Resolution Authority:
Lessons From The Lehman Experience

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The Lehman Business Model

- In 2008, Lehman was the fourth largest US investment bank and had been in operation for more than 150 years.
- By 2008, Lehman had grown exponentially from a client advisory and private investment bank using its own balance sheet to a multi-faceted public entity directed by the new breed of executive leaders – traders.
- The repeal of the Glass-Steagall Act had transformed financial institutions such as Lehman, effectively, to encourage substantial risk taking in the quest for increasing revenues and profits.
- Lehman operated its business as a single, integrated business covering three major business lines:
    1. Capital Markets;
    2. Investment Banking; and
    3. Investment Management.

  Its business encompassed global financial transactions; asset management; private investment management and private equity.

The Lehman Business Model

- Lehman had more than 25,000 employees and over 6,000 subsidiaries in more than 40 countries. Lehman's main nerve centers were located in New York, London and Tokyo. Fewer than 1,000 subsidiaries had any active relationship to the ongoing business.
- Lehman operated two US insured depository institutions (banks) that were subject to FDIC oversight and potential seizure: Aurora Bank FSB and Woodlands Commercial Bank (formerly Lehman Brothers Commercial Bank). As of March 31, 2011, the value of LBHI's equity interests in Aurora Bank and Woodlands were reported, on a fair value basis, at $892 million and $896 million.
- Consistent with its mode of operation, employees were largely ignorant of which legal entity employed them. In New York, a trader on the equities desk would book trades anywhere in world with any legal entity, including Lehman entities.

The Lehman Business Model

- Lehman Brothers Inc. (“LBI”), a regulated US broker dealer, subject to oversight by the Securities Investor Protection Corporation and the SEC, employed most of the 10,000 employees in the New York area. LBI was the legal entity and parent of the legal entities that were engaged in US capital markets and investment banking businesses.
- Lehman Brothers Holdings Inc. (“LBHI”), the ultimate parent corporation, acted as central banker for the Lehman enterprise and operated the cash management system that each night swept all cash to LBHI and then, the next day, disbursed cash throughout the enterprise on an “as needed” basis. LBHI also borrowed or raised funds necessary to provide liquidity for the Lehman enterprise.

The Seeds of Destruction-Spiraling Out of Control

- As the first decade of the 21st Century progressed, Lehman grew aggressively by taking on more risk and increasing leverage, essentially by short-term borrowings.
- Lehman transformed from being a conduit for investments to taking on inventory as a proprietary investor focused primarily on real estate, leveraged loans and private equity.
- As the subprime crisis erupted, in 2007, Lehman responded by, essentially, "doubling down" on real estate investments, and modifying its own internal risk prevention systems and controls in order to enable such transactions. Many Lehman investments were long-term, but were financed with short-term borrowings.
- Lehman's primarily source of liquidity was through overnight repos. It borrowed tens of billions of dollars to obtain the necessary liquidity to maintain operations.
- Lehman's debt to equity leverage ratios often exceeded 40:1 and during the mid period of any reporting period, might go up to 60:1.

The Seeds of Destruction-Spiraling Out of Control

- For 2007, Lehman realized record revenues and earnings.
- Spring of 2008 revealed a different picture. The subprime crisis was expanding and the situation was exacerbated by the fall and bailout of Bear Stearns, the fifth largest investment banker, in March, 2008.
- After Bear Stearns, Lehman became the focus of attention and was widely pointed to as the next financial failure. Hedge funds were particularly critical of Lehman’s valuation of its assets.
- As spring passed into the summer of 2008, the US Treasury, the Federal Reserve Bank of New York and, to some extent, the SEC, became more agitated about Lehman.
- Lehman was able to raise substantial additional equity during the summer of 2008, but its other efforts to reduce leverage and to identify potential purchasers and take other actions had limited success.

The Seeds of Destruction-Spiraling Out of Control (Continued)

- Lehman became more and more dependent upon the ability to borrow larger and larger amounts in the form of overnight repos. The providers of the facilities for such repos, Lehman's clearing banks, began to show signs of apprehension. As the summer of 2008 wore on, clearing banks began to make demands for collateral security.
- JPMorgan Chase, Lehman's primary clearing bank, in the beginning of September, 2008, aggressively demanded collateral security for clearing activities. In the same period, the takeover of Fannie Mae and Freddie Mac by the US Treasury and the creation of the conservatorship on Sept. 7, 2008 increased pressure on Lehman.
- In that period, demands for collateral securitization increased, negative rumors abounded, major accounts began to leave Lehman and the posting of collateral security began to drain the enterprise of liquidity.
- Between Sept. 8-12, 2008, more than $15-20 billion in cash and securities was posted with various clearing banks, mostly with JPMorgan Chase, as collateral security for the obligations of not only of LBHI and LBI, but of all of the Lehman entities.

The Fateful Weekend of September 13-15, 2008

- Despite the significant deterioration in liquidity, Lehman leadership had little doubt that a solution or strategic alternative was in the offing.
- At the suggestion of the US Treasury, Lehman sought a buyer and focused on the Bank of America and then, Barclays.
- At meetings held at the New York Fed during Saturday, September 13, 2008, attended by the "heads of the families" and representatives of the US Treasury and the SEC, Lehman executives were interrogated as to liquidity and asset values. During those meetings, the US Secretary of the Treasury made it clear that there would be no federal bailout of the Lehman enterprise and encouraged the negotiations with Bank of America and Barclays.
- During those meetings, John Thain, then CEO of Merrill Lynch, recognized that Merrill Lynch was not far behind Lehman and he withdrew and immediately contacted Ken Lewis, the Chairman and CEO of Bank of America. Bank of America dropped out of the Lehman negotiations.

The Fateful Weekend of September 13-15, 2008

- Negotiations ensued with Barclays. Richard Fuld and the Lehman executive leadership were confident there would be a transaction with Barclays.
- The parties left the negotiations late Saturday night, September 13, 2008 confident that the essential terms of an acquisition by Barclays had been agreed upon.
- By Sunday morning, September 14, 2008, after Secretary Paulson reiterated, “not one dime of taxpayer monies for Lehman,” and the UK Chancellor of the Exchequer, Alistair Darling, noted that the UK government could not be seen to bail out a US investment bank without the participation of the US Treasury, the proposed Barclays transaction cratered.

The Commencement of Bankruptcy/Insolvency Proceedings

- There was absolutely no intention on the part of Lehman to consider the possibility of bankruptcy or an insolvency proceeding for LBHI or any part of the Lehman enterprise. Consequently, there was no preparation for that eventuality.
- The entire focus of Lehman's management and executives was to effectuate a transaction that would enable the Lehman business to continue.
- By the late afternoon of September 14, 2008, at meetings with the federal authorities at the New York Fed, Lehman was, effectively, directed to initiate a bankruptcy case prior to midnight of that day.
- Arguments as to the potential disastrous consequences of a Lehman bankruptcy filing upon the financial markets were to no avail.
- After considerable debate and a surprising presentation to the LBHI board by the General Counsel of the New York Fed and the Chairman of the SEC, the LBHI Board of Directors authorized the commencement of a chapter 11 case by LBHI.

The Commencement of Bankruptcy/Insolvency Proceedings

- The chapter 11 petition that was ultimately filed at approximately 2:00 a.m. on September 15, 2008 was the most bare-bones chapter 11 petition ever filed. The objective was to start the process and stop a race to the courthouse and piecemeal disintegration of the Lehman enterprise.
  - In its petition LBHI reported assets totaling $634 billion and liabilities totaling $611 billion (ultimately, more than 67,000 claims were filed in excess of $1 trillion).
- The commencement of the LBHI chapter 11 case precipitated insolvency proceedings throughout the world and the appointment of receivers or administrators in over 80 insolvency proceedings that ensued.
- The commencement of insolvency proceedings under the laws of the United Kingdom in London for Lehman Brothers International (Europe) – a major and integral part of the Lehman enterprise – had a major negative impact on the subsequent chapter 11 administration of Lehman.
- The UK Administrator closed down the Lehman enterprises' information and operational systems with resultant inability to retrieve necessary information as to assets, liabilities, etc.
- The situation, in the face of total lack of preparation, was chaotic and completely novel in the world of bankruptcy.

Post Bankruptcy Days –
September 15, 2008 – October 1, 2008

- On the bankruptcy filing date, September 15, 2008, the Lehman enterprise was essentially devoid of any liquidity for operations. Receivers, administrators and liquidators appointed in foreign insolvency proceedings immediately began to divest assets in the drive to raise cash.
- The only exception was LBI, the US broker dealer. LBI was not qualified to commence a chapter 11 bankruptcy. LBI was subject to the Securities Investor Protection Act and any actions that might be initiated by the Securities Investor Protection Corporation ("SIPC").
- In negotiations with the New York Fed, it was agreed that LBI could continue to operate and access funds from the New York Fed on an overnight repo basis, provided that LBI posted adequate collateral security. It was assumed that that relationship and agreement would continue for a period of at least five days.
- Lehman obtained this relief by demonstrating to the New York Fed and SIPC that continued operations of LBI would be for the benefit of the public customers of LBI.
- LBI was not to use loan proceeds to provide any liquidity for the operations of LBHI and the rest of the Lehman enterprise.

Weil

The Emergence of Barclays As an Acquiror

- There were no plans as to how to manage or protect the assets of the Lehman enterprise, as the chapter 11 case began on September 15, 2008.
- At 7:00 a.m. on September 15, 2008, Barclays returned to the negotiating table and expressed its desire to acquire Lehman's North American Capital Markets business.
- Intensive negotiations commenced early that morning at the Lehman headquarters with the representatives of Barclays. Time was of the essence.
- Barclays expressed its desire to acquire a going concern business and, thus, would not be interested in any protracted proceedings or if the capital markets business was suspended or terminated. Weil and Lehman developed a scheme to effectuate a transfer of the capital markets business as a going concern within a week.

The Emergence of Barclays As an Acquiror

- SIPC was convinced that the proposed procedure would protect the public interest and agreed to monitor the chapter 11 administration, appoint a person to be the SIPC Trustee and to commence a SIPA proceeding for LBI on Friday, September 19, 2008 to be administered concurrently with the LBHI chapter 11 case and jointly propose the sale of the North American Capital Markets business to Barclays.
- The process was successful and on September 22, 2008, the transaction was consummated and essentially all of the 10,000 Lehman employees were transferred on that day to Barclays.

The Post Barclays Acquisition

- The Lehman administration was bereft of knowledgeable employees and executives post the Barclays transaction.
- Alvarez & Marsal ("A&M"), the financial advisory firm, was formally engaged on September 18, 2008.
- A&M quickly realized the tenuous situation and rapidly deployed hundreds of persons to gain control of the assets of the Lehman enterprise not transferred to Barclays or joined in the race to the courthouse in foreign jurisdictions.
- It was touch and go, as order was created out of chaos.
- The Barclays transaction provided the Lehman enterprise with over $1B of cash with which to commence an effective administration of the Lehman enterprise.
- A Transition Services Agreement ("TSA") had been negotiated with Barclays so that key systems and data would be available to the chapter 11 administrators. It proved to be a difficult transition that required extensive negotiations and modifications and concessions by Barclays.

Loss of access to information, systems, personnel

- Other entities had to commence insolvency cases around the world as they faced derivative terminations caused by LBHI/LBIE insolvencies, other defaults as a result of LBHI guaranties, setoff of bank accounts by banks, and/or no liquidity due to loss of funding from LBHI.
- The loss of value due to derivatives terminations alone was massive.
- By early October 2008, the significant US entities were all in chapter 11. Soon there were more than 80 proceedings in at least 16 different jurisdictions. Today, there are more than 100 insolvency proceedings underway around the world.
- Lehman used 2,700 interrelated software programs. Commencement of different proceedings instantly cut off access to other entities’ data and personnel.
- Lehman’s worldwide financial information system broke down immediately after the UK Administrators shut down the system.

The Role of the Bankruptcy Court

- The Barclays transaction provided a basis upon which the administration of the Lehman enterprise in bankruptcy could be rationally undertaken. It provided a stable foundation upon which to build.
- Nonetheless, there were enormous difficulties and hundreds of objections to the process.
- The bankruptcy court became a focal point for all types of litigation and objections.
- The bankruptcy court was resolute in fostering and emphasizing the need for an orderly administration and a global view of the chapter 11 cases and their relationship to the other insolvency proceedings being conducted throughout the globe.

What Might Have Been Done?

- The flexible and rigid rejection of authorities to sanction any other course of action should not be repeated.
  - Regulators did not understand the size and scope of the problem.
  - Did not advise US allies (UK, France) about the impending chapter 11.
- Financial institutions are extremely sensitive and generally not amenable to reorganization – financial piranhas begin to circle at the first signs of weakness and lack of liquidity. Planning for potential financial or operational problems is extremely limited.

What Might Have Been Done?

- Preparing a financial company for chapter 11 is very different from preparing a commercial entity.
  - Can't hire advisors ahead of time.
  - Financial institutions deal in a fungible commodity – money.
- An alternative might have been an orderly wind down. Even though it would have exposed the taxpayers to liability, it would not have produced the loss of value and injuries to the financial markets and the public that resulted.
- Regulators should have discharged their duties more effectively and demonstrated the will to regulate.

Lehman's Resolution

- 1. Filing, sale to Barclays
- 2. Gathering of information and stabilization of assets
  - Preserving "melting ice-cubes"
  - Securing control of assets and key affiliates
  - Preparing inventory of assets
  - Understanding corporate organization
  - Securing resources and IT systems (some of which were sold to Barclays)
  - Implementation of "transition services agreements" with Barclays, Nomura, and Lehman Brothers International (Europe)

Lehman's Resolution

- 3. Development of chapter 11 plan and path forward
  - Organize teams around asset classes
    - Real estate
    - Private equity / principal investments
    - Corporate loans
    - Derivatives
    - Regulated banks
  - Develop asset realization plans on an asset by asset basis
  - Execute cross-border protocol with key foreign affiliates
  - Implement resolution strategy for regulated banks

Lehman's Resolution

- 4. Exit Strategy
  - Execute asset disposition strategy
  - Develop chapter 11 plan for (i) distribution of funds to creditors and (ii) settlement of certain overarching issues
    - Substantive consolidation
    - Recharacterization
    - Enforceability of guarantee claims
  - Claims mitigation
    - Approx. 67,000 claims filed in excess of $1 trillion
    - Settlement of intercompany claims using (i) last accounting close as a basis for non-trading claims, and (ii) end-of-day close, mid-screen pricing for trading claims

What Are The Lessons of Lehman?

- Self regulation does not work.
- Regulators must have the will to regulate.
- Excessive leverage must be contained.
- Proprietary trading must be segregated from other operations.
- Regulatory agencies must offer a career path to attract the best and the brightest.
- The relationship between the financial industry and legislators must be transparent – sunlight is the best disinfectant.
- Regulators should have the power to cause a change in leadership. E.g. –
  - June 3, 2012, Robert Diamond resigned as CEO of Barclays under pressure from the Bank of England;
  - March 29, 2009, Rick Wagoner agreed to resign as CEO and Chairman of General Motors ("GM") under pressure from the Obama administration and to avoid otherwise jeopardizing financial support from the US treasury.
- Regulators need to understand the consequences of their decisions.