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Prosecuting Edwards but not Lehman Brothers?

By Timothy D. Reuben

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The Lehman Brothers corporate sign in polished metal is taken into an auction house in London, 2010.

CBS aired a 60 Minutes segment on Sunday, April 22 about Lehman Brothers and the report done by the Bankruptcy Examiner who found there are "colorable claims" of fraud. Anton Valukas, the Chicago lawyer appointed by the Bankruptcy Court to investigate the Lehman disaster, gave his first public interview on his efforts. The 15 minute segment is well worth watching and is easily accessible on the Web.

Valukas is a partner at Jenner & Block where he has focused on white collar crime. He worked as a prosecutor for the Justice Department for six years and ultimately was appointed U.S. attorney for the Northern District of Illinois from 1985 to 1989 by President Ronald Reagan. He has also served as adjunct professor at Northwestern Law School, his alma mater. He and his team of over 70 lawyers examined over 40 million pages of documents, emails, etc., accessed almost 100 internal computer systems, and informally interviewed more than 250 witnesses, including all the Lehman senior officers and board members. The interviews were relatively low key; they were not depositions and not under oath, although most interviewees were represented by counsel and were provided advance notice of the topics and documents to be covered. Valukas also communicated weekly with the U. S. attorneys and the SEC. He and his team ultimately prepared a detailed, heavily footnoted, and extensive written report which he delivered in March 2010, in which he concluded that there were "colorable claims" against specified senior officers of Lehman — a point he reiterated on 60 Minutes. He also noted that certain witnesses told stories which were directly contrary to the evidence.

But while the government apparently has the resources to prosecute John Edwards over a sex scandal that now has little significance — beyond feeding the tabloids fresh prurient material — the SEC appears to have done nothing about the Valukas report. As echoed by 60 Minutes, there has not been a single prosecution against anyone for this massive financial fraud — which was such a factor in bringing down the entire US economy and causing so much trauma and pain for so many Americans.

The reason for this failure to prosecute suggested by 60 Minutes is that the SEC had staff on site at Lehman and had access to all Lehman's documents during the very period that Lehman was committing this fraud. It is surmised that the talented criminal counsel who would undoubtedly be hired to defend Lehman executives would make mincemeat out of the prosecution because of the government's utter failure at the time to recognize the wrongful conduct.

If indeed CBS has correctly guessed why there are no prosecutions in connection with the Lehman fraud (and it certainly sounds right), that is no reason for the government to fail to act. Prosecutors have successfully pursued other very well heeled financial frauds — Charles Keating and Michael Miliken to name a few. While the government has obviously put Bernie Madoff behind bars and is prosecuting Allen Stanford and others, none of these men had as profound effect on the entire financial system as the Lehman collapse.

It is true that the Lehman fraud is perhaps the most complicated ever. CBS tried to explain how an accounting device known at Lehman as "Repo 105" was used to materially play with the financial reports — but even CBS' laudable effort falls short of making it clear. Valukas found that the Repo 105 transactions "sole function by Lehman was balance sheet manipulation." The truth is that Lehman's financial manipulations were so

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complex and confusing, and the instruments and tactics used so sophisticated, that even experts in finance failed to understand or recognize them. Indeed, Valukas believed that other than CEO and Chairman of the Board Dick Fuld, none of the other members of even Lehman's own board of directors knew or understood Lehman's manipulations. This latter conclusion of Valukas does seem a bit surprising, but perhaps it is because Valukas conservatively accepted the informal statements by Lehman directors who claimed ignorance. Clearly, it is just as reasonable to believe that some or all of the other directors had to know what was going on — after all, they did all sign off on the public financials. But despite his very circumspect approach, Valukas did expressly conclude: "Colorable claims exist against the senior officers who were responsible for balance sheet management and financial disclosure, who signed and certified Lehman's financial statements and who failed to disclose Lehman's use and extent of Repo 105 transactions to manage its balance sheet."

It is not that John Edwards should be let off the hook. If he did violate campaign finance laws in covering up his sexual scandal, he may deserve prosecution — although obviously he has already been ostracized and vilified quite a bit for his personal conduct. But the conviction of John Edwards will hardly have any significant societal impact — although it will sell some papers. Politicians may be reminded once again of the risks of secret sexual affairs and the need to insure campaign funds are spent properly. But some politicians presumably will continue to participate in improprieties which the media will disclose and which will inevitably result in loss of office and reputation. But what about investment bankers, financial whiz kids, and hedge fund billionaires? What have they learned from the government's failure to prosecute? If it is complicated enough, or involves too much money, is the government simply afraid to challenge Wall Street?

Prosecutors at both the state and federal level are generally hardworking, dedicated and ethical public servants who deserve nothing but praise. But the Lehman fraud is unique to our times — it was huge and murky with vast ramifications. We can all understand the John Edwards sex scandal, so it will not add much to the public knowledge. And while it may be true in the case of Lehman, that the government will (and should) take some lumps, that is no excuse to avoid it, particularly in light of Valukas' extensive report — over 1000 pages with detailed citations to specific evidence plus multiple appendices. The prosecution has a roadmap of what Valukas conservatively describes as "sufficient credible evidence to support a finding by a trier of fact." It is this kind of fraud that screams out for public exposure through prosecution, lest it happen again. The pace of high finance is fast and the use of complex instruments dazzling (like swaps, options and other derivatives). Avaricious and dishonest types will always defraud, particularly when the dollars involved are so ridiculously high.

As technology advances quickly, unethical Wall-Streeters may find new ways to take advantage — but that makes it more critical for prosecutors to be less afraid of their own behinds and more willing to challenge what is complex but clearly wrong. The government must take on that responsibility when so many have been victimized.