THE WALL STREET JOURNAL.
WSJ.com

LAW | MAY 27, 2010

Lehman's Bankruptcy Estate Sues J.P. Morgan

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Lehman Brothers Holdings Inc.'s estate sued J.P. Morgan Chase & Co., alleging J.P. Morgan illegally siphoned billions of dollars from Lehman in the days before the troubled investment bank filed for the largest bankruptcy in U.S. history.

The lawsuit alleges that J.P. Morgan Chief Executive James Dimon and other top executives used inside knowledge to take advantage of Lehman as its financial state worsened. J.P. Morgan, the suit alleged, coerced Lehman to turn over $8.6 billion in collateral in September 2008, triggering a liquidity squeeze that contributed to Lehman's collapse. The estate is hoping to recoup billions in collateral the bank demanded, and billions in other damages.

J.P. Morgan spokesman Joe Evangelisti said the lawsuit "is ill-conceived and meritless, and we will vigorously defend it."

The lawsuit, long expected, contains among the most-significant allegations to date about the interplay between Lehman and its onetime Wall Street brethren.

J.P. Morgan served as Lehman's main "clearing bank," meaning it acted as a middleman between Lehman and its lenders and investors. In this capacity, it knew more than most market players about Lehman's financial condition, which was growing more dire in the summer and fall of 2008.

The lawsuit alleges J.P. Morgan used this advantage to squeeze billions of dollars out of Lehman by demanding more collateral to cover its risks, ensuring J.P. Morgan "would stand ahead of all other [Lehman creditors]—not just for its clearance exposure, but for all possible exposure that could result from [a Lehman] bankruptcy."

Lehman bowed to J.P. Morgan's demands, said the suit, claiming Lehman feared that if J.P. Morgan ceased its clearing activities, it would have triggered the firm's immediate collapse.

A bankruptcy-court examiner found in a recent report that Lehman could pursue a legal claim against J.P. Morgan for making "excessive collateral requests," though he labeled it "not a strong claim." The examiner said Lehman could have a legal claim to claw back $6.9 billion of the $8.6 billion pledged to J.P. Morgan.

The bankruptcy-court examiner assailed Lehman for using certain accounting techniques to mask its leverage and mislead market participants before its collapse. Meantime, J.P. Morgan was among the only institutions to continue lending to Lehman before and after its bankruptcy.

J.P. Morgan's Mr. Evangelisti said: "As the examiner's report makes clear, it was the ill-advised decisions of Lehman itself and its principals to take on perilous leverage and to double-down on subprime mortgages ... and not any conduct by J.P. Morgan that led to Lehman's demise and the enormous losses to its various constituencies."

He added that there was "absolutely no inappropriate use of confidential information by any employee."

Lehman outlined a series of events in which it claimed J.P. Morgan took advantage of being the "ultimate insider" and contributed to Lehman's tumble into bankruptcy court. The following timeline is based on Lehman's versions of events contained in the suit:

In late August, J.P. Morgan, aware that Lehman's situation was deteriorating, asked Lehman to revise its clearance agreement to give J.P. Morgan added protections.

Not long after, in early September, senior J.P. Morgan and Lehman executives met to discuss Lehman's upcoming quarterly results. J.P. Morgan was given access to Lehman's books and records.

On Sept. 9, Mr. Dimon met with Federal Reserve Chairman Ben Bernanke and Treasury Secretary Hank Paulson to discuss Lehman's fate and the government's intention to avoid rescuing the firm. Those meetings prompted J.P. Morgan to accelerate efforts to get Lehman collateral, the suit alleges.

The same day, Steve Black, co-head of J.P. Morgan's investment banking division, agreed to send a deals team to Lehman to discuss pumping money into the troubled firm—an idea Mr. Dimon had discussed with Lehman's chief executive, Richard Fuld.

But J.P. Morgan instead sent bankers to probe Lehman's records and plans, Lehman's suit alleges. The team later told Mr. Dimon and others that Lehman wanted a credit line from J.P. Morgan. In an email, Mr. Black responded by asking about the "drugs they apparently have been taking to think that we would do something like that."

In the evening hours of Sept. 9, J.P. Morgan's in-house lawyer, Diane Genova, called Andrew Yeung, a junior Lehman lawyer, alerting him that J.P. Morgan was drafting a new set of security agreements Lehman needed to sign before it released earnings results the next morning, the suit alleges.

Executives authorized to sign the agreement, including finance-chief Ian Lowitt, were unavailable, the suit alleges. J.P. Morgan told Mr. Yeung that Mr. Fuld, Lehman's CEO, had agreed to the new deal's terms in a conversation with J.P. Morgan's Mr. Black. Lehman said in the complaint that was "untrue."

The new agreement gave J.P. Morgan broader protections, requiring Lehman's holding company give broad guarantees to all J.P. Morgan's exposures to all Lehman entities, regardless of their nature. The new deal also canceled Lehman's access to previously pledged collateral through an overnight account, the suit alleges.

With the threat of J.P. Morgan stopping clearing activities looming, Mr. Yeung sent the agreement back, signed by Lehman treasurer Paolo Tonucci.

J.P. Morgan demanded more collateral over the next week, culminating in a $5 billion request late Sept. 11. Senior Lehman officers circulated a "Back-Up Contingency Plan" that noted J.P. Morgan continued to ask for collateral. "If we don't provide the cash, they refuse to clear, we fail ... , " part of the plan said.

On Sept. 12, Lehman delivered "what was essentially its last available $5 billion in cash," the complaint said. Over the weekend, Lehman "repeatedly" requested access to some of the collateral to stay afloat long enough to sell itself or wind down. J.P. Morgan refused.

The government declined to rescue Lehman. On Sept. 15, the then fourth-largest investment bank in the U.S. filed for bankruptcy, setting off the financial crisis.

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