“Freefall”: A GRR Lehman special

Douglas Thomson
15 September 2018

istock.com/ratpack223

A decade ago today, on 15 September 2008, Lehman Brothers Holdings filed the biggest Chapter 11 filing in history, plunging the world into an economic vortex from which it has still not fully escaped. **Douglas Thomson** investigates the legacy that the collapsed bank left on cross-border insolvency law and what the next “Lehman” might look like.

The laconic space of Lehman’s standard-form Chapter 11 petition offers a few hints of the upheaval that was to come. “Debtor is not a small business debtor” – not by some distance. “Total assets: US$639 billion. Total debts: US$613 billion.”

Those assets were leveraged 31-to-one against shareholder equity, and Lehman’s mid-2000s gobbling-up of the subprime mortgage market meant it had a huge, vulnerable mortgage securities portfolio. When the subprime crisis heated up the spring of 2008 with the near-collapse of Bear Stearns, Lehman’s position looked precarious.

First published on the *Global Restructuring Review* website, September 2018

A second-quarter loss of US$2.8 billion in June, then successive plunges in stock value as summer turned to autumn. A potential saviour – South Korea's state-backed Korea Development Bank – came and went. From the US government, concerned at moral hazard from bailing out too many banks, the word came there would be no rescue for Lehman.

On 14 September Lehman employees were already clearing out their offices. The firm retained a team from Weil Gotshal & Manges, headed by the late **Harvey Miller**, doyen of Chapter 11, with partners **Richard Krasnow**, **Lori Fife**, **Shai Waisman** and **Jacqueline Marcus**, the first five attorneys to practise in what has since turned into a field all of its own – Lehman.

It was a "freefall Chapter 11", one lawyer involved in the case told *GRR*. **James Peck**, the now retired judge who oversaw the Lehman Chapter 11 until he stepped down from the bench in 2014 for his current role as a partner at Morrison Foerster, calls the petition "a sudden and abrupt filing that took place with no planning whatsoever".

"One has to wonder whether Lehman should have been permitted to fail in the first instance," he says, pointing out that subsequent litigation in the UK was "strongly indicative" that the bank's asset base – there, at least – was not insolvent. "In retrospect I think it would have been better for Lehman to have been afforded liquidity to have a softer landing into Chapter 11."

"The random assignment of a lifetime"

The filing came before Judge Peck, then two and a half years into his time on the US Bankruptcy Court for the Southern District of New York, from a random allocation of court dockets.

"I felt it was a tremendous responsibility. But oddly I felt I was well-prepared to handle it," he says. Because Lehman was such a "one of a kind" case, Peck says no amount of previous experience could really have been adequate preparation.

"But in the nine months preceding the Lehman filing I had been paying very close attention to issues of systemic risk in the global economy. I had been reading about it and talking to other people about it. So I thought I was eerily attuned to the issues of the case, and in a sense I'd been informally preparing myself for what turned out to be the random assignment of a lifetime."

The Lehman case became international almost instantaneously. "My phone started ringing on 15 September," says Morrison & Foerster partner **Sonya van der Graaf**, who at the time of the filing was finishing six years in-house at Bear Stearns, before moving to Brown Rudnick that month.

First published on the *Global Restructuring Review* website, September 2018

Van der Graaf was soon advising “dozens of clients” related to UK Lehman entity Lehman Brothers International Europe (LBIE) in cases including the *Client Assets* litigation – claims by LBIE clients who argued their money should be ringfenced from the claims of the bank’s general creditors – the *Four Unnamed Funds* litigation and the successive *Waterfall* litigations.

South Square barrister **Felicity Toube QC**, then a senior junior, got the call the day after Lehman went under. “Very quickly, pretty much everyone in chambers – everybody, from top to bottom, was either on the LBIE team or adverse. Any time we had a new tenant, they would almost immediately be involved in some form of Lehman.”

Toube ended up acting for the US parent, Lehman Brothers Europe, LB UK Re Holdings and Lehman Bankhaus – “Basically anybody who wasn’t LBIE.” She says she got the call for her involvement in *Re Global Trader Europe*, the first case on client money rules, where she developed the arguments – unsuccessfully, in that case – that eventually prevailed before the UK Supreme Court in LBIE’s case. LBIE was in an unusual position, and ended up one of the Lehman success stories.

It was cashflow insolvent, but not balance sheet insolvent. “The estate recovered over time, because the administrators were successful against other Lehman entities. So unsecured creditors in LBIE managed to do very well,” van der Graaf says. “There’s been a lot of pain because of Lehman. But a lot of astute investors, too, who made a lot of money.”

Distressed investors in particular did very well. “If you buy a claim with a face value of £1 for 20p, and you get paid out for more than 20p, you’re doing well. But in LBIE you’re getting investors receiving more than the £1.”

That threw up issues that none of the practitioners involved had ever seen before. “Lehman is just unparalleled in terms of the sheer number of novel points. You could pretty much guarantee that any question that came up in Lehman would be new,” Toube says. “It’s a solvent non-trading administration – which is quite about as unusual as you can get – where if you actually have a provable debt you are actually going to be paid, and it’s not tuppence ha’penny, it’s millions.”

“The UK Insolvency Act wasn’t designed for a situation where the supposedly insolvent estate pays out at more than par,” van der Graaf says. “That’s why we had to send so many questions to the court, where the Insolvency Act was really no more than a guide.”

With the Lehman bankruptcy spawning cross-border actions across the world, in 2009 Judge Peck initiated a cross-border protocol that has since been lauded as one of the saving graces of the case, and one of its biggest legacies.

First published on the *Global Restructuring Review* website, September 2018

“The cross-border protocol actually grew out of a speech I gave at the World Bank in January 2009, where I’d been invited to give a talk to a colloquium of academic and regulatory figures who were talking about the failure of major non-bank financial institutions,” Peck says.

Peck’s speech dwelled on a cross-border protocol he’d agreed before with a court in Montreal for the 2008 CCAA proceedings of Canadian printing company Quebecor World.

“I talked about the protocols at the World Bank and it was on my mind. So during a Lehman ‘state of the estate’ hearing I brought up the subject.” That led to the development of the protocol by Lehman’s counsel with the other Chapter 11 parties.

“I believe it was one of the first major cases where the use of a cross-border protocol was instrumental in bringing together a number of parties,” says Curtis Mallet-Prevost Colt & Mosle partner **Lynn Harrison**. “There were a number of parties throughout the world that thought it was in the interest of their estates to have a protocol.”

“It was in essence the testing of the Chapter 11 process in the context of a worldwide insolvency meltdown, and a very good use of the mechanisms and tools that were in place – specifically the use of the UNCITRAL Model Law and the use of protocols.”

The Chapter 11 was also spinning out into adversary proceedings, including clawback actions against JP Morgan and Citibank worth over US$10 billion and over US$2 billion respectively.

“I had just returned from a business trip to Hong Kong and Seoul, and was in Mexico when I initially got involved with Lehman,” says Harrison, who acted for Lehman in those cases. “I knew Harvey Miller quite well – and working with him was one of the highlights of my entire experience in Lehman – and we’d previously worked very closely with Weil on other cases.”

Curtis's reputation for conflicts and high-profile litigation assignments put it in a good place to take on the adversary instruction, he says. “My initial reaction was figuring out where to begin. Someone said it was like ‘drinking water through a firehose’. You were in the midst of the greatest economic crisis since the Great Depression. You were working on the largest international insolvency case in history. There were cutting edge issues obviously.”

Those included how to address financial products in the context of an insolvency proceeding. “You had securitisations, and very complex, esoteric financial products, that you were dealing with, in an international context, for the first time on this scale.”

First published on the *Global Restructuring Review* website, September 2018

He adds: “There was the question of what companies are ‘Too Big to Fail’, particularly on a global scale, and how to restructure those types of institutions.”

Harrison also says that for him working with Miller, who died in 2015, “was extraordinary – he was the creator and purveyor of Chapter 11 as we know it today, and to work with him on such a case in this environment was an experience worth remembering”.

The JP Morgan and Citibank clawback claims went on for over eight years. “We thought that banks had an unfair advantage, given the insolvent position of Lehman, and they took full advantage of protecting their interests, to the detriment of unsecured creditors in general,” Harrison says. Eventually they settled, for in excess of US$1 billion in both cases.

Lessons learned

Lehman’s litigations are still not done. That first Chapter 11 initiated by Miller’s team at Weil 10 years ago, now overseen by **Judge Shelley Chapman**, saw its latest plan administration update – the 58,829th filing in the mammoth case docket – on 14 September, as this piece was being finalised.

Much of the remaining work to do lies outside the US – in UK, Swiss, German, Indian and Spanish proceedings. The 14 September filing notes that “it could take years” for those matters to conclude.

In the US, most assets have now been reduced to cash, but the plan administrators say the matters still remaining before the Chapter 11 court are more likely to require judicial resolution.

“One of the most important lessons is that the US Chapter 11 regime is a remarkably flexible and resilient protocol for resolving financial failure, which was tested to its limits – and perhaps beyond its limits – by the Lehman filing,” says Peck. “But I have long sensed that Chapter 11, while not 100% perfect and not purely adapted to financial institution failure, performed at a very high level.”

He says the cross-border protocol was a “useful tool”, but just a start. “There probably needs to be a fully developed understanding, among the courts of the leading commercial jurisdictions, for procedures that could be applied in the event of the next major cross-border failure.”

He says the special administration of derivatives trader MF Global, one of the cases to come in the wake of the hot years of the Lehman bankruptcy, showed progress. “Even though they are not exactly comparable cases I think MF Global was more effectively handled by virtue of those provisions that were adopted from Lehman.”

First published on the *Global Restructuring Review* website, September 2018

Despite the success of the Lehman cross-border protocol, Peck says it's unlikely the procedure will be institutionalised in advance for future cross-border financial failures. "It would be better if procedures were established that could be pulled off the shelf and applied as the situation demanded. But the reality of human nature is that people tend to respond in a crisis rather than dealing with hypotheticals. It's more likely that procedures will be designed on an ad hoc basis to meet the requirements of the moment."

Harrison however thinks the protocols' appeal will allow them to spread of their own accord. "The use of protocols is going to become commonplace in many jurisdictions, particularly with the advent of the Judicial Insolvency Network (JIN)," he says.

The JIN, a Singaporean judge-led initiative, is a global gathering of bankruptcy judges every couple of years. Its first outing, in 2016, led to the birth of a set of cross-border cooperation guidelines for bankruptcy courts to adopt around the world. Courts in Seoul and the Cayman islands have been the latest to adopt them.

"I know there are political reasons why these protocols may not be realistic in some jurisdictions. But I'm willing to wager that, given the competition underway between the various insolvency hubs like Hong Kong, Singapore, London, New York, Delaware – and perhaps Germany because of Brexit – there will be an inclination to support these types of cross-border agreements," Harrison says. "This will become an important aspect in determining choice of where to file a cross-border case."

Van der Graaf says Lehman's positive impact was to put governments' insolvency regimes at the front of their minds. "In the past some jurisdictions have had very clunky 'debtor friendly' regimes that aren't debtor friendly at all," she says. "When some jurisdictions have such low rates of recovery, they realise they are not able to tap US and international credit markets. So the Netherlands has been looking at something like the UK scheme of arrangement. France has vastly improved its regime. The UK has just announced it's looking at cross-class cramdown."

She says Lehman also showed the importance of good courts. "In the UK we're lucky to have courts that are second to none, an adversarial system and judges who really know what they are talking about. You can change the law all you want but if your judge does not understand how to apply that law then there is a problem." She highlights Italy, which still retains an inquisitorial regime for its courts, and Spain, where a complex case may end up being decided in the court of a provincial town. "That's not a good thing."

Toube agrees. "I may be biased but there is no comparison in Europe for the quality and depth of the English judiciary – the way in which we can get a hearing heard and a judgment determined in an extraordinarily short period of time is not mirrored in

First published on the *Global Restructuring Review* website, September 2018

continental Europe. So unless things change quite substantially, my concern is if this happens again, you won't end up with a solvent Lehman because the cross-border workout that happened between the US and UK this time just won't be possible. It'll be disastrous for the creditors of these companies."

"A lot of us are very concerned about what Brexit will do," she says, calling attention to the urgency of enacting "some version of the European Insolvency Regulation" after Brexit.

"If there are parallel proceedings, I'm not sure we will have the experience working between us and the continental European jurisdictions – partly because it would be common and civil law, and because we have so spectacularly shot ourselves in the foot by Brexiting, which may mean that continental Europe isn't minded to be terribly cooperative with us. And partly because continental jurisdictions are simply not set up for the sort of multiple applications that the English court is set up for."

The actual case law impact of LBIE in particular may be limited by it being so unique, Toube and van de Graaf say. "The *Waterfall* cases were so bespoke to the solvency aspect of Lehman, so the case law will be less called-upon. But all the other stuff – cases on derivatives, the flip clauses, the details of the master agreement – they are all very helpful and will be called upon every day by people in the industry," Van der Graaf says.

Toube says the courts' rulings have meant that a lot of questions have been settled, though. "The interaction of pensions and insolvency, and the meaning of provable debts, and what is the difference between a provable debt and an expense. We now know categorically what the answer is to those because the Supreme Court has told us."

She says it's seen a lot of standard paperwork redrafted. "We now know what certain clauses and standard documentation mean," Toube says. "We either use them to mean those things, or we use different things to mean what we thought they meant in the first place."

Peck says the crisis changed insolvency practice too. "It is my perception that professionals in the insolvency field now recognise that their work is more global than it is local. Globalisation has obvious consequences in terms of the failure of businesses that have assets and operations in various parts of the world. The Lehman experience became something of a test case for a high level of cooperation between and among practitioners in different parts of the world."

That may be a boon for the future. "That history of co-operation represents an intangible asset that can be exploited for the benefit of reorganisation regimes around the world," Peck says. "It's one thing to have procedures that can be followed

domestically. It's another thing to connect those procedures for the benefit of stakeholders in multiple jurisdictions."

The next Lehman

Away from the law, Lehman changed the culture in finance according to Toube. "No doubt they're forgetting this lesson again, but at least for a time people actually read financial documents and tried to understand how these financial products actually worked – because before, the culture was one of financial products which nobody really understood but which nobody was willing to admit they didn't understand. Entire vast economies were built on things nobody understood," she notes.

"The world has changed so much since Lehman," van der Graaf adds. "We've seen a shift from the prominence of investment banks to private direct lending funds descending onto Europe, which are pulling in the riskier investments, which the banks can't pick up anymore. That's a result of Lehman and the financial crisis it precipitated."

She says this shadow banking industry is "enormous, absolutely enormous", and says it's likely there that we will find the pressure points for the next crisis.

"Now financial indebtedness is commonly on a covenant-light basis. Because liquidity's awash right now, the terms of credit are really in the hands of the borrowers. Corporates are in a negotiating position where they can set the terms on which they borrow money. The ability of the lender to bring the borrower to the table has been reduced, so it's now hard to point to a trigger for default," van der Graaf says.

That means lenders aren't doing what they should be: "You see a lot of zombie companies wandering around. Banks are kicking the can down the road rather than insisting on the restructuring a lot of these borrowers dearly need. So when the next crisis hits, it's going to be quite widespread."

Toube agrees. "Because of the horrible situation 10 years ago, people are much more unwilling to let the big insolvencies happen. That's why you have rollovers, and why we have the zombie companies, because no-one quite wants to push the final domino." That's good and bad, she says. "Some companies just need to go."

Harrison points to other factors. "With the confluence of artificial intelligence, cryptocurrency and cybersecurity, I think we're probably headed for a similar event. I am not going to predict when that's going to happen but those areas should give professionals pause. It all centres around technology, this brave new world of something "artificial". When you look at Lehman, there were a lot of things that were "artificial" also, but on a different scale."

First published on the *Global Restructuring Review* website, September 2018

“I don’t have a crystal ball,” Peck says cautiously. “I think it’s reasonably foreseeable that at some point in the future there will be another crisis. I don’t know whether it will arise within the financial sector itself or may be brought about by external factors like political unrest, cyber attacks or sovereign failures. But history does tend to work in cycles when it comes to financial failures, and leverage is very frequently highly correlated with such failures.”

Financial institutions are “generally on a sounder financial footing” than in 2008, he adds. “That represents an effective oversight by regulators and central banks, all geared to the proposition that we may not have ideal resolution procedures but we should minimise the risk that these institutions are going to fail in the first place.”

Peck is continuing to advocate for a Single Point of Entry regime in the US regime – a resolution strategy that envisages the bail-in and recapitalisation of the financial institution’s parent company by the national resolution authority of that company’s home jurisdiction, leaving operation subsidiaries unaffected. “I’m hopeful those may be adopted sometime between now and whenever there may be a need to use them.”

“Regulators are going to be key” for the next crisis, van de Graaf says. “They are now more ready to step in and take control. Pre-Lehman we were regulation-light. Now regulators are all over the institutions they regulate.” But she says this does not apply to the shadow banking industry.

The rules for a crisis remain the same, though. “When liquidity dries up because investors get scared, people behave in a different way from the good times,” van de Graaf says. “Creditors behave in a way that’s more about protecting their own skins.”

“The issues in Lehman won’t recur again in exactly the same form,” Toube says. “What will recur will be the sorts of issues that always occur in financial collapses. Because there will be financial collapses. The fact that all the recent ones have been big retail collapses doesn’t mean we’re not going to see a big financial collapse again.”

The post-Lehman regulatory reforms that did get adopted have not yet been tested, Harrison adds. “The day will come when they will be tested. I would like to think we will be in a better position to address these types of financial meltdown in the future,” he says.

“We’ve learned that a freefall Chapter 11 is not the best solution, but I think it’s a testament to Chapter 11 that it was flexible enough, in the crucible we’re talking about here, of the greatest meltdown since the Great Depression, and still Chapter 11 stood the test of time.

First published on the *Global Restructuring Review* website, September 2018