligence to a third party only if he or she intends to supply the information for the benefit of one or more third parties in a specific transaction or type of transaction

[61] 255 N.Y. 170, 174 N.E. 441 (N.Y. 1931) at 255 N.Y. 173.

[62] *Caparo Industries PLC v. Dickman et al*. [1990] 2 AC 605.

[63] Restatement (Second) of Torts §552 (1975).

[64] 834 P.2nd 745 (Cal. 1992, modified, 3 Cal. 4th 1049 (1992)

[65] In *Bily*, Arthur Young failed to discover an understatement of liabilities in the amount of $ 3 million dollars, turning a purported profit of $ 69,000 into an operating loss of approximately $3 million dollars. Subsequently, Osborne filed for bankruptcy. The court held that the investors, who purchased warrants in Osborne in anticipation of an IPO relying upon the audited opinion, and who suffered substantial loses, were sophisticated professionals outside the protection of Restatement (Second) ß 552.

identified to the supplier". Paraphrasing the rule of Restatement ß 552 makes it difficult to discern a meaningful difference between the rule in *Ultramares* and the *Restatement* test. The *Bily* Court turned back the clock when audit firms were liable only if they knew with reasonable certainty the identity of the parties relying upon the audit opinion. The *Restatement* test does not reflect the contemporary use of audited financial statements used by market participants generally and containing information that determines the price of securities.

4.1. Toward a Reconstruction of Law Governing Auditor Liability to External Users for Misleading Financial Statements

The starting point to construct a new legal standard requires a fundamental norm. That norm is expressed in the Supreme Court's decision in *United States v. Arthur Young & Co.* where Chief Justice Burger stated, in *dicta*:

> "By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporations, creditors and stockholders, as well as to the investing public (emphasis added). This "public watchdog function" demands... complete fidelity to the public trust".[66]

The only non-contractual formulation of a legal principle fitting the norm is the "foreseeability test" developed by the New Jersey Supreme Court in *H. Rosenblum, Inc. v. Adler*. In *Rosenblum*, the Supreme Court rejected the policy assumptions underlying Cardozo's decision in *Ultramares*, and recognised the evolving role of independent audits for external users. The Court noted, with justifiable irony, the contradictory rationale of *Ultramares* with Cardozo's opinion in *MacPherson v. Buick Motor Co*., where Cardozo had no problem imposing virtually unlimited liability upon a manufacturer of defective tangible goods for physical and economic loss, without concern for the indeterminate class of persons who may purchase the product after entry into the stream of commerce.[67] The Court rightly found an absence of principled distinction between liability for intangible defective "information products" and liability for tangible defective manufactured products.

Consistent with this reasoning, the Court asked: "Why should a claim of negligent misrepresentation be barred in the absence of privity when no such limit is imposed where the plaintiff's claim sounds in tort, but is based on liability for defects in products arising out of a negligent misrepresentation?" The Court found that auditors were not entitled to an exception from liability when placing defective "information

[66] 465 U.S. 805, 917-18 (1984). While the statement is *dicta*, that is, inessential to the *ratio decidendi* of the case, nevertheless, the statement unequivocally expresses the view of the U.S. Supreme Court regarding the public charge of an auditor.

[67] *Macpherson v. Buick Motor Co*., 217 N.Y. 382, 111 N.E. 1050 (1916).

products" into the stream of commerce. Auditors know that external users use audited financial statements for many legitimate business purposes, including the submission of financial statements to banks and other lenders. Invoking the language of the SEC, the Court reiterated, "the responsibility of a public accountant is not only to the client who pays his fee, but also to investors, creditors, and others who may rely on the financial statements which he certifies".

The Court further observed that the critical function of the auditor was to act as an "independent evaluator of the adequacy and fairness of financial statements issued by management to stockholders, creditors and others", and not to place an imprimatur upon managements' efforts to meet earnings expectations or to present financial results in a light favourable to its market objectives. Expanded liability would lead to the exercise of more care thoroughly consistent with the "conservatism" principle permeating financial accounting. The Court also considered, and rejected, the argument that imposing a duty upon accountants to third parties would lead to the "spectre of financial catastrophe," the argument currently being pressed by the auditing profession in the US and in the European Union, to again permit auditors to hide behind the shield of "privity" to escape the consequences of their own negligence.

Crucial to the Court's deference to the argument based upon the "spectre of financial catastrophe" was its observation that expansion of auditor liability to external users was not equivalent to a door of unlimited liability. The Court stated, "The extent of financial exposure has certain built in limits", stemming from the burden of proof any external user would have to bear to demonstrate that an auditor was liable for its economic losses, such as actual reliance upon the misleading financial statements and recovery subject to actual loss. The limitation is aptly captured by the phrase the "unbearable heaviness of the burden of proof." Hence, audit firms having released audited financial statements into the stream of commerce are responsible for negligent misrepresentations to parties who justifiably relied upon the audited financial statements. That excludes any person, whether investor or debtor, who did not rely upon the audited financial statements to undertake a legitimate business transaction with the Company. Therefore, the distinction omits the ordinary investor who never reads financial statements, or if read, must prove that the decision to invest was based upon an understanding of the financial statements, a prospect hardly likely to develop.

With the exception of the *scienter* requirement, this model of liability is consistent with the refusal of Judge Kaplan to dismiss claims against E & Y based on issuing unqualified audit opinions on the financial statements of LBHI. In *E/D Class Action* and *Securities/ERISA Class Action*, Judge Kaplan did not dismiss claims made against E&Y for its alleged wrongful certification of LBHI financial statements, since evidence supported that E & Y knew, should have known, that the use of accounting devices,

such as Repo 105, violated compliance with GAAP. [68] The court also found that the actions of E & Y survived the "loss causation" test, an integral part of tort law to establish liability. Non-contractual obligations result from affirmative conduct that creates a foreseeable risk of harm to those who may be harmed by the conduct.[69] Audit firms cannot "contract away" the commission of "torts". Audit firms that have deviated from professional standards cannot hide behind the veil of contract to evade liability. However, given the rejection of the "foreseeability" test, the legal regime requires a new standard.

Law and Economics: Support for the Reformulated Doctrine of Auditor Liability to External Users of Misleading Financial Statements of Publicly Listed Companies [Economics]

Law and Economics has its roots in the *Coase theorem*. Under that theorem, all obstacles to bargaining constitute "transactions costs". Harm that cannot be settled by private agreement, such as agreements within the law of property or the law of contract, is deemed an "externality". In the domain of tort law, parties cannot negotiate and settle by private agreement "transactions costs". For example, "every driver cannot negotiate with every other driver and agree among themselves concerning how to allocate the costs of future accidents".[70] The object of tort law is to internalize externalities created by high transaction costs and the inability to allocate risk by private agreement.

The traditional theory of tort law governing negligence premised recovery for damages upon the showing of three elements: (1) a person [plaintiff] must have suffered harm, (2) the action of the injurer [defendant] must have caused the harm, and (3) the defendant's act must constitute a breach of a duty owed to the plaintiff. By contrast economic analysis does not define negligent torts by their traditional elements, but models the effects of liability.[71] The economic model of tort liability induces injurers to internalize the costs of harm that they impose upon other persons and provides incentives for the victim take precaution at efficient levels.

Couter and Ulen have developed a theory of negligence by formulating and combining three models: (1) the legal standard of care, (2) minimization of social costs of accidents, and (3) incentives for precaution under a negligence rule. While the models are abstract and do not contain legal standards narratively expressed, the abstractions provide a system within which to articulate a standard to govern auditor liability.

[68] *In re Securities/ERISA Class Action*, supra note 41 at 55, 56.

[69] Mark A. Geistfield, *Restatement (Third) of Torts Symposium: Social Value As a Policy-Based Limitation of The Ordinary Duty to Exercise Reasonable Care* (2009), New York University Public Law and Legal Theory Working Papers, available at http://lsr.nellco.org/nyu_plltwp/163.

[70] Robert Couter and Thomas Ulen, *Law & Economics*, 324 (Pearson 5th ed. 2007)

[71] *Id* at 335.

The first step is to define a duty of care, that is, a legal standard prescribing the minimum level of precaution. Couter and Ulen use a simple figure to distinguish conduct that results in liability from conduct that does not result in liability. Let x≈ denote the legal standard of duty of care, then it follows that precaution below x≈ is a breach of the standard, and precaution equal to or exceeding x≈ satisfies the duty of care:

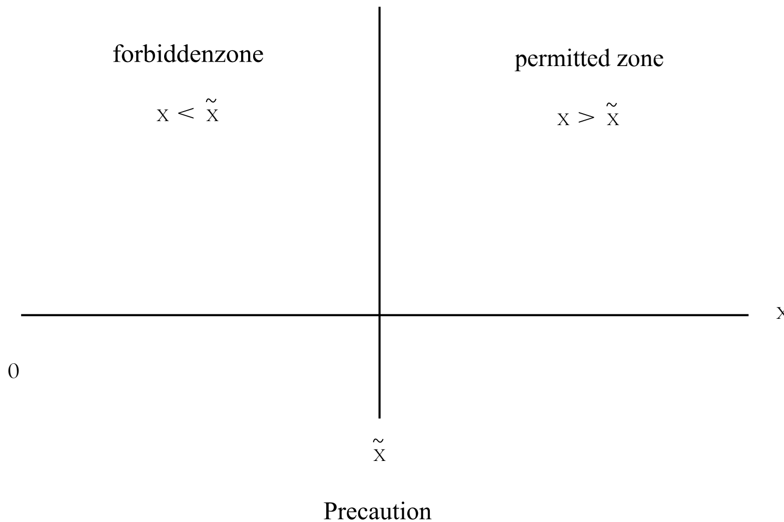

Figure 4. Identification of Permitted versus Unpermitted Behaviour of Market Participants[72]

Precaution x≈ creates two zones of activity: permitted and forbidden. Therefore, when x<x≈, the actor is at fault and when x>x≈, the actor is not at fault. However, the first step is incomplete because it assumes unilateral precaution while bi-lateral precaution provides incentives for both the injurer and the victim to take precautions.

The second step in the development of an economic model of tort law integrates two additional elements: the cost of harm and the cost of avoiding harm.[73] The probability of an accident [p] decreases with increases in precaution [x], thus p = (p)(x) where the probability of an accident declines with increases in precaution. When an accident occurs, it causes harm, such as monetary loss, physical harm, and property damage. In the following figure, “A” denotes the monetary value of harm from an accident. The monetary value of harm multiplied by the probability of the accident equals the expected harm in dollars [or other currency unit]. The expected harm p(x)(A) also is a decreasing function of x. Expected harm decreases as precaution increases. Precaution costs money, time and inconvenience. Couter and Ulen, for purposes of their analysis, assume that precaution costs $w per unit, and that “w” is constant and does not change with the amount of precaution x. The designation w(x) equals the

[72] Source: Couter & Ullen, *supra* n. 70.

[73] *Id* at 336.

total amount spent on precaution. Hence, the expected social costs of accidents may be shown as the sum of precaution costs and the expected cost of harm:

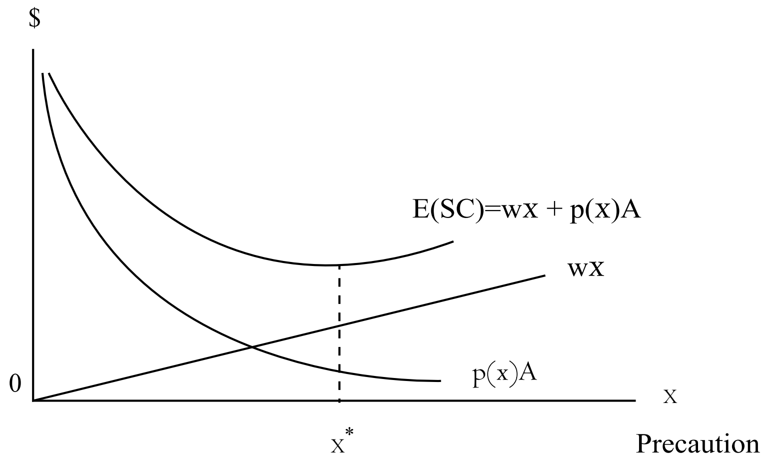

Figure 5. Relationship among Precaution, Probability of Harm, and Cost[74]

Because the expected social cost curve is U-shaped, a value of x exists that corresponds to the bottom of the U. This value, denoted x^*, is the level of precaution that minimizes the expected social costs of an accident. Thus, x^* is the socially efficient level of precaution. However, the efficient level of precaution expressed in the equation $E(SC) = wx + p(x)(A)$ still fails to distribute bi-laterally incentives to take precaution.

The third step in the construction of an economic model of tort law gives efficient incentives to both injurer and victim. Accomplishing this objective requires combining the negligence rule with the economic analysis of incentives. In step one, the legal standard of duty of care was denoted x≈. In step two, x^* denoted the efficient level of precaution. Combining the two requires showing the relationship between the legal standard and the efficient level of precaution. The simplest assumption states that x≈, the required legal standard is equal to x^*, the efficient level of precaution. This assumption allows the combination of the work set forth in steps one and two to produce a figure that demonstrates that the injurer will set precaution at x^* where liability falls to zero. When the injurer is not liable, then the victim does not receive any compensation. A rule of no liability gives the victim an incentive to internalize the marginal costs and benefits of precaution, that is, incentives to take efficient precaution.

[74] Source: Couter & Ullen, *supra* n. 70.

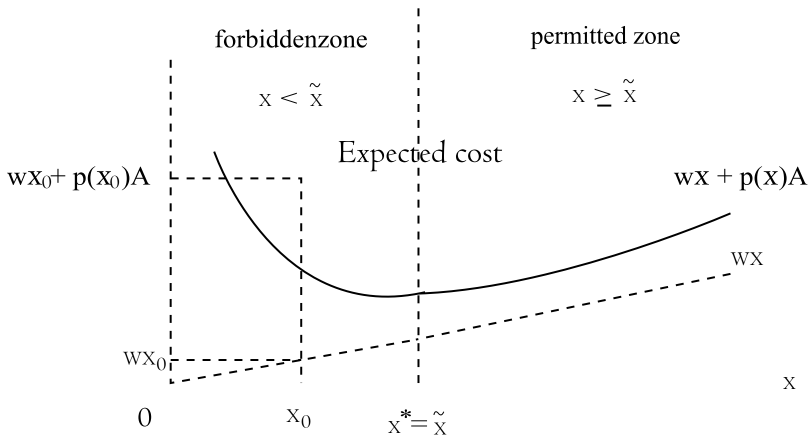

Figure 6. Depiction of Effect of Behaviour of Firms related to Harm and Cost Allocates Liability[75]

The abstract analytical models of law and economics models must be concretised to produce a legal standard that provides incentives for efficient bi-lateral precaution in the context of audited financial statements intended for use by external users. An auditor has a duty of care [the legal standard] to external users of audited financial information. Liability results if the marginal cost of taking precaution [the burden of taking efficient precautions] is less than the probability of misinformation [the accident] multiplied times the cost of harm [monetary loss]. In the context of an audit, the auditor has an obligation not only to comply with GAAS and GAAP rules but also to make certain, given knowledge of the client and its financial activities, that the financial statements, subject to the imprimatur of the auditor, accurately reflect the financial condition of the firm. Because this legal standard does not impose a rule of strict liability, then the auditor may take precautions where liability reaches zero. Hence, the external user of audited financial statements must take efficient precaution knowing that an audit does not guarantee the veracity of information in the audited financial statements of a firm. In other words, the external user must take precautions to internalize the costs of the "expectations gap".

In the context of the collapse of LBHI, E&Y would bear liability to external users that made investment decisions upon the basis of audited financial statements. The precautions taken by E&Y never reached x≈ since it countenanced the use of Repo 105 and Repo 108 transactions, without ever requiring LBHI to make public its Repo 105 policy, and without ever requiring LBHI to disclose in notes to the financial statements that LBHI was contractually committed to repurchase transferred assets and increase its liabilities and assets thereby increasing its net leverage ratio. Assume a model of perfect disclosure. E&Y had technology to reproduce in readable and concise format the history of LBHI key financial transactions that took place during the period of the

[75] Source: Couter & Ullen, *supra* n. 70.

audit. Under this model, E&Y would have been required to reproduce in graphical form the nature of ordinary and extraordinary repurchase agreements. Users of the data would have seen that repurchase agreement transactions characterized as "asset sales" were used to manipulate net leverage ratios since LBHI repurchased in full all transferred assets purportedly "sold" under the Repo 105 policy. External users would have seen that the transactions were carried out principally to coincide with obligatory public reporting requirements, and they would have seen the actual ability of the firm to fund its liabilities. Had such disclosure been in place the market would have disciplined LBHI probably as early as 2005. That market discipline would have required LBHI to rethink its strategy. Perhaps LBHI would have survived.

This legal standard also does not require a court to determine the question of "materiality" of information, an odd allocation of responsibility to a court. Rather, the court or other decision maker finds that the auditor is negligent if the marginal cost of precaution is less than the resulting marginal benefit. E&Y easily could have internalized the expected harm [externality] of providing an unqualified audit opinion by increasing its precaution requiring disclosure of the nature of Repo 105 and Repo 108 transactions.

Conclusion

A firm is best described as a matrix of financial data. Principles of accounting are essential to understand the nature of the firm. A legal perspective alone fails to furnish the skills required to pierce the façade of the "legal entity" and expose how it works in practice. Principles drawn from economics and finance also are required to understand the nature of the firm. This article has attempted to view LBHI from the tri-lateral perspective of accounting, law and economics to arrive at a proper statement of auditor liability to external users of misleading financial statements. Since 2008 collapse of LBHI and the misconduct of its auditors, Ernst & Young, nothing has changed to augment audit quality. In 2014, Tesco PLC overstated its profits by £326 million, under the auspices of PwC.[76] In 2011, MF Global, a New York investment firm run by former Goldman Sachs CEO and NJ Senator John Corzine, filed for bankruptcy. PwC was its auditor.[77] The firm had commingled customer funds with its own funds, and Corzine reported that he could not account for customer funds amounting to hundreds of millions of dollars.

[76] Alia Shoalb, *FRC closes investigation into PwC over Tesco accounts*, Accountancy Age [6 June 2017]; found at https://www.accountancyage.com/2017/06/06/frc-closes-investigation-into-pwc-over-tesco-accounts/, last visited 18 November 2018.

[77] Francine McKenna, *BankThink Auditor PwC Should Have Been on Top of MF Global*, American Banker [4 November 2011] found at https://www.americanbanker.com/opinion/auditor-pwc-should-have-been-on-top-of-mf-global, last visited 18 November 2018.

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