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### Statement By Thomas H. Cruikshank To House Financial Services Committee

Thomas Cruikshank

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## **Statement By Thomas H. Cruikshank To House Financial Services Committee**

I would like to thank the House Financial Services Committee for inviting me to appear at today's hearing on public policy issues raised by the Lehman Bankruptcy Examiner's Report. No one can deny that the bankruptcy of Lehman Brothers has had a disastrous impact – on the company, its employees, its investors, and even on our country and its economy. As a director of the firm, Lehman's collapse weighs on me personally each and every day. It is vital that we learn from Lehman's history so we do not repeat it. In this spirit, I applaud the Committee for holding these hearings today.

### **My Background**

I joined Lehman Brothers Holdings Inc. ("Lehman") as a director in 1996, and have served on the Board for approximately 14 years. I have been a member of the Audit Committee of the Board since the beginning of my tenure and chairman of that Committee since 2003. I have also served on the Board's Nominating and Corporate Governance Committee.

After graduating from Rice University with a degree in Business Administration and Economics, I began my career at the accounting firm Arthur Andersen. While working, I also attended law school. I left Arthur Andersen in 1955 to serve as an officer in the Navy at the end of the Korean War. After completing my service, I rejoined Arthur Andersen for a few years until I decided to try my hand at practicing law at Vinson & Elkins. Looking for another new challenge, in 1969 I joined Halliburton. I spent the next 25 years working in a number of roles, including Chief Financial Officer, President, Chief Executive Officer and Chairman. I finally retired from Halliburton after the end of 1995.

During my career, I have had the honor of serving on a number of boards of directors, including those of Goodyear, the Williams Companies, Seagull Energy, and Central and Southwest, in addition to serving as the chairman of both National Junior Achievement and Up with People (an international education organization that addresses the need for young adults and leaders to develop global perspectives, intercultural understanding and knowledge of worldwide social issues). I joined Lehman's Board because I had been very impressed by the firm's work for Halliburton when I was CEO, and because I was interested in its aspiration to build a world-class investment banking enterprise based on the "One Firm" model. During my time on Lehman's Board, I saw the company grow from a modest niche player, specializing in corporate finance and trading, into a global powerhouse that was the fourth largest investment bank in America.

Over the years, I attended dozens upon dozens of Board and Committee meetings. I also got to know a number of incredibly talented and dedicated employees (not to mention my fellow directors for whom I have an enormous amount of admiration). I developed a great respect for and strong attachment to Lehman. All of this made it so much harder to see the company collapse during the early morning hours of September 15, 2008. Indeed, that Monday was the darkest day of my professional career.

## Lehman's Fall

I, along with my fellow directors, know all too well that Lehman's fall has had drastic consequences. Thousands of employees lost their jobs and much, if not all, of their savings. Investors, including me and my fellow directors, collectively lost billions of dollars. Notably, consistent with the Board's view of proper compensation practices, Lehman's employees owned approximately one quarter of the company's common shares.

Lehman's bankruptcy has had a ripple effect on America's economy – the Dow Jones index plunged 500 points on the day of the bankruptcy, and, just weeks later, Congress stepped in and passed a \$700 billion rescue program for the economy (now commonly known as TARP). The collapse of Lehman, a company to which I have been devoted for nearly fifteen years, troubles me very deeply and will always continue to do so.

## The Examiner's Report

Given the staggering impact that Lehman's bankruptcy has had not only on the company, but our country, it is critical that we explore the reasons behind the firm's failure so that we can learn from it and do our best to make sure something like this does not happen again. I want to thank Anton Valukas, Lehman's Bankruptcy Examiner, for all the hard work that went into producing his report. It is important to study, analyze, assess, debate and learn from it. Indeed, the Examiner, his attorneys, and his accountants spent tens of thousands of hours investigating and chronicling their understanding of Lehman and the events leading up to its bankruptcy – reviewing millions of pages of documents and interviewing more than 250 witnesses. The resulting 2200 page report (before even counting its 34 separate appendices) is a testament to the complexity of the myriad issues that Lehman faced over its last two years.

Looking back, I am sure that there are things Lehman could have done differently. But, as has often been pointed out, hindsight is twenty-twenty. And what may seem crystal clear today in 2010 was much less so back in 2007 and 2008. As you may recall, in the spring of 2007, Benjamin Bernanke, the Chairman of the Federal Reserve, advised that “the effect of the troubles in the subprime sector on the broader housing market [would] likely be limited,” and that there should not be “significant spillovers from the subprime market to the rest of the economy or to the financial system.”<sup>1</sup> Indeed, even after Bear Stearns nearly collapsed in March 2008, then Treasury Secretary Henry Paulson stated that the “worst [was] likely behind us,”<sup>2</sup> and that “[t]his

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<sup>1</sup> Ben Bernanke, Chairman, Fed. Reserve, Speech at Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition (May 17, 2007).

<sup>2</sup> Michael M. Phillips & Damian Paletta, *Paulson Sees Credit Crisis Waning*, Wall Street Journal (May 7, 2008), available at, <http://online.wsj.com/article/SB121011652297872261.html> (last visited Apr. 19, 2010).

[was] a very manageable situation . . . .”<sup>3</sup> If only they, and many other leaders in the financial world, had been right.

Still, even in retrospect, the Examiner found that there are absolutely no colorable claims against the independent directors in connection with our work on behalf of the company. The Examiner carefully reviewed the facts and circumstances regarding, among other things, Lehman’s: (1) risk-taking and risk-management activities; (2) efforts to raise capital, attract strategic investors, and spin off its commercial real estate assets; (3) purported use and disclosure of “Repo 105” transactions; and (4) disclosure of its liquidity pool. His conclusion, that there are no claims against the outside directors for breaching their duties,<sup>4</sup> comports with my own belief and the belief of my fellow directors that we did our absolute best in exercising our business judgment to try and help navigate Lehman through what was the greatest financial tsunami since the Great Depression.

#### The Role of Lehman’s Board of Directors

Going forward, as Congress continues to consider corporate governance issues, it is important to remember the role of a board of directors. It is not to manage, or micromanage, a corporation. That is the province of the company’s officers and senior management who devote their careers to the corporation – 60, 80, 100 hours a week, 52 weeks a year. A board of directors, on the other hand, brings its collective wisdom, experience, and outside perspective to bear in “thoughtfully appointing officers, establishing or approving goals and plans and monitoring [a company’s] performance.”<sup>5</sup> And that is exactly what we, as Lehman’s outside directors, worked extremely hard to do.<sup>6</sup>

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<sup>3</sup> “Paulson braces public for months of tough times,” Associated Press Online (July 21, 2008).

<sup>4</sup> See, e.g., Report of Anton R. Valukas, Examiner (“Examiner’s Report”), at 188-95, 611, 992, 1479-80, Case No. 08-13555 (JMP) (Bankr. S.D.N.Y. Mar. 11, 2010) [Docket No. 7531].

<sup>5</sup> R. Franklin Balotti & Jesse A. Finkelstein, *Balotti and Finkelstein’s Delaware Law of Corporations and Business Organizations*, DELCBO 4.10, 2006 WL 2450219, \*1 (2009) (internal citations omitted).

<sup>6</sup> Courts have recognized that “[b]usiness decision-makers must operate in the real world, with imperfect information, limited resources, and an uncertain future,” and that imposing “liability on directors for making a ‘wrong’ business decision,” would be bad public policy and “cripple their ability to earn returns for investors by taking business risks.” *In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106, 126 (Del. Ch. 2009).

Since the beginning of 2007 through Lehman's bankruptcy filing in September 2008, our Board and its committees convened on more than 80 occasions in that less than 21 month span. I still remember one week in July 2008, when we were examining and analyzing the company's strategic options, meeting every day for six days in a row.

At just about every Board meeting, we received detailed reports from management on Lehman's financial performance and other important issues. These reports were made by various groups and individuals at Lehman and included, where appropriate, consultation with outside experts. We reviewed numerous metrics including the firm's balance sheet, leverage, average risk appetite usage, long term capital, as well as comparative competitive information such as ten-year debt spreads and long-term debt credit ratings. We also looked into the firm's monthly financial results and the key initiatives in each division, including fixed income, equities, banking, investment management and principal investments.

Moreover, management regularly made presentations to the Board and its committees on key topics. Such presentations included updates on:

- Lehman's Subprime Mortgage Origination Business (March 20, 2007);
- Lehman's Liquidity, Leveraged Loan Commitments and Mortgage Positions (September 11, 2007);
- Lehman's ABS CDO Exposure (November 8, 2007);
- Lehman's 2008 Financial Plan Summary (January 29, 2008);
- Liquidity and the Market (March 25, 2008);
- Lehman's Commercial Real Estate (March 25, 2008);
- Lehman's Risk Management (April 15, 2008);
- Lehman's Fixed Income Division (May 7, 2008);
- Concerns Raised Regarding Balance Sheet and Legal Entity Controls (July 22, 2008);
- Lehman's Strategic Alternatives (July 22, 2008);
- Risk Issues Facing Lehman (June 19, 2008 and August 13, 2008); and
- Lehman's Valuations (July 22, 2008).

Board meetings were an active and dynamic affair. Board members probed management, asked numerous questions and demanded and received detailed, cogent answers. In my entire career, I have never seen officers and employees who were more responsive to answering questions from its Board members. I still recall, after seeing Lehman's second quarter 2008 results, asking management for a full presentation on the company's valuations. In response, at the July Audit Committee meeting, two members of senior management presented a 23-page report, which provided an in-depth discussion and analysis of Lehman's valuation adjustments, mark downs, processes and procedures.

### Risk Management

One issue that management spent a great deal of time discussing with the Board was risk. Risk-related issues were addressed by the full Board at nearly every regularly scheduled meeting. They were analyzed at the meetings of the Finance and Risk Committee. And risk issues were also addressed by other committees as well – such as the Audit Committee. Thus, as the Examiner himself noted, Lehman's Board “plainly implemented a sufficient reporting system and controls.”<sup>7</sup>

As directors, we took great comfort from management's reports regarding Lehman's extensive risk management system, which was widely regarded as being among the best in the business. Indeed, management described in detail how risk management was at the heart of the culture of the firm; how the firm's CEO, President and entire Executive Committee took an active leadership role in key risk decisions and oversight; and how the Risk Committee, which included members of the Executive Committee and heads of key trading businesses, met weekly to discuss such topics as risk appetite, counterparty risks, market risks, and event risks. In addition, we were told about how Lehman made decisions on large risk exposures by committee; how frequently those decisions included the full Executive Committee of the firm; and how there were more than 20 different committees that served as a check on Lehman's risk taking activities. Management also informed the Board that Lehman's internal control environment had multiple overlapping and reinforcing elements. And, the Board was further reassured by the size, structure and expertise of Lehman's Global Risk Management Group, which employed industry-leading quantitative approaches to risk management and qualitative approaches to risk evaluation. This group, which had approximately 250 employees, plus more than 200 technologists (two thirds of whom had advanced degrees), was organizationally independent of the business, but had risk managers placed in the business units they covered so that they were a part of what was happening real time, day-to-day. The Board took additional comfort from management's reports regarding Lehman's extensive Valuation and Control group, which consisted of a technical staff well-versed in the products they covered.

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<sup>7</sup> Examiner's Report at 194.

## Reliance on Professionals

In performing its oversight role, Lehman's Board of Directors – like boards at companies across the country – relied upon the expertise of a variety of professionals, both inside and outside the firm. For example, the Audit Committee worked closely with Lehman's Corporate Audit Group, which employed more than 140 people and allocated its resources to address key risks across the firm, including financial, compliance, and operational risks.

We also retained Ernst & Young ("E&Y"), one of the most highly-regarded accounting firms in the world, as the company's auditors. E&Y performed reviews on a quarterly basis by applying analytical review procedures and making inquiries of persons responsible for financial and accounting matters. They further conducted a robust annual audit of the firm's financial statements. E&Y regularly attended Audit Committee meetings, met in private sessions with the Audit Committee members and certified Lehman's financial disclosures. While E&Y regularly had substantive discussions with the Audit Committee about Lehman's audited financial statements, at no time in 2007 or 2008 did E&Y raise any red flags regarding Lehman's risk management, valuation, or the firm's certified filings.

In addition to E&Y, in early 2007, Lehman retained another world-renowned accounting firm – PricewaterhouseCoopers – to support the more quantitative aspects of risk testing by evaluating the completeness of the supporting documentation for the firm's risk models, assessing the adequacy of the methodology and testing to ensure that the models were implemented appropriately. Lehman also worked intimately with one of the most well-respected law firms in the nation, which advised it on public disclosure issues.

## Interaction with Government Regulators

As a Board of Directors, we had confidence in what we understood to be Lehman's close working relationship with government regulators. Even before the financial crisis, Lehman voluntarily subjected itself to the scrutiny of the Securities and Exchange Commission ("SEC") as a part of that agency's consolidated supervised entity ("CSE") program. The purpose of this program was to give global investment banks a way to submit voluntarily to regulation that was not required by law. Under the CSE program, which provided the SEC with new and far greater transparency into Lehman's financial information, not only did Lehman meet with regulators from the SEC on at least a quarterly basis, but Lehman's Corporate Audit group also implemented systems to verify the operating effectiveness of controls supporting Lehman's capital calculation and other CSE activities and adopted a testing framework to meet the SEC's expectations. The Board understood that the SEC's CSE reviews covered corporate governance, functional risk management activities, business specific products, and capital calculation and reporting. And, we were told by management that the SEC considered Lehman a model member of the CSE program.

In addition, as the financial crisis deepened, both the SEC and the Federal Reserve Bank of New York ("FRBNY") worked intimately with Lehman to monitor and assess the firm's liquidity.

The weekend after Bear Stearns's near collapse, Lehman, together with the SEC and the FRBNY, collaborated to identify all refinancing risk. By that time, both the FRBNY and SEC had installed teams of monitors at Lehman's offices. Thereafter, management maintained a constant dialogue with the SEC and the FRBNY regarding liquidity issues.

### Lehman's Efforts to Respond to the Worsening Financial Crisis

Notwithstanding the start of what became the subprime crisis, Lehman's year-end 2007 financial results reached record levels.<sup>8</sup> Still, in 2007 and 2008, the firm took numerous steps to adjust to the worsening economic climate. For example, by August of 2007, Lehman had shut down its subprime mortgage lending unit. The firm reduced its mortgage and asset-backed securities exposure by many billions of dollars between the fourth quarter of 2007 and third quarter of 2008. Indeed, during this period, both residential mortgage exposure and commercial real estate exposure were substantially reduced.<sup>9</sup> We also discussed what had appeared to have gone wrong at Bear Stearns, how Lehman was different, and what we should nonetheless do to strengthen Lehman in light of Bear Stearns's collapse. In response, through the spring of 2008, Lehman raised more than \$15 billion in new capital.

Throughout 2008, Lehman also explored and pursued a number of strategic alternatives in an effort to strengthen the firm as the financial crisis deepened. Such initiatives included selling some or all of its highly lucrative investment management division, spinning off commercial real estate assets into a new company, lowering costs, reducing its dividend, decreasing leverage, and searching for strategic partners and for buyers of the entire business. While times remained troubling, a number of Lehman's efforts appeared to pay off. The Board was told how Lehman's liquidity had, between the second quarter of 2007 and the second quarter of 2008, nearly doubled to a record high.

### Repo 105

The Examiner's Report has raised questions about certain transactions now known as "Repo 105." While the Examiner does not claim that Lehman's accounting for these transactions was wrong, his report suggests that these transactions should have been better disclosed.

As the Examiner has concluded, this Repo 105 issue was never brought to the attention of the Board by anyone.<sup>10</sup> During 2007 and 2008, the Audit Committee discussed a broad array of

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<sup>8</sup> Press Release, *Lehman Brothers Reports Record Net Revenues, Net Income and Earnings Per Share for Fiscal 2007* (Dec. 13, 2007).

<sup>9</sup> Press Release, *Lehman Brothers Announces Preliminary Third Quarter Results and Strategic Restructuring* (Sept. 10, 2008) (Attachments II - V).

<sup>10</sup> Examiner's Report at 945.



financial matters with E&Y on an average of once a month. In order to ensure that the Audit Committee obtained unfettered information from our respected independent auditors, we routinely met with E&Y outside the presence of any management representatives as part of our regular process. If they had any question whatsoever about Lehman's accounting or disclosure regarding Repo 105's or any other issue, I believe that E&Y would have promptly raised the issue with the Audit Committee and I would have expected them to do so. They did not.

Still, I think it is clear that Repo 105 is not the reason Lehman failed. According to the Examiner's Report, without the use of Repo 105, Lehman's net leverage was still substantially reduced from the fourth quarter of 2007 to the second quarter of 2008.<sup>11</sup> And, as I have now learned, Repo 105 generally involved highly liquid government bonds that constituted a small percentage of Lehman's balance sheet.

### Lehman's Bankruptcy

So, if Repo 105 was not the culprit, why did Lehman collapse into bankruptcy? I am not so presumptuous as to say that I know the definitive answer to this question. I believe that there were many factors that contributed to this failure – including, among other things, the firm's real estate exposure (which was exacerbated by the rules for applying mark-to-market accounting), the numerous short-sellers who were capitalizing on and fueling rumors about Lehman's troubles, the tightening of the short-term credit market, and perhaps most of all, a loss of confidence in Lehman in the financial world that led to a run on the bank. Since Lehman, like all investment banks, relied on a sizable amount of short-term refinancing for its survival, loss of confidence and a market-wide panic was a fatal combination.

That said, I was dismayed when, on the evening of Sunday, September 14, 2008, the Chairman of the SEC and the general counsel of the FRBNY essentially told the Board that Lehman needed to file for bankruptcy before the Asian markets opened. I do not purport to be an expert on what would have been best for our national economy, nor do I generally have a view on bailouts and the like as policy matters. Nonetheless, to this day I wonder whether more could have been done to save Lehman and stabilize the financial system. While there may be good reasons that I do not comprehend, I still do not understand why the government did not help finance a sale of Lehman to Barclays (which was on the verge of buying our company), like it did to facilitate JP Morgan's purchase of Bear Stearns. I still do not know why, the same day Lehman was told to file for bankruptcy, the Fed expanded access to its Primary Dealer Credit Facility for other major investment banks. Nor do I understand why the government did not expedite Lehman's conversion to a bank holding company, as was done for Goldman Sachs and Morgan Stanley within a week of Lehman's bankruptcy, granting those investment banks long-term access to the Fed's discount window. I still do not know why Lehman was allowed to fail after the government had saved Fannie Mae and Freddie Mac by injecting billions of dollars into them. And, I remain at a loss as to why AIG was given a \$85 billion bailout on September 16, 2008,

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<sup>11</sup> Examiner's Report at 748.

when Lehman was given nothing. There may be good and reasonable reasons for all of these distinctions, but as a director of Lehman I do not know them.

The drastic impact of Lehman's bankruptcy on the wider economy was swift and severe. The Dow Jones dropped more than 500 points the day Lehman declared bankruptcy – at the time the largest single-day drop by points since the days following the terrorist attacks on September 11, 2001. The commercial paper market dried up. And relentless pressure was put on other major financial institutions who themselves teetered on the edge of ruin. As a result, the government stepped in with the TARP program. While we cannot rewrite history, had the government acted to stabilize Lehman so that it could have been sold or unwound, it is quite possible our country's financial crisis would not have been nearly as severe and widespread.

### My Fellow Directors

Before concluding my remarks, I would like to take a moment to recognize and thank my fellow Board members for their hard work and dedication to Lehman. Lehman had a practice of selecting directors who had a history of successfully managing major companies and who had the wisdom, experience, talent and mettle to provide oversight and guidance to management and the corporation. My fellow directors have held CEO positions at such esteemed companies as I.B.M., the U.S. Export-Import Bank, Vodafone, Sotheby's, Celanese, Telemundo, U.S. Bancorp, and a large brokerage firm. The Lehman directors have also sat on various other boards of well run, successful companies. One director, a former executive committee member and chief economist at Salomon Brothers, is a world-renowned luminary in the field of economics. And yet another was a Rear Admiral in the United States Navy, the first woman to command a U.S. naval station, and the head of the American Red Cross. They truly are a remarkable group of people and it has been an honor and a privilege to serve alongside them.

My thanks to Chairman Frank, Ranking Member Bachus, and the rest of the House Financial Services Committee for the opportunity to speak with you today. While I may not have the knowledge and expertise of my fellow panelists appearing before this Committee, I am happy to address any questions you may have.