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N.Y. Attorney General Cuomo sues Ernst & Young, alleging Lehman accounting fraud

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The big accounting firm Ernst & Young helped Wall Street investment bank Lehman Brothers conceal its deteriorating financial condition before Lehman's historic collapse, New York Attorney General Andrew Cuomo charged Tuesday.

The civil lawsuit, which seeks more than $150 million, is the first law enforcement action to stem from Lehman's failure. The bankruptcy of the firm, which was an important cog in the machinery of the capital markets, caused immense collateral damage.

The allegations against Lehman are not new. The federally appointed lawyer examining the causes behind the firm's bankruptcy reported in March that it had cooked its books to conceal how little cash it had available in the months before it failed.

The allegations centered on sham trades that allowed Lehman to window-dress its balance sheet before filing quarterly financial reports, making it seem like it had more cash than it actually did.

Cuomo's lawsuit aims to hold accountable one of the less-mentioned players in the saga - Ernst & Young, Lehman's auditor, which allegedly turned a blind eye to the accounting machinations.

The case does not resolve the fate of senior Lehman executives, such as former chief executive Richard Fuld, who have been under investigation by the Securities and Exchange Commission.

As for Lehman itself, it has been sold for parts, mostly to the British bank Barclays.

Ernst & Young said in a statement that it would defend itself against Cuomo's claims. The firm said "there is no factual or legal basis" for the suit since it had followed legal accounting standards in auditing Lehman's books.

"Lehman's audited financial statements clearly portrayed Lehman as a highly leveraged entity operating in a risky and

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volatile industry," Ernst & Young said.

Lehman was one of Wall Street's storied investment houses. It survived the initial panic in the financial markets that devoured its corporate rival, Bear Stearns, in March 2008.

As the economic crisis intensified in the fall of 2008, Lehman executives insisted their firm was fine. But over a few days, Lehman quickly ran out of money. It begged for a government bailout but was turned down and was forced to file for bankruptcy protection.

The firm's collapse started a wave of dominos falling that was only arrested by dramatic government intervention, including the bailout of American International Group and the bank rescue known as the Troubled Assets Relief Program.

Cuomo's lawsuit and the report by the bankruptcy examiner asserted that during these eventful months - and years before - Lehman was misleading investors about its financial health.

According to the charges, Lehman would engage in an arcane accounting trick shortly before releasing quarterly financial results to the public.

This trick would make the firm seem like it had less leverage - a measure of how much debt a company has compared to how much cash it has. Investors, analysts and regulators often view excessively high leverage as a warning sign about a company's financial condition.

Before these quarterly reports, Lehman would transfer assets to European banks. It would receive cash in return. This cash made it seem as though Lehman had less leverage.

The problem was that, shortly after the publication of the reports, the European banks would sell the assets back to Lehman for a premium. The cash that Lehman appeared to have disappeared.

The firm's leverage was actually much higher than it seemed - $50 billion before the firm's collapse, according to the lawsuit.

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The boomerang trade was referred to as "Repo 105," short for repurchase, since Lehman agreed to buy back the assets before selling them.

"This practice was a house-of-cards business model designed to hide billions in liabilities in the years before Lehman collapsed," Cuomo said in a statement. "Just as troubling, a global accounting firm, tasked with auditing Lehman's financial statements, helped hide this crucial information from the investing public."

The lawsuit says Ernst & Young was aware of the transactions and endorsed them. It also claims that the accounting firm failed to object when Lehman misled analysts during its earnings calls about its leverage ratios. And it claims that Ernst & Young did not tell Lehman's board about a whistleblower's concerns about the "Repo 105" transactions.