

## The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act

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### Introduction

The bankruptcy filing of Lehman Brothers Holdings Inc. (Lehman or LBHI) on September 15, 2008, was one of the signal events of the financial crisis. The disorderly and costly nature of the LBHI bankruptcy—the largest, and still ongoing, financial bankruptcy in U.S. history—contributed to the massive financial disruption of late 2008. This paper examines how the government could have structured a resolution of Lehman under the orderly liquidation authority of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and how the outcome could have differed from the outcome under bankruptcy.

The Dodd-Frank Act grants the Federal Deposit Insurance Corporation (FDIC) the powers and authorities necessary to effect an orderly liquidation of systemically important financial institutions. These authorities are analogous to those the FDIC uses to resolve failed insured depository institutions under the Federal Deposit Insurance Act (FDI Act).<sup>1</sup> The keys to an orderly resolution of a systemically important financial company that preserves financial stability are the ability to plan for the resolution and liquidation, provide liquidity to maintain key assets and operations, and conduct an open bidding process to sell the company and its assets and operations to the private sector as quickly as practicable. The FDIC has developed procedures that have allowed it to efficiently use its powers and authorities to resolve failed insured institutions for over 75 years. The FDIC expects to adapt many of these procedures, modified as necessary, to the liquidation of failed systemically important financial institutions.

### The Events Leading to the Lehman Bankruptcy

#### Background

The events leading up to Lehman's bankruptcy are documented in a number of books and articles; but perhaps most extensively in two documents: the Report of Anton R. Valukas, Examiner, Bankruptcy of Lehman Brothers Holdings Inc., and the Trustee's Preliminary

Investigation Report of the Attorneys for James W. Giddens, Trustee for the Securities Investors Protection Act (SIPA) Liquidation of Lehman Brothers, Inc. The analysis in this paper assumes that the events leading up to Lehman's bankruptcy filing took place roughly as described in these two reports.

Prior to 2006, Lehman had been described as being in the "moving business," primarily originating or purchasing loans and then selling them through securitizations.<sup>2</sup> Beginning in 2006, the firm shifted to an aggressive-growth business strategy, making "principal" investments in long-term, high-risk areas such as commercial real estate, leveraged lending and private equity. Even as the sub-prime crisis grew, the firm continued its rapid growth strategy throughout 2007.

At the beginning of 2008, with no end of the sub-prime crisis in sight, Lehman again revised its business strategy and began the process of deleveraging. However, by the end of the first quarter of 2008, the firm had made no substantial progress in either selling assets or in raising large amounts of equity. Richard S. Fuld, Jr., Lehman's CEO, told the Examiner that he had decided that Lehman would not raise equity unless it was at a premium above book value.<sup>3</sup>

After Bear Stearns failed and was purchased by JPMorgan Chase on March 15, 2008, Lehman was seen by many as the next most vulnerable investment bank.<sup>4</sup> At this time, Lehman began raising equity and seeking investment partners. In late March, Lehman contacted Warren E. Buffett, unsuccessfully seeking an investment from either Mr. Buffett or one of Berkshire Hathaway's subsidiaries. At the beginning of April, Lehman completed a \$4 billion convertible preferred stock issuance. In late May, Lehman began talks with a consortium of Korean banks, but no deal was reached. On June 7, Lehman announced a \$2.8 billion loss for the second

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<sup>1</sup>12 U.S.C. § 1811 *et seq.*

<sup>2</sup> Anton R. Valukas, *Examiner's Report: Bankruptcy of Lehman Brothers Holdings Inc.*, Vol. 2, 43, (Mar. 11, 2010) (hereinafter, Examiner's Report).

<sup>3</sup> *Id.* at 150–52. Lehman did raise capital at a later date. Presumably more could have been raised at this time if Lehman had been willing to consider less favorable terms to the then-current shareholders.

<sup>4</sup> *Id.* at 612–13.

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quarter and on June 12 it raised \$6 billion in preferred and common stock, resulting in \$10 billion in the aggregate of new capital for the second quarter of 2008.

By mid-June, Lehman recognized that its commercial real estate portfolio was a major problem and began to develop a “good bank-bad bank” plan to spin off the portfolio. It identified \$31.6 billion in assets that would be placed in a so-called bad bank to be named SpinCo, which would reduce Lehman’s balance sheet and shed risky assets. For a number of reasons, the plan never came to fruition.<sup>5</sup>

Although the consortium of Korean banks withdrew from negotiations, one of the consortium’s banks, the government-owned Korean Development Bank (KDB), continued to express an interest in buying or making a substantial investment in Lehman. The talks between Lehman and KDB went through a number of iterations, with KDB becoming increasingly concerned about Lehman’s risky assets. In August, KDB proposed an investment in a “Clean Lehman,” where all risk of future losses (risky assets) would be spun off from Lehman. By late August, KDB decided that the deteriorating global financial situation and the declining value of Korea’s currency made that transaction too problematic and withdrew from further negotiations.<sup>6</sup>

In July 2008, Lehman contacted Bank of America with a proposal whereby Bank of America would buy a 30 percent interest in LBHI, but the discussions never culminated in a transaction. In late August, Lehman again contacted Bank of America, this time about helping finance SpinCo. Lehman subsequently asked Bank of America to consider buying the entire firm, but Bank of America did not pursue a transaction.

MetLife had also been in contact with Lehman about a possible purchase. MetLife began due diligence in early August, but decided within a few days that Lehman’s commercial real estate and residential real estate assets were too risky. Also in August, the Investment Corporation of Dubai explored a potential investment principally in Lehman’s Neuberger Berman wealth and asset management business. Discussions ceased in early September.<sup>7</sup>

By the late summer of 2008, Lehman’s liquidity problems were becoming acute. Lehman’s urgent need to find a buyer was precipitated in part by panic in the

financial markets following the two largest players in the U.S. mortgage market, Fannie Mae and Freddie Mac, being placed into conservatorship on September 7, 2008, and the ensuing devaluation of those institutions’ common and preferred stock. On September 9, Treasury Secretary Henry M. Paulson, Jr. contacted Bank of America and asked it to look into purchasing Lehman.<sup>8</sup> During that conversation on September 9, Secretary Paulson informed Bank of America that the government would not provide any assistance.<sup>9</sup> Bank of America began due diligence, and on September 11 told Secretary Paulson that there were so many problems with the assets on Lehman’s balance sheet that Bank of America was unwilling to pursue a privately negotiated acquisition. Secretary Paulson then told Bank of America that, although the government would not provide any assistance, he believed a consortium of banks could be encouraged by the government to assist Bank of America in an acquisition of Lehman by taking the bad assets in a transaction similar in certain respects to the 1998 rescue of Long-Term Capital Management.<sup>10</sup> Bank of America then agreed to continue to consider the purchase of Lehman. At various times in the following two days, Bank of America discussed its analysis of Lehman with the Treasury Department and concluded that Lehman had approximately \$65-67 billion in commercial real estate and residential mortgage-related assets and private equity investments that it was unwilling to purchase in any acquisition without the government providing loss protection. Independently, on September 13, Merrill Lynch approached Bank of America and shortly thereafter Bank of America agreed to acquire Merrill Lynch.<sup>11</sup>

Lehman reported further losses on September 10, and announced plans to restructure the firm.<sup>12</sup> The panic also affected Lehman’s trading counterparties, which began to lose confidence in the firm. Many of these counterparties withdrew short-term funding, demanded increasingly greater overcollateralization on borrowings or clearing exposures, demanded more collateral to cover their derivatives positions and subsequently began to move their business away from Lehman. Lehman’s clearing banks also began to demand billions of dollars of additional collateral.

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<sup>8</sup> Henry M. Paulson, Jr., *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System*, 177 (2010) (hereinafter, *On the Brink*).

<sup>9</sup> *Id.* at 177, 184–85.

<sup>10</sup> *Id.* at 199–206.

<sup>11</sup> Examiner’s Report at 696–703.

<sup>12</sup> Lehman Brothers Holdings Inc., Periodic Report on Form 8-K, Sept. 10, 2008.

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<sup>5</sup> *Id.* at 640–62.

<sup>6</sup> *Id.* at 668–81.

<sup>7</sup> *Id.* at 687–94.

A final attempt at a sale of Lehman occurred on September 11, 2008, when Lehman was contacted by Barclays, a large U.K. commercial and investment bank.<sup>13</sup> Barclays commenced due diligence of Lehman on September 12 and soon identified \$52 billion in assets that it believed Lehman had overvalued and that Barclays would not purchase as part of the transaction. As in the case of Bank of America, these assets were concentrated in commercial real estate, residential real estate, and private equity investments. For a variety of reasons, Barclays could not get immediate regulatory approval from the U.K. authorities and the transaction was abandoned on September 14.<sup>14</sup>

LBHI started work on a plan for an “orderly” wind-down. The plan estimated it would take six months to unwind Lehman’s positions and made the assumption that the Federal Reserve Bank of New York would assist Lehman during the wind-down process.<sup>15</sup> On September 14, 2008, the Federal Reserve Bank of New York told LBHI that, without the Barclay’s transaction, it would not fund Lehman.

### Chapter 11 Filing

With no firm willing to acquire LBHI and without funding from the central bank, LBHI filed for Chapter 11 bankruptcy on September 15, 2008.<sup>16</sup> On that date, a number of LBHI affiliates also filed for bankruptcy protection and Lehman’s U.K. broker-dealer, Lehman Brothers International (Europe) (LBIE), filed for administration in the United Kingdom. These events adversely affected the ability of Lehman’s U.S. broker-dealer, Lehman Brothers Inc. (LBI), to obtain adequate funding and settle trades. LBI remained in operation until September 19, when it was placed into a SIPA liquidation.<sup>17</sup>

The Lehman bankruptcy had an immediate and negative effect on U.S. financial stability and has proven to

be a disorderly, time-consuming, and expensive process.<sup>18</sup> Of Lehman’s creditors, the one that experienced the most disruption was the Reserve Primary Fund, a \$62 billion money market fund. On the day of the filing, the fund held \$785 million of Lehman’s commercial paper, representing 13.8 percent of the amount outstanding as of May 31, 2008.<sup>19</sup> The fund immediately suffered a run, facing redemptions of approximately \$40 billion over the following two days. With depleted cash reserves, the fund was forced to sell securities in order to meet redemption requests, which further depressed valuations. The fund’s parent company announced it would “break the buck” when it re-priced its shares at \$0.97 on September 16, 2008. During the remainder of the week, U.S. domestic money market funds experienced approximately \$310 billion in withdrawals, representing 15 percent of their total assets and eventually prompting the U.S. Treasury to announce a temporary guarantee of money market funds.<sup>20</sup>

LBHI’s default also caused disruptions in the swaps and derivatives markets and a rapid, market-wide unwinding of trading positions for those financial markets contracts not subject to the automatic stay in bankruptcy. For example, LBHI’s bankruptcy filing affected LBI’s exposure in the commodities markets via its positions that settled on markets operated by CME Group. LBI’s assets on CME Group markets were largely contracts to hedge risk for the energy business conducted in its other entities. LBHI typically was guarantor of the swap contracts of its subsidiaries and affiliates. For those derivative financial instruments for which LBHI acted as guarantor, the Chapter 11 filing of LBHI constituted a default under the International Swaps and Derivatives Association agreements governing the swaps, which had the effect of allowing termination of those trades. This left naked hedges and exposed LBI to considerable pricing risk since it was not able to offer both sides of the hedge when liquidating the portfolio.<sup>21</sup> Similarly, the Options Clearing Corporation (OCC) threatened to invoke its emergency clearing house rules which would allow it to

<sup>13</sup> Similar to the case of Bank of America, Barclays contacted Lehman at Treasury’s encouragement. Barclays and Bank of America were proceeding under similar expectations that there would not be any government assistance.

<sup>14</sup> Examiner’s Report at 703–11 and *On the Brink* at 203–11.

<sup>15</sup> Examiner’s Report at 720–21.

<sup>16</sup> LBHI filed for bankruptcy protection on Monday, September 15, 2008, at 1:30 am EDT. *Id.* at 726.

<sup>17</sup> LBHI’s demise left LBI unable to obtain adequate financing on an unsecured or secured basis. LBI lost customers and experienced both an increase in failed transactions and additional demands for collateral by clearing banks and others. See *Trustee’s Preliminary Investigation Report of the Attorneys for James W. Giddens, Trustee for the SIPA Liquidation of Lehman Brothers, Inc.*, 10, 25–26, 56.

<sup>18</sup> After more than two years in bankruptcy proceedings, total fees paid to advisers involved in the Lehman bankruptcy have exceeded \$1 billion. See Liz Moyer, *Lehman Fees Hit \$1 Billion and Counting*, Wall Street Journal, Nov. 23, 2010, available at <http://online.wsj.com/article/SB20001424052748704243904575630653803513816.html>.

<sup>19</sup> Lehman used November 30 as its year end for financial reporting purposes. Accordingly, May 31, 2008, was the date of the close of its second quarter financial period.

<sup>20</sup> *President’s Working Group on Financial Markets: Money Market Fund Reform Options* (Oct. 2010), available at <http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf>.

<sup>21</sup> SIPA Trustee Report Section V.B., p. 66.

liquidate all of LBI's positions unless a performing third party agreed to assume the positions. The Depository Trust & Clearing Corporation (DTCC) shared the same concerns as the CME Group and the OCC, and was unwilling to perform settlement and transfer functions for LBI unless a performing third party assumed all potential liability. When Barclays refused to assume the potential liability, the DTCC began liquidating LBI's positions as a broker-dealer whose membership had been terminated on September 22, 2008. Consequently, account transfer requests from customers that were already in process were canceled. The DTCC also reversed all account transfers that had taken place on September 19, 2008, a Friday. As a result, \$468 million of customer assets that otherwise would have been immune from seizure were seized.<sup>22</sup> It was not until February 11, 2009, that a court order restored the reversed transactions.

Other unsecured creditors of LBHI are projected to incur substantial losses. Immediately prior to its bankruptcy filing, LBHI reported equity of approximately \$20 billion; short-term and long-term indebtedness of approximately \$100 billion, of which approximately \$15 billion represented junior and subordinated indebtedness; and other liabilities in the amount of approximately \$90 billion, of which approximately \$88 billion were amounts due to affiliates. The modified Chapter 11 plan of reorganization filed by the debtors on January 25, 2011, estimates a 21.4 percent recovery for senior unsecured creditors. Subordinated debt holders and shareholders will receive nothing under the plan of reorganization, and other unsecured creditors will recover between 11.2 percent and 16.6 percent, depending on their status.<sup>23</sup>

Just prior to Lehman's bankruptcy filing, the firm had identified \$31.6 billion in commercial real estate assets of questionable value. Potential acquirers of Lehman had identified additional problematic assets—for a total value between \$50 billion and \$70 billion. Even if there had been a total loss on these assets, which would have eliminated any shareholder and subordinated debt holder potential for recovery, a quick resolution of LBHI that maintained the operational integrity of the company including its systems and personnel could have left general unsecured creditors with substantially more value than projected from the bankruptcy. By

<sup>22</sup> *Id.* at 73.

<sup>23</sup> Joseph Checkler, *Lehman's New Creditor Plan Doesn't Factor in Key Group*, Wall Street Journal, Jan. 27, 2011. The plan of reorganization is subject to approval by creditors.

preserving the going-concern value of the firm, creditors could have been provided with an immediate payment on a portion of their claims through either an advance dividend or the prompt distribution of proceeds from the sale of assets. The panic selling that ensued—further precipitating a decline in asset values and a decline in the value of collateral underlying the firm's derivatives portfolio—could have been avoided and markets would likely have remained more stable.

## The Resolution and Receivership Process for Failed Banks

### Resolution Process

The FDIC has been successful in using its authority under the FDI Act to maintain stability and confidence in the nation's banking system, including in the resolution of large, complex insured depository institutions. The FDIC, as receiver for an insured depository institution, is given broad powers and flexibility under the FDI Act to resolve an insured depository institution in a manner that minimizes disruption to the banking system and maximizes value. The FDIC is given similar tools to those under the Dodd-Frank Act to accomplish these goals, including the ability to create one or more bridge banks, enforce cross-guarantees among sister banks, sell and liquidate assets, and settle claims.

When an insured bank fails, the FDIC is required by statute to resolve the failed bank in the least costly way, to minimize any loss to the deposit insurance fund, and, as receiver, to maximize the return on the assets of the failed bank.<sup>24</sup> Banks and thrifts are typically closed by their chartering authority when they become critically undercapitalized and have not been successful in their plan to restore capital to the required levels.<sup>25</sup> The

<sup>24</sup> The FDIC is required, pursuant to 12 U.S.C. § 1823(c)(4), to resolve failed insured depository institutions in the manner that is least costly to the deposit insurance fund. The Dodd-Frank Act does not require that a least cost determination be made in respect of a covered financial company, though the FDIC is required, to the greatest extent practicable, to maximize returns and minimize losses in the disposition of assets. See section 210(a)(9)(E) of the Dodd-Frank Act, 12 U.S.C. § 5390(a)(9)(E).

<sup>25</sup> Some banks, particularly large banks, may also be closed due to a liquidity failure (an inability to pay debts as they become due).

FDIC is then appointed receiver.<sup>26</sup> When structuring a bank resolution, the FDIC can pay off insured depositors and liquidate the bank's assets, sell the bank in whole or in part (a purchase and assumption transaction, or P&A), or establish a bridge institution—a temporary national bank or federal thrift—to maintain the functions of the failed bank during the process of marketing the bank's franchise. Senior management and boards of directors are not retained, and no severance pay or "golden parachutes" are permitted.

Final planning and marketing for a bank resolution normally begins 90–100 days prior to the institution being placed into receivership, though the process may be accelerated in the event of a liquidity failure. It begins when a bank's problems appear to be severe enough to potentially cause it to fail. During this period, the FDIC coordinates its actions—including the scheduling of the failure—with other regulators. When a bank becomes critically undercapitalized, the primary federal regulator (PFR) has up to 90 days to close the institution and appoint the FDIC as receiver. The FDIC and the PFR require that the bank seek an acquirer or merger partner, and insist that top management responsible for the bank's failing condition leave in order to improve the prospects for such, before the FDIC has to exercise its powers as receiver. The FDIC's authority to take over a failed or failing institution, thus wiping out stockholders and imposing losses on unsecured and uninsured creditors, not only provides an incentive for management to actively seek an acquirer, but also encourages the institution's board of directors to approve (or recommend for approval to shareholders) such transactions to avoid the risk of an FDIC receivership.

During this planning phase, the FDIC collects as much information as possible about the bank and structures the resolution transaction. This information assists the FDIC in determining the best transaction structures to offer potential acquirers. The FDIC also values bank assets and determines which assets may be particularly

<sup>26</sup> As a receiver, the FDIC succeeds to the rights, powers, and privileges of the failed bank and its stockholders, officers, and directors. It may collect all obligations and money due to the institution, preserve and liquidate the institution's assets and property, and perform any other function of the institution consistent with its appointment as receiver. It has the power to sell a failed bank to another insured bank, and to transfer the failed bank's assets and liabilities without the consent or approval of any other agency, court, or party with contractual rights. The FDIC may also, as permitted by statute, repudiate contracts such as leases that are burdensome to the receivership and may rid the receivership of burdensome obligations. The FDIC operates its receiverships independently of the court or bankruptcy system, although certain of the FDIC's actions are subject to judicial review.

problematic for an acquiring institution and may need to be retained in the receivership for disposition after resolution or covered by some level of risk protection. Qualified bidders are contacted to perform due diligence, subject to a confidentiality agreement. Due diligence is offered both on-site and off-site through the use of secure internet data rooms. Bidders are then asked to submit bids on the basis of the transaction structures offered by the FDIC. The FDIC analyzes the bids received and accepts the bid that resolves the failed bank in the least costly manner to the deposit insurance fund. The least-cost requirement ensures that the deposit insurance fund will not be used to protect creditors other than insured depositors and prevents differentiation between creditors except where necessary to achieve the least costly resolution of the failed bank. Then, at the point of failure, the institution is placed into receivership and immediately sold—with the sale resulting in a transfer of deposits and assets that renders the process seamless to insured depositors. The FDIC is also able to make an immediate payment, or advance dividend, to uninsured creditors not assumed by the assuming institution based upon estimated recoveries from the liquidation.

### The Orderly Liquidation of Covered Financial Companies

#### Introduction

Title II of the Dodd-Frank Act defines the framework for orderly resolution proceedings and establishes the powers and duties of the FDIC when acting as receiver for a covered financial company.<sup>27</sup> The policy goal of the Dodd-Frank Act is succinctly summarized in section 204(a) as the liquidation of "failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard." Creditors and shareholders are to "bear the losses of the financial company" and the FDIC is instructed to liquidate the covered financial company in a manner that maximizes the value of the company's assets, minimizes losses, mitigates risk, and minimizes moral hazard.<sup>28</sup>

This section discusses the key provisions of Title II and highlights the differences between the resolution of a

<sup>27</sup> A failed systemically important financial institution is deemed a covered financial company for purposes of Title II of the Dodd-Frank Act once a systemic determination has been made by the Secretary of the Treasury pursuant to section 203(b) thereof, 12 U.S.C. § 5383(b). See "—Appointment," *infra*.

<sup>28</sup> See sections 204(a)(1) and 210(a)(9)(E) of the Dodd-Frank Act, 12 U.S.C. §§ 5384(a)(1) and 5390(a)(9)(E).

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systemically important financial institution under Title II of the Dodd-Frank Act and a proceeding under the Bankruptcy Code.<sup>29</sup> What follows is a brief summary of the appointment process and five of the most important elements of the authority available to the FDIC as receiver of a covered financial company. Those five elements are: (i) the ability to conduct advance resolution planning for systemically important financial institutions through a variety of mechanisms similar to those used for problem banks (these mechanisms will be enhanced by the supervisory authority and the resolution plans, or living wills, required under section 165(d) of Title I of the Dodd-Frank Act); (ii) an immediate source of liquidity for an orderly liquidation, which allows continuation of essential functions and maintains asset values; (iii) the ability to make advance dividends and prompt distributions to creditors based upon expected recoveries; (iv) the ability to continue key, systemically important operations, including through the formation of one or more bridge financial companies; and (v) the ability to transfer all qualified financial contracts<sup>30</sup> with a given counterparty to another entity (such as a bridge financial company) and avoid their immediate termination and liquidation to preserve value and promote stability.<sup>31</sup>

### **Appointment**

Under section 203 of the Dodd-Frank Act, at the Secretary of the Treasury's (Secretary) request, or of their own initiative, the Board of Governors of the Federal Reserve System (Federal Reserve) and the FDIC are to make a written recommendation requesting that the Secretary appoint the FDIC as receiver for a systemically important financial institution that is in

default or danger of default.<sup>32</sup> The recommendation to place a broker or dealer, or a financial company in which the largest domestic subsidiary is a broker or dealer, into receivership is made by the Federal Reserve and the Securities and Exchange Commission (SEC), in consultation with the FDIC. Similarly, the recommendation to place an insurance company or a financial company in which the largest domestic subsidiary is an insurance company, is made by the Federal Reserve and Director of the newly established Federal Insurance Office, in consultation with the FDIC.

The Secretary is responsible for making a determination as to whether the financial company should be placed into receivership, and that determination is based on, among other things, the Secretary's finding that the financial company is in default or in danger of default; that the failure of the company and its resolution under otherwise applicable State or Federal law would have serious adverse consequences on the financial stability of the United States; and that no viable private sector alternative is available to prevent the default of the financial company.<sup>33</sup>

The Dodd-Frank Act provides an expedited judicial review process of the Secretary's determination. Should the board of directors of the covered financial company object to the appointment of the FDIC as receiver, a hearing is held in federal district court, and the court must make a decision on the matter within 24 hours. Upon a successful petition (or should the court fail to act within the time provided), the Secretary is to appoint the FDIC receiver of the covered financial company.<sup>34</sup>

### **Special Powers under Title II**

*Ability to Preserve Systemic Operations of the Covered Financial Company.* The Dodd-Frank Act provides an efficient mechanism—the bridge financial company—to quickly preserve the going-concern value of the

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<sup>29</sup> 11 U.S.C. § 101 *et seq.*

<sup>30</sup> Generally, qualified financial contracts are financial instruments such as securities contracts, commodities contracts, forwards contracts, swaps, repurchase agreements, and any similar agreements. *See* section 210(c)(8)(D)(i) of the Dodd-Frank Act, 12 U.S.C. § 5390(c)(8)(D)(i).

<sup>31</sup> *See generally* section 165 of Title I of the Dodd-Frank Act, 12 U.S.C. § 5365 and "The Orderly Resolution of Covered Financial Companies—Special Powers under Title II—Oversight and Advanced Planning," *infra*.

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<sup>32</sup> Upon a 2/3 vote by the boards of both the FDIC and the Federal Reserve, a written recommendation is delivered to the Secretary. The recommendation includes: an evaluation of whether the financial company is in default or is in danger of default; a description of the effect the failure of the financial company would have on U.S. financial stability; an evaluation of why a case under the Bankruptcy Code is not appropriate; an evaluation of the effect on creditors, counterparties, and shareholders of the financial company and other market participants, and certain other evaluations required by statute. *See* section 203(a)(2) of the Dodd-Frank Act, 12 U.S.C. § 5383(a)(2).

<sup>33</sup> *See* section 203(b) of the Dodd-Frank Act, 12 U.S.C. § 5383(b).

<sup>34</sup> *See* section 202(a)(1)(A) of the Dodd-Frank Act, 12 U.S.C. § 5382(a)(1)(A).

firm's assets and business lines. There are no specific parallel provisions in the Bankruptcy Code,<sup>35</sup> and therefore it is more difficult for a debtor company operating under Chapter 11 of the Bankruptcy Code to achieve the same result as expeditiously, particularly where circumstances compel the debtor company to seek bankruptcy protection before a wind-down plan can be negotiated and implemented. Where maximizing or preserving value depends upon a quick separation of good assets from bad assets, implementation delays could adversely impact a reorganization or liquidation proceeding.

The Dodd-Frank Act authorizes the FDIC, as receiver of a covered financial company, to establish a bridge financial company to which assets and liabilities of the covered financial company may be transferred.<sup>36</sup> Fundamental to an orderly liquidation of a covered financial company is the ability to continue key operations, services, and transactions that will maximize the value of the firm's assets and operations and avoid a disorderly collapse in the marketplace. To facilitate this continuity of operations, the receivership can utilize one or more bridge financial companies. The bridge financial company is a newly established, federally chartered entity that is owned by the FDIC and includes those assets, liabilities, and operations of the covered financial company as necessary to achieve the maximum value of the firm. Shareholders, debt holders, and other creditors whose claims were not transferred to the bridge financial company will remain in the receivership and will receive payments on their claims based upon the priority of payments set forth in section 210(b) of the Dodd-Frank Act. Like the bridge banks used in the resolution of large insured depository institutions,<sup>37</sup> the bridge financial company authority permits the FDIC to stabilize the key operations of the covered financial company by continuing valuable, systemically important operations.

<sup>35</sup> Similar to the FDIC's repudiation powers provided by section 210(c)(1) of the Dodd-Frank Act, 12 U.S.C. § 5390(c)(1), a bankruptcy trustee is authorized to reject certain contracts (which may be related to certain problem assets) of the debtor.

<sup>36</sup> See section 210(h) of the Dodd-Frank Act, 12 U.S.C. § 5390(h). There are statutorily imposed limitations upon the transfer of assets and liabilities from the receiver to the bridge financial company, including a prohibition against a bridge financial company assuming any liability that is regulatory capital of the covered financial company. See section 210(h)(1)(B)(i) of the Dodd-Frank Act, 12 U.S.C. § 5390(h)(1)(B)(i). Additionally, the liabilities transferred from a covered financial company to a bridge financial company are not permitted to exceed the assets so transferred. See section 210(h)(5)(F) of the Dodd-Frank Act, 12 U.S.C. § 5390(h)(5)(F).

<sup>37</sup> See 12 U.S.C. § 1821(n).

While the covered financial company's board of directors and the most senior management responsible for its failure will be replaced, as required by section 204(a)(2) of the Dodd-Frank Act,<sup>38</sup> operations may be continued by the covered financial company's employees under the strategic direction of the FDIC, as receiver, and contractors employed by the FDIC to help oversee those operations. These contractors would typically include firms with expertise in the sector of the covered financial company. In addition, former executives, managers and other individuals with experience and expertise in running companies similar to the covered financial company would be retained to oversee those operations.

A bridge financial company also provides the receiver with flexibility in preserving the value of the assets of the covered financial company and in effecting an orderly liquidation. The receiver can retain certain assets and liabilities of the covered financial company in the receivership and transfer other assets and liabilities, as well as the viable operations of the covered financial company, to the bridge financial company. The receiver may also transfer certain qualified financial contracts to the bridge financial company, as discussed below. The bridge financial company can operate until the receiver is able to stabilize the systemic functions of the covered financial company, conduct marketing for its assets and find one or more appropriate buyers.<sup>39</sup>

*Transfer of Qualified Financial Contracts.* Under the Bankruptcy Code, counterparties to qualified financial contracts with the debtor company are permitted to terminate the contract and liquidate and net out their position. The debtor company or trustee has no authority to continue these contracts or to transfer the contracts to a third party, absent the consent of the

<sup>38</sup> This may be contrasted with a typical Chapter 11 resolution, in which the management of the pre-insolvency institution will continue to manage the operations of the debtor institution.

<sup>39</sup> In 2008, the FDIC implemented a successful resolution of IndyMac Bank through a transaction involving a "pass-through conservatorship," which is similar to the utilization of a bridge financial company. The transfer of assets to a *de novo* institution, named IndyMac Federal Bank, and its subsequent sale to a private investor in 2009 enabled the FDIC to sell the core business intact. This was more efficient and less costly than a liquidation and retained the value of the institution's assets. As of January 31, 2009, IndyMac Federal Bank had total assets of \$23.5 billion and total deposits of \$6.4 billion. The assuming institution agreed to purchase all deposits and approximately \$20.7 billion in assets at a discount of \$4.7 billion. The FDIC retained the remaining assets for future disposition. See Press Release, FDIC, *FDIC Closes Sale of IndyMac Federal Bank*, Pasadena, California (March 20, 2009), available at <http://www.fdic.gov/news/news/press/2009/pr09042.html>.

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counterparty, after the debtor company's insolvency. A complex, systemic financial company can hold very large positions in qualified financial contracts, often involving numerous counterparties and back-to-back trades, some of which may be opaque and incompletely documented. A disorderly unwinding of such contracts triggered by an event of insolvency, as each counterparty races to unwind and cover unhedged positions, can cause a tremendous loss of value, especially if lightly traded collateral covering a trade is sold into an artificially depressed, unstable market. Such disorderly unwinding can have severe negative consequences for the financial company, its creditors, its counterparties, and the financial stability of the United States.

In contrast, the Dodd-Frank Act expressly permits the FDIC to transfer qualified financial contracts to a solvent financial institution (an acquiring investor) or to a bridge financial company.<sup>40</sup> In such a case, counterparties are prohibited from terminating their contracts and liquidating and netting out their positions on the grounds of an event of insolvency.<sup>41</sup> The receiver's ability to transfer qualified financial contracts to a third party in order for the contracts to continue according to their terms—notwithstanding the debtor company's insolvency—provides market certainty and stability and preserves the value represented by the contracts.<sup>42</sup>

By the time of the failure of the troubled financial company, most if not all of its qualified financial contracts would be fully collateralized as counterparties sought to protect themselves from its growing credit risk. As a result, it is likely that a transfer of qualified financial contracts to a third party would involve the

transfer of fully collateralized transactions and not expose the receiver to risk of loss.<sup>43</sup> To the extent the derivatives portfolio included qualified financial contracts which were under-collateralized or unsecured, the FDIC, as receiver of the covered financial company, would determine whether to repudiate or to transfer those qualified financial contracts to a third party based upon the FDIC's obligation to maximize value and minimize losses in the disposition of assets of the entire receivership.

*Funding.* A vital element in preserving continuity of systemically important operations is the availability of funding for those operations. A Chapter 11 debtor operating under the Bankruptcy Code will typically require funds in order to operate its business—referred to as debtor-in-possession financing (DIP financing). Although the Bankruptcy Code provides for a debtor company to obtain DIP financing with court approval, there are no assurances that the court will approve the DIP financing or that a debtor company will be able to obtain sufficient—or any—funding or obtain funding on acceptable terms, or what the timing of such funding might be. For a systemically important financial institution, the market may be destabilized by any delay associated with negotiating DIP financing or uncertainty as to whether the bankruptcy court will approve DIP financing. Further, the terms of the DIP financing may limit the debtor's options for reorganizing or liquidating and may diminish the franchise value of the company, particularly when the DIP financing is secured with previously unencumbered assets or when the terms of the DIP financing grant the lender oversight approval over the use of the DIP financing.

The Dodd-Frank Act provides that the FDIC may borrow funds from the Department of the Treasury, among other things, to make loans to, or guarantee obligations of, a covered financial company or a bridge financial company to provide liquidity for the operations of the receivership and the bridge financial company. Section 204(d) of the Dodd-Frank Act provides that the FDIC may make available to the receivership funds for the orderly liquidation of the

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<sup>40</sup> See section 210(c)(9) of the Dodd-Frank Act, 12 U.S.C. § 5390(c)(9).

<sup>41</sup> The exemption from the automatic stay under the Bankruptcy Code in the case of qualified financial contracts generally works well in most cases. However, for systemically important financial institutions, in which the sudden termination and netting of a derivatives portfolio could have an adverse impact on U.S. financial stability, the nullification of the *ipso facto* clause is needed. By removing a right of termination based solely upon the failure of the counterparty, the bridge financial company structure provides the flexibility to incentivize qualified financial contract counterparties to either maintain their positions in such contracts, or exit their positions in a manner which does not jeopardize U.S. financial stability.

<sup>42</sup> There are implications under the Dodd-Frank Act to transferring all of a covered financial company's qualified financial contracts to a bridge financial company in order to avoid such contracts' termination by their counterparties. As such contracts continue, following such transfer, to be valid and binding obligations of the bridge financial company (before being eventually wound down), the bridge financial company is required to perform the obligations thereunder, including in respect of meeting collateral requirements, hedging, and being liable for gains and losses on the contracts.

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<sup>43</sup> Title VII of the Dodd-Frank Act, 15 U.S.C. § 8301 *et seq.*, contemplates requirements for increased initial and variation margin.



covered financial company.<sup>44</sup> Funds provided by the FDIC under section 204(d) of the Dodd-Frank Act are to be given a priority as administrative expenses of the receiver or as amounts owed to the United States when used for the orderly resolution of the covered financial company, including, *inter alia*, to: (i) make loans to or purchase debt of the covered financial company or a covered subsidiary; (ii) purchase (or guarantee) the assets of the covered financial company or a covered subsidiary; (iii) assume or guarantee the obligations of a covered financial company or a covered subsidiary; and (iv) make additional payments or pay additional amounts to certain creditors. In the unlikely event that recoveries from the disposition of assets are insufficient to repay amounts owed to the United States, there will be a subsequent assessment on the industry to repay those amounts. By law, no taxpayer losses from the liquidation process are allowed.

Once the new bridge financial company's operations have stabilized as the market recognizes that it has adequate funding and will continue key operations, the FDIC would move as expeditiously as possible to sell operations and assets back into the private sector. Under certain circumstances the establishment of a bridge financial company may not be necessary, particularly when the FDIC has the ability to pre-plan for the sale of a substantial portion of the firm's assets and liabilities to a third party purchaser at the time of failure.

The rapid response, preservation of systemically important operations and immediate funding availability under the Dodd-Frank Act may be expected to provide certainty to the market, employees, and potential buyers. This promotes both financial stability and maximization of value in the sale of the assets of the covered financial company.

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<sup>44</sup> The FDIC may issue or incur obligations pursuant to an approved orderly liquidation plan (up to 10 percent of the total consolidated assets of the covered financial company) and pursuant to an approved mandatory repayment plan (up to 90 percent of the fair value of the total consolidated assets of the covered financial company that are available for repayment). See section 210(n)(6) and (9) of the Dodd-Frank Act, 12 U.S.C. § 5390(n)(6) and (9). To the extent that the assets in the receivership are insufficient to repay Treasury for any borrowed funds, any creditor who received an additional payment in excess of what other similarly situated creditors received, which additional payment was not essential to the implementation of the receivership or the bridge financial company, may have the additional payment clawed back. See section 210(o)(1)(D)(i) of the Dodd-Frank Act, 12 U.S.C. § 5390(o)(1)(D)(i). This provision is consistent with Title II's directive to minimize moral hazard. To the extent that the clawbacks of additional payments are insufficient to repay Treasury for any borrowed funds, the FDIC is required to assess the industry. See section 210(o)(1)(B) of the Dodd-Frank Act, 12 U.S.C. § 5390(o)(1)(B).

*Advance Dividends and Prompt Distributions.* The FDIC, as receiver for a covered financial company, satisfies unsecured creditor claims in accordance with the relevant order of priorities set forth in section 210(b) of the Dodd-Frank Act. To provide creditors with partial satisfaction of their claims as expeditiously as practicable, the FDIC, as receiver, is able—though not required—to make advance dividends to unsecured general creditors based upon expected recoveries. The FDIC may use funds available to the receivership, including amounts borrowed as discussed above under “—Funding,” to make these advance dividends in partial satisfaction of unsecured creditor claims.<sup>45</sup> These advance dividends would be made at an amount less than the estimated value of the receivership assets so as not to leave the receivership with a deficit in the event the realized value is less than the expected value of the liquidation.

The FDIC, as receiver, also makes periodic distributions to unsecured creditors from the sale of assets. Accordingly, an unsecured creditor will not be required to wait until all claims are valued, or until all assets are disposed of, before receiving one or more substantial payments on his claim. The ability promptly to provide creditors with partial satisfaction of claims following the failure of a covered financial company serves the Title II mandate of mitigating systemic impact, particularly in the case of key counterparties. The FDIC has successfully provided advance dividends to unsecured creditors (including uninsured depositors) and distributions from the sale of assets to unsecured creditors in the resolution of insured depository institutions under the FDI Act to quickly move funds to claimants and to help to stabilize local markets.

In large, complex bankruptcy cases such as Lehman, a creditor may not receive any payment on his claim for a considerable period of time following the commencement of the bankruptcy case. One reason for this is that it often takes a great deal of time to establish both the size of the pool of assets available for general unsecured creditors and the legitimate amounts of the claims held by such creditors. Litigation is typically needed to establish both of these numbers, which can require years of discovery followed by trial, then more years of appeals and remands.

If sufficient certainty can be attained regarding a portion of the claims, the Chapter 7 trustee will petition the

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<sup>45</sup> Amounts which may be borrowed from the Department of the Treasury are based upon the assets, or assets available for repayment, of the covered financial company. See footnote 44, *supra*.

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court for permission to make an interim distribution, or the Chapter 11 trustee or debtor-in-possession will provide in the plan of reorganization or plan of liquidation for interim distributions as various stages of the restructuring are reached.<sup>46</sup> However, except in the case of “prepackaged” plans of reorganization, even an interim distribution can take months or years to materialize. In the case of LBHI, there has been no distribution to general unsecured creditors more than two years after LBHI’s initial bankruptcy filing.

*Oversight and Advanced Planning.* An essential prerequisite for any effective resolution is advance planning, a well-developed resolution plan, and access to the supporting information needed to undertake such planning.

Bankruptcy proceedings are typically challenging in the case of systemically important financial institutions in part because the participants have little notice or opportunity for advance preparation or coordination. The bankruptcy court, which must approve actions by the debtor outside of the ordinary course of business, may have little or no knowledge about the systemically important financial institution, and would have to rely

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<sup>46</sup> In recent years a common practice has developed in bankruptcy cases of allowing payments shortly after the filing of a Chapter 11 petition to certain priority creditors (wage claimants (up to \$11,725), employee benefits claimants (up to \$11,725), taxing authorities and several less frequently used groups) if sufficient assets are at hand, on the theory that such creditors will be paid first anyway at the time final distributions are made (thus, no creditor’s rights will be impaired so long as the equity in available assets clearly exceeds the total priority claims). Permission to make such payments is generally sought as part of the debtor-in-possession’s “first day motions,” and such creditors generally receive payment within three to five days of the date of filing of the petition. A secondary consideration for paying prepetition wages is the desire on the part of management to retain an experienced work force at a time of turmoil. A second practice has developed in large Chapter 11 bankruptcy cases of paying “critical vendors” after obtaining a “first day order” shortly after the petition is filed. While such vendors have the status of general unsecured creditors, an argument is typically made to the Bankruptcy Court that certain trade creditors are considered key suppliers to the debtor-in-possession, and may refuse to do business with the Chapter 11 debtor unless they receive immediate payment on their prepetition claim, thus causing the entire reorganization effort to fail through loss of the going concern. This practice is more controversial than that of paying priority claimants, since (except in “prepackaged” bankruptcy cases) it is often very difficult to predict at the outset of the case what the percentage payout to general unsecured creditors will be at the end of the case. The practice has also come under criticism in recent years and has been cut back. One reason for the cutback is that there is little formal support in the Bankruptcy Code for the practice. See *In re Kmart Corp.*, 359 F. 3d 866 (7th Cir. 2004) and discussion in Turner, Travis N., “Kmart and Beyond: A ‘Critical’ Look at Critical Vendor Orders and the Doctrine of Necessity,” 63 Wash. & Lee L.Rev. 431 (2006).

upon the management of such institution for requisite information.

Title I of the Dodd-Frank Act significantly enhances regulators’ ability to conduct advance resolution planning in respect of systemically important financial institutions through a variety of mechanisms, including heightened supervisory authority and the resolution plans, or living wills, required under section 165(d) of Title I of the Dodd-Frank Act.<sup>47</sup> The examination authority provided by Title I of the Dodd-Frank Act will provide the FDIC with on-site access to systemically important financial institutions, including the ability to access real-time data.<sup>48</sup> This will enable the FDIC, working in tandem with the Federal Reserve and other regulators, to collect and analyze information for resolution planning purposes in advance of the impending failure of the institution.

An essential part of such plans will be to describe how this process can be accomplished without posing systemic risk to the public and the financial system. If the company does not submit a credible resolution plan, the statute permits increasingly stringent requirements to be imposed that, ultimately, can lead to divestiture of assets or operations identified by the FDIC and the Federal Reserve to facilitate an orderly resolution. The Dodd-Frank Act requires each designated financial company to produce a resolution plan, or living will, that maps its business lines to legal entities and provides integrated analyses of its corporate structure; credit and other exposures; funding, capital, and cash flows; domestic and foreign jurisdictions in which it operates; its supporting information systems and other essential services; and other key components of its business operations, all as part of the plan for its rapid and orderly resolution. The credit exposure reports required by the statute will also provide important information critical to the FDIC’s planning processes by identifying the company’s significant credit exposures, its component exposures, and other key information across the entity and its affiliates. The elements contained in a resolution plan will not only help the FDIC and other domestic regulators to better understand a firm’s business and how that entity may be resolved, but the plans will also enhance the FDIC’s ability to coordinate with foreign

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<sup>47</sup> See generally section 165 of Title I of the Dodd-Frank Act, 12 U.S.C. § 5365.

<sup>48</sup> See “Orderly Resolution of Lehman under the Dodd-Frank Act—March–July, Due Diligence and Structuring the Resolution—Planning in the Crisis Environment,” *infra*.

regulators in an effort to develop a comprehensive and coordinated resolution strategy for a cross-border firm.<sup>49</sup>

### **Structure and Bidding**

Once the structure is developed, the FDIC would seek bids from qualified, interested bidders for the business lines or units that have going-concern value. The FDIC would analyze the bids received and choose the bid or bids that would provide the highest recovery to the receivership. The winning bidder would be informed and would take control of the business lines or units concurrent with the closing of the institution. Losses would be borne by equity holders, unsecured debt holders, and other unsecured creditors that remain in the receivership. These creditors would receive payment on their claims in accordance with the priority of payment rules set forth in the Dodd-Frank Act.<sup>50</sup> The FDIC could make advance dividend payments to creditors based upon an upfront conservative valuation of total recoveries. As recoveries are realized, the FDIC could also pay out distributions to creditors as it has done successfully with failed insured banks. See “—Special Powers under Title II—Advance Dividends and Prompt Distributions,” above.

### **Orderly Resolution of Lehman under the Dodd-Frank Act**

#### ***March–July, Due Diligence and Structuring the Resolution***

*Planning in the Crisis Environment:* As the financial crisis enveloped Bear Stearns, the FDIC would have worked closely with the Federal Reserve and other appropriate regulators to gather information about the systemically important firms that may fall under the FDIC’s resolution authority. At a minimum, the firms’ resolution plans would have been reviewed jointly by the FDIC and the Federal Reserve to make sure that the plans were credible and up-to-date. The information support-

ing these plans and any additional information that the FDIC and Federal Reserve would have received through on-site discussions with the firms during their review of the resolution plans would have provided the FDIC with valuable information necessary for effective resolution planning, information not available to the FDIC prior to the passage of the Dodd-Frank Act. In this regard the FDIC’s presence would not be indicative that a resolution is imminent, but rather that in a crisis the FDIC seeks to assure that all firms’ resolution plans are sufficiently robust to allow an orderly liquidation of any particular firm that might fail.

For Lehman, if senior management had not found an early private sector solution, the FDIC would have needed to establish an on-site presence to begin due diligence and to plan for a potential Title II resolution. Lehman was not the only firm in possible trouble and the FDIC would likely have had a heightened presence in other subject firms at the time. Thus, the market would not necessarily have taken the FDIC’s heightened presence as a signal that a failure was imminent as the market already was aware of Lehman’s problems. While it is possible in this situation or in other situations that the FDIC’s on site presence could create signaling concerns, this argues for the FDIC having a continuous on-site presence for resolution planning during good times.

*Discussions with Lehman:* In the various accounts of the failure of Lehman it is noteworthy that senior management discounted the possibility of failure until the very last moment.<sup>51</sup> There was apparently a belief, following the government’s actions in respect of Bear Stearns, that the government, despite statements to the contrary, would step in and provide financial assistance and Lehman would be rescued. If Title II of the Dodd-Frank Act had been in effect, the outcome would have been considerably different. Lehman’s senior management would have understood clearly that the government would not and could not extend financial assistance outside of a resolution because of the clear requirements in the Dodd-Frank Act that losses are to be borne by equity holders and unsecured creditors, and management and directors responsible for the condition of the failed financial company are not to be retained.

<sup>49</sup> Domestic and foreign regulators are currently actively involved through the Financial Stability Board’s Cross-Border Crisis Management Group to develop essential elements of recovery and resolution plans that will aid authorities in understanding subject firms’ global operations and planning for the orderly resolution of a firm across borders. A number of jurisdictions are currently working to develop legislative and regulatory requirements for recovery and resolution plans, and domestic U.S. authorities are working to align regulatory initiatives in order to have a comprehensive and coordinated approach to resolution planning. For example, in January 2010, the FDIC and the Bank of England entered into a Memorandum of Understanding concerning the consultation, cooperation, and exchange of information related to the resolution of insured depository institutions with cross-border operations in the United States and the United Kingdom.

<sup>50</sup> See section 210(b)(1) of the Dodd-Frank Act, 12 U.S.C. § 5390(b)(1).

<sup>51</sup> According to the Examiner’s Report, following the near collapse of Bear Stearns in March 2008, “Lehman knew that its survival was in question.” Lehman’s management believed, however, that government assistance would be forthcoming to prevent a failure. See Examiner’s Report at 609, 618.

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To convey this point to Lehman and its Board of Directors, the FDIC could have participated in a meeting in the spring of 2008, together with Lehman's Board of Directors, the Federal Reserve, and the SEC, to outline the circumstances that would lead to the appointment of the FDIC as receiver for one or more Lehman entities, and what that resolution would entail. The regulators would have emphasized that any open-company assistance or "too big to fail" transaction would be unavailable,<sup>52</sup> and that the alternative to a sale of the company or a substantial capital raising would be a bankruptcy under the Bankruptcy Code or a resolution under Title II with no expectation of any return to shareholders.

The regulators could have set a deadline of July to sell the company or raise capital. This would have clearly focused Lehman's Board of Directors on the urgency of the matter and encouraged the Board to accept the best non-government offer it received notwithstanding its dilutive nature; virtually any private sale would yield a better return for shareholders than the likely negligible proceeds shareholders would receive in an FDIC receivership, as equity holders have the lowest priority claims in a receivership.

Lehman's senior management and Board of Directors may have been more willing to recommend offers that were below the then-current market price if they knew with certainty that there would be no extraordinary government assistance made available to the company and that Lehman would be put into receivership. Such avenues may have been available. For instance, KDB is reported to have suggested paying \$6.40 per share when Lehman's stock was trading at \$17.50 on August 31—just 15 days prior to Lehman's bankruptcy filing.

Forcing Lehman to more earnestly market itself to a potential acquirer or strategic investor well in advance of Lehman's failure would serve several other goals, even if such private sector transaction were unsuccessful. The FDIC would be able to use this marketing information to identify appropriate bidders who would be invited to join in the FDIC-led due diligence and bidding process as described in "—Due Diligence" and "—Structuring the Transaction," below.

The preferred outcome under the Dodd-Frank Act is for a troubled financial company to find a strategic investor or to recapitalize without direct government involvement or the FDIC being appointed receiver. To that end, the recommendation and determination prescribed by section 203(a)(2)(E) and (b)(3) of the Dodd-Frank Act, respectively, concern the availability of a viable private sector alternative. Requiring a troubled financial company to aggressively market itself pre-failure helps to ensure that exercise of the orderly resolution authority in Title II is a last resort. In this matter, the FDIC's experience with troubled banks is instructive. The commencement of the FDIC's due diligence process has frequently provided the motivation senior management has needed to pursue sale or recapitalization more aggressively. Between 1995 and the end of 2007, the FDIC prepared to resolve 150 institutions. Of this number, only 56—that is, 37 percent—eventually failed. Of course, many fewer problem banks have been able to find merger partners or recapitalize since the crisis began. However, from 2008 to 2010, of the 432 banks where the FDIC began the resolution process, 110—25 percent—avoided failure, either by finding an acquirer or recapitalizing.

*Due Diligence:* Just as when an insured depository institution is a likely candidate for an FDI Act receivership, the FDIC will need to gather as much information as possible about a systemically important financial institution in advance of any Title II resolution. In the case of LBHI, the SEC and the Federal Reserve Bank of New York began on-site daily monitoring in March 2008, following the collapse and sale of Bear Stearns, at which point the FDIC would already have been on-site at Lehman to facilitate the FDIC's Title I resolution planning and monitoring activities.<sup>53</sup> The FDIC would have determined, jointly with other supervisors, the condition of the company for the purposes of ordering corrective actions to avoid failure, and it otherwise would have prepared for a Title II orderly resolution.

The FDIC would continue assembling information about the condition and value of Lehman's assets and various lines of business. In preparing for a Title II resolution of a company subject to heightened prudential standards under Title I, the FDIC will have access to the information included in such company's resolution

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<sup>52</sup> The Preamble to the Dodd-Frank Act notes that it was enacted, *inter alia*, "to end 'too big to fail' [and] to protect the American taxpayer by ending bailouts."

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<sup>53</sup> See "Orderly Resolution of Lehman under the Dodd-Frank Act—March–July, Due Diligence and Structuring the Resolution—Planning in the Crisis Environment," *supra*.

plan, or living will.<sup>54</sup> Though that resolution plan is designed to provide for the resolution of the systemically important financial institution under the Bankruptcy Code, it would provide regulators with invaluable information about the institution's structure, organization, and key operations that could form the basis for an orderly liquidation under Title II. It is the FDIC's experience that management of a troubled institution often has an overly optimistic view of the value of its franchise and the firm's prospect for recovery. Thus, while the resolution plan would provide key financial and other data about the consolidated entity, an independent examination of the troubled firm may have been necessary. The FDIC will also have access to real-time data from on-site monitoring conducted by the FDIC and other prudential regulators.

The FDIC's participation in gathering information and in exercising its examination authority would be done in coordination with the on-site monitoring activities of the SEC and the Federal Reserve Bank of New York. The development of additional information to facilitate a potential resolution would be done in a manner that would not disrupt the business operations or indicate an imminent failure of the financial company. As regulated entities under the Dodd-Frank Act, heightened supervision by the FDIC, the Federal Reserve, and other prudential regulators will be normal. As a result, these information-gathering activities should neither signal increased distress nor precipitate market reaction.

While conducting due diligence, the FDIC would have begun developing the transaction and bid framework by analyzing the legal structure of the firm, its operations, and its financial data. In this case, LBHI was a large holding company with major overseas operations.<sup>55</sup> As with any large, complex financial company, there were many interrelations among the major affiliates of the group. LBHI was the guarantor of all obligations of LBI and the source of funding for a number of other Lehman entities. LBI was the employer of record for much of the company, including various foreign subsid-

aries. LBI was also the owner and operator of key IT systems used throughout the company and provided custody and trade execution services for clients of foreign Lehman entities, primarily for trades conducted by LBIE in the United States. Likewise, LBIE provided custody and trade execution services for clients of LBI conducting trades outside of the United States. The interconnected nature of Lehman's operations would have argued for maintaining maximum franchise value by developing a deal structure that would have maintained the continuing uninterrupted operation of the major business lines of the firm by transferring those assets and operations to an acquirer immediately upon the failure of the parent holding company.<sup>56</sup>

During the FDIC's investigation of the Lehman group, it would have identified subsidiaries which would be likely to fail in the event of a failure of LBHI but would likely not be systemic and would provide little or no value to the consolidated franchise. The FDIC would not have recommended a resolution under Title II for those subsidiaries, and they would likely have been resolved under the Bankruptcy Code or other applicable insolvency regime.<sup>57</sup> The assets of these subsidiaries would not have been part of a Title II receivership, other than the receiver's equity claim; the FDIC would have had no expected return on the equity for any such non-systemic subsidiary placed into bankruptcy. The FDIC also would have identified any subsidiary that would be likely to fail in the event of a failure of LBHI, and whose failure likely would be systemic. The FDIC would have made an evaluation as to whether the resolution of any such subsidiary under

<sup>54</sup> Had the Dodd-Frank Act been enacted sufficiently far in advance of Lehman's failure, undoubtedly much more supervisory information would have been available in March 2008. The Federal Reserve and the FDIC would have had the detailed information presented in Lehman's statutorily required resolution plan under Title I of the Dodd-Frank Act. See section 165(d) of Title I of the Dodd-Frank Act, 12 U.S.C. § 5365(d).

<sup>55</sup> The principal operating entities in the holding company were LBI, the U.S. broker-dealer, and LBIE, the U.K.-based broker-dealer. Lehman also had a smaller Asian trading operation headquartered in Japan, and various smaller subsidiaries in other countries.

<sup>56</sup> By completing a sale at the time of failure of the parent holding company, the acquirer would have been able to "step into the shoes" of LBHI and provide liquidity, guarantees, or other credit support to the newly acquired subsidiaries. Were the FDIC unable to promptly complete such a transaction, it could provide any necessary liquidity to certain key subsidiaries, such as LBIE, pending a sale of those assets. See footnote 58, *infra*.

<sup>57</sup> See section 202(c)(1) of the Dodd-Frank Act, 12 U.S.C. § 5382(c)(1).

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Title II would have aided in the orderly resolution of the parent company.<sup>58</sup>

As is the case with insured depository institutions that have foreign operations, the FDIC would have begun contacting key foreign financial authorities on a discrete basis to discuss what legal or financial issues might arise out of an FDIC receivership, or out of foreign resolution regimes in the case of Lehman entities operating outside of the United States, and how those resolutions could be coordinated. In addition, foreign financial authorities would have been consulted when foreign financial companies and investors expressed interest in investing in or purchasing Lehman. These discussions would have addressed, at a minimum, the financial strength of the acquirer, types of approvals that would be required to consummate a transaction, and any identified impediments to the transaction. Regular, ongoing contact would be particularly important after the transaction structure was determined and qualified bidders had been contacted and had expressed interest.

*Valuation and Identification of Problem Assets:* On a consolidated basis, LBHI and its subsidiaries had total assets of \$639 billion, with \$26.3 billion in book equity and total unsecured long-term and short-term borrowings of \$162.8 billion as of May 31, 2008. The parent company, LBHI, had \$231 billion in assets, with \$26.3 billion in book equity and \$114.6 billion in unsecured long-term and short-term borrowings. On September 14 (just prior to bankruptcy), LBHI (unconsolidated) was slightly smaller with \$209 billion in assets, \$20.3 billion in book equity, and \$99.5 billion in long-term and short-term unsecured debt, including \$15 billion in subordinated debt. In addition, LBHI's short-term unsecured debt included \$2.3 billion in commercial paper—

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<sup>58</sup> Upon a parent entering a Title II receivership, the FDIC may appoint itself receiver over one or more domestic covered subsidiaries of a covered financial company in receivership in accordance with the self-appointment process set forth in section 210(a)(1)(E) of the Dodd-Frank Act, 12 U.S.C. § 5390(a)(1)(E). This appointment process requires a joint determination by the FDIC and the Secretary of the Treasury that the covered subsidiary is in default or danger of default, that putting it into receivership would avoid or mitigate serious adverse effects on U.S. financial stability, and that such action would facilitate the orderly liquidation of the covered financial company parent. Once in receivership, the covered subsidiary would be treated in a similar manner to any other covered financial company: its shareholders and unsecured creditors would bear the losses of the company, and management and directors responsible for the company's failure would not be retained. The receiver, to aid in the orderly liquidation of the company, could extend liquidity to it in accordance with section 204(d) of the Dodd-Frank Act, 12 U.S.C. § 5384(d).

almost 40 percent of the approximately \$5.7 billion in commercial paper outstanding enterprise wide.

By March 2008, Lehman had recognized that its commercial real estate related holdings were a major impediment to finding a merger partner. Its SpinCo proposal identified \$31.7 billion in significantly underperforming commercial real estate related assets. During the week leading up to Lehman's bankruptcy filing, Bank of America identified an additional \$38.3 billion in suspect residential real estate related assets and private equity assets that it would not purchase in an acquisition. Barclay's identified \$20.3 billion of similar potentially additional problem assets in its due diligence. In the FDIC's resolution process, the FDIC's structuring team as well as prospective bidders would have had sufficient time to perform due diligence and identify problem asset pools. While Lehman was seeking an investor pre-failure, the FDIC would have identified and valued these problem asset pools in order to set a defined bid structure for Lehman. The bid structure would have allowed prospective acquirers to bid upon options to purchase all of Lehman's assets in a whole financial company P&A with loss sharing on defined pools of problem assets, or a purchase which excludes those problem asset pools. In the latter bid option, the receivership estate would have purchased the problem assets out of Lehman's subsidiaries at their fair market value prior to consummating the purchase agreement with the acquirer. These problem assets, in addition to those directly owned by the holding company, could have been retained in the receivership or placed into a bridge financial company prior to future disposition. Either bid would have allowed a further option for the prospective acquirer to pay to assume the commercial paper and other critical short-term securities of Lehman. The bidding structure is discussed more fully in "—August, Begin Marketing Lehman," below.

Both bid structures are intended to provide comfort to not only the potential acquirer, but also to its regulators, concerning the potential down-side exposure to problem assets. In excluding pools of identified problem assets from a bid, an acquirer is protected directly by effectively capping its exposure to such assets—which are left with the receivership—at zero. This risk minimization comes at the cost of lost potential upside from returns on servicing the troubled assets, higher administrative costs of the receiver, and a less attractive bid. In the loss-sharing structure, a potential acquirer receives tail-risk protection: the acquirer is able to cap its exposure to an identified pool of problem assets at set levels. This comfort is particularly important where a potential

acquirer is unable to undertake in-depth due diligence on such assets, or must do so on an abbreviated time table. This down-side protection will also be important to regulators, as it mitigates the risk of an acquirer experiencing financial distress due to the problem assets of an acquiree.<sup>59</sup>

*Structuring the Resolution:* During due diligence, the FDIC would have identified certain pools of assets of Lehman—including certain commercial real estate, residential real estate, and private equity assets—that would make a whole financial company P&A transaction difficult. See “—Valuation and Identification of Problem Assets,” above. These troubled assets were estimated to be between \$50 and \$70 billion in book value.

The FDIC would have set up a data room to enable potential acquirers to conduct due diligence, and would have begun developing a marketing structure for Lehman and its assets. The FDIC would have identified potential acquirers of Lehman. Criteria would have included maximization of value on the sale, the stability of the potential acquirer, and the ability of the acquirer expediently to consummate an acquisition.<sup>60</sup> Having identified the potential acquirers, the FDIC would have explained the bid structure and invited the firms to conduct (or continue) due diligence of Lehman.

During this time, the FDIC would have continued to monitor Lehman’s progress in marketing itself. This would have encouraged Lehman to consummate a non-government transaction, which remained the best outcome for all parties. It would also have provided the FDIC with key information concerning interested acquirers and potential issues and concerns of such acquirers in completing a transaction.

Also during this time, as is the case with insured depository institutions that have foreign operations, the FDIC would have continued a dialogue with key foreign financial authorities to discuss what legal or financial issues might arise out of an FDIC receivership, or out of foreign resolution regimes in the case of Lehman entities operating outside of the United States, and how

those resolutions could be coordinated.<sup>61</sup> Specifically, the FDIC would address issues of ring-fencing of assets, particularly of Lehman’s U.K.-based broker-dealer. See “—Due Diligence,” above.

### *August, Begin Marketing Lehman*

Assuming Lehman were unable to sell itself, the FDIC would have commenced with marketing Lehman.<sup>62</sup> The FDIC would have set a defined bidding structure. Prospective acquirers previously identified (as discussed in “—March–July, Due Diligence and Structuring the Resolution—Structuring the Transaction,” above) would have been invited to bid based on the following options:

*Option A:* Whole financial company purchase and assumption with partial loss share (loss-sharing P&A). Under this option, the assets and operations of Lehman are transferred to the acquirer with no government control and no ongoing servicing of Lehman assets by the government. Due to the problem assets discussed above, however, it may be necessary for the receivership estate to offer a potential acquirer protection from loss in respect of that identified pool of problem assets. In this type of transaction, the acquirer purchases the assets at their gross book value, and assumes, at a minimum, the secured liabilities. Depending on the bid, other liability classes may be assumed as well. Since the book value of assets must always exceed the amount of liabilities assumed in this structure, the acquirer, after factoring its discount bid for the assets, must also provide a combination of cash and a note payable to the receivership estate to balance out the transaction.<sup>63</sup> The receivership estate’s share of loss

<sup>59</sup> Both Barclays and its U.K. regulators were concerned with exposure to problem assets of Lehman following a potential acquisition by Barclays. See footnote 68, *infra*.

<sup>60</sup> We also note the impact of section 622 of the Dodd-Frank Act, 12 U.S.C. § 1852, which could prohibit a large financial company from entering into a transaction to acquire another financial company if the *pro forma* liabilities would exceed certain statutory levels.

<sup>61</sup> For example, in the case of East West Bank’s acquisition of United Commercial Bank, San Francisco, California, the FDIC engaged with the China Banking Regulatory Commission and the Hong Kong Monetary Authority in advance of the resolution to discuss potential acquirers, regulatory approvals and options for resolving or selling the assets and liabilities of United Commercial Bank’s wholly owned subsidiary in China and its foreign branch in Hong Kong.

<sup>62</sup> Any agreement reached in respect of Lehman would be contingent upon its failure, a systemic determination under sections 203(b) or 210(a)(1)(E) of the Dodd-Frank Act, 12 U.S.C. §§ 5383(b) or 5390(a)(1)(E), as applicable, and the appointment of the FDIC as receiver under section 202 of the Dodd-Frank Act, 12 U.S.C. § 5382. In the case of Lehman, and for purposes of our analysis, had there been a viable acquirer or strategic investor pre-failure, no Title II resolution would be required. As discussed in “The Events Leading to the Lehman Bankruptcy,” *supra*, and in footnote 68, *infra*, no such private sector alternative was available.

<sup>63</sup> A simple formula to reflect the amount of the acquirer’s note payable is: Book value of assets purchased less the sum of (book value of liabilities assumed plus discount bid plus cash payment) is equal to note payable.

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payments are made through reductions in the outstanding balance of the note payable as loss claims occur over time.

Transactions offering an option for a sharing of potential future losses between the acquirer and the FDIC have been frequently used to resolve failed banks. Loss-share transactions allow the FDIC to obtain better bids from potential assuming institutions by sharing a portion of the risk on a pool of assets. This has been particularly important during periods of uncertainty about the value of assets. The FDIC's experience has been that these transactions result in both better bid prices and improved recoveries for the receivership and receivership creditors.

Another benefit of loss sharing is that the FDIC is able to transfer administration of the failed financial company's problem assets to the assuming institution and receive a premium for the failed company's franchise value, thereby maximizing value. By having the assuming company absorb a portion of the loss, the FDIC induces rational and responsible credit management behavior from the assuming institution to minimize credit losses. Compared to the alternative of retaining problem assets in receivership, the loss-share structure tends to be more efficient, as it limits losses and administrative costs of the receivership.

The FDIC would therefore permit bidders to bid on a structure based on a sale of the whole financial company, with partial but substantial coverage of losses on those identified problem assets.<sup>64</sup> The loss-share structure encourages bidders to maximize their bids by offering downside credit risk protection from loss on an identified pool of problem assets. This can produce a more efficient outcome as it incentivizes the acquirer to maximize recoveries while reducing administrative costs of the receivership. See "The Resolution and Receivership Process for Failed Banks—Loss Share," above.

*Option B:* Modified purchase and assumption without loss share, which excludes certain identified problem assets (modified P&A, similar to a good bank—bad bank resolution strategy). Under this option, the majority of the assets and operations of Lehman are

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<sup>64</sup> To the extent problem assets were held directly by LBHI, or LBHI experienced significant intercompany exposures to losses in subsidiaries and affiliates, loss sharing would be more likely to be a preferred bid structure.

transferred to the acquirer. Identified pools of problem assets would not be included in the transaction, but retained for disposition at a later date.<sup>65</sup>

*Liabilities:* While the FDIC would transfer the assets of Lehman to the acquirer in accordance with Option A or Option B described above, most unsecured creditor claims would remain with the receivership, including shareholder claims and claims of holders of unsecured, long-term indebtedness. Fully secured claims would be transferred, along with the collateral, to the acquirer. The bid participants would have the opportunity to bid on acquiring certain short-term indebtedness of Lehman, particularly Lehman's outstanding commercial paper. In order for this bid structure to be successful, bidders would need to bid an amount sufficient to cover the loss that the commercial paper and other short-term creditors would have otherwise incurred had the creditors remained in the receivership.

In comparing bids under Option A and Option B, the receivership estate's cost of managing and disposing of the identified problem assets would be taken into consideration. Depending on the bid, the acquirer would purchase the acquired assets through a combination of one or more of cash, notes, and assumed liabilities.

It should be noted that the proposed bid structure represented by Option A and Option B represents one set of options for disposing of the assets and operations of a covered financial company in an efficient manner. The FDIC would have the flexibility to restructure these bids as the facts and circumstances of a particular covered financial company warrant in order to satisfy the FDIC's statutory mandates of promoting financial stability, maximizing recoveries, and minimizing losses.

#### **Early September, Closing**

Following due diligence, interested parties would have submitted closed, or sealed, bids. The FDIC would have evaluated the bids based upon the requirement under the Dodd-Frank Act to maximize value upon any disposition of assets.<sup>66</sup> Bids would have been evaluated on a

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<sup>65</sup> As discussed under "—March–July, Due Diligence and Structuring the Resolution—Due Diligence," *supra*, subsidiaries holding such assets would generally be resolved under the Bankruptcy Code. To the extent any subsidiary was deemed systemic, it could be put into a separate receivership under Title II, its assets liquidated and its claims resolved in accordance with the Dodd-Frank Act.

<sup>66</sup> See section 210(a)(9)(E) of the Dodd-Frank Act, 12 U.S.C. § 5390(a)(9)(E).



present-value basis. The FDIC would have selected the winning bid, and the acquirer and the FDIC, as the receiver for LBHI, would enter into a conditional P&A agreement based upon the agreed upon bid structure.<sup>67</sup>

We have assumed, for the limited purpose of this discussion, that Barclays would have provided a winning bid to complete an acquisition of Lehman.<sup>68</sup>

We have further assumed that, as LBHI reached a point at which it was in default or in danger of default, a systemic determination would have been made by the Secretary of the Treasury and the FDIC would have been appointed receiver of LBHI.<sup>69</sup>

At the time a determination was made that Lehman should be put into receivership and the FDIC named receiver, the assets and select liabilities of Lehman would have been transferred to Barclays as the acquiring institution based upon the structure of the winning bid.<sup>70</sup> Barclays would have maintained the key operations of Lehman in a seamless manner, integrating those operations over time. Disruptions to the market likely would have been minimal. Barclays would have continued to make scheduled payments on liabilities transferred to it, including secured indebtedness and, to

the extent assumed by Barclays, commercial paper.<sup>71</sup> To the extent Barclays' winning bid had been based upon a whole financial company with loss share, it would have been responsible for servicing problem assets in accordance with the terms of the loss-sharing P&A agreement.

Lehman's derivatives trading was conducted almost exclusively in its broker-dealer, LBI, and in LBI's subsidiaries.<sup>72</sup> As a result, Barclays' acquisition of the broker-dealer group would have transferred the derivatives operations, together with the related collateral, to Barclays in its entirety as an ongoing operation. At the moment of failure, Barclays would have assumed any parent guarantee by Lehman outstanding in respect of the subsidiaries' qualified financial contracts. This action should have substantially eliminated any commercial basis for the subsidiaries' counterparties to engage in termination and close-out netting of qualified financial contracts based upon the insolvency of the parent guarantor. This would have removed any financial incentive to do so as well, as a financially secure acquirer would have assumed the obligations and provided guarantees to the same extent as its predecessor, in part to preserve the significant franchise value of the derivatives portfolio (including the underlying collateral).<sup>73</sup> The more limited derivatives operations conducted by LBHI would have been subjected to haircuts to the extent that any net amount due to a counterparty was not collateralized or hedged. Particularly in the future, it is expected that the vast majority of the derivatives transactions of a covered financial company will be fully collateralized.

Barclays would have purchased the acquired assets through a combination of one or more of the following: cash, notes, and the assumption of liabilities. The FDIC, as receiver for Lehman, would have disposed of any problem assets left behind in the receivership or

<sup>67</sup> See footnote 62, *supra*.

<sup>68</sup> We note that this analysis is purely hypothetical in nature, and a bid conducted by the FDIC could have produced strong bids by a number of potential acquirers. Barclays, however, was close to completing a transaction with Lehman in September 2008. It was unable to proceed based upon the risk of financial loss due to problem assets it identified in its due diligence and the inability to gain an exemption from U.K. regulators from the requirement to hold a shareholder vote prior to approving a transaction with Lehman based upon the proposed structure. The FDIC believes it would have been able to alleviate Barclays' concerns—and facilitate requisite regulatory approvals—by structuring the transaction as a loss-sharing P&A or as a modified P&A. For the purpose of this discussion, therefore, a winning bid from Barclays would be one reasonable outcome from the bidding process outlined in “—August, Begin Marketing Lehman,” *supra*.

<sup>69</sup> For a detailed discussion of the recommendation, determination, and appointment process under sections 203 and 202 of the Dodd-Frank Act, 12 U.S.C. §§ 5383 and 5382, see “The Orderly Liquidation of Covered Financial Companies—Appointment,” *supra*.

<sup>70</sup> There is a danger of value dissipation—in proportion to the size and complexity of the covered financial company—the longer such covered financial company stays in receivership prior to a sale being consummated. Accordingly, the FDIC would generally prefer, where possible, to time a sale of the assets and operations of the covered financial company at or near the date of failure. The FDIC may also transfer key operations to a bridge financial company, as described under “The Orderly Resolution of Covered Financial Companies—Special Powers under Title II—Ability to Preserve Systemic Operations of the Covered Financial Company,” *supra*. These same challenges are faced in the resolution of larger insured depository institutions under the FDI Act.

<sup>71</sup> Despite paying a premium to assume the commercial paper obligations, an acquirer may have been incentivized to bid on such business due to the incremental franchise value of the business line and to preserve customer goodwill.

<sup>72</sup> LBHI conducted its derivatives activities primarily in subsidiaries of LBI (the broker-dealer), including Lehman Brothers Special Financing Inc., Lehman Brothers Derivatives Products, Inc., and Lehman Brothers Financial Products, Inc.

<sup>73</sup> Under the International Swaps and Derivatives Association master agreements (and trades placed thereunder), parties may choose whether to be governed by New York or English law. To the extent that parties to a particular qualified financial contract are validly governed by English law (and a court recognizes and applies such choice of law), such contract may not be subject to the Dodd-Frank Act in terms of nullification of its *ipso facto* clause.

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managed the loss-share agreement with Barclays in respect of those assets, and would have settled creditor claims in accordance with the priority for repayment set forth in the Dodd-Frank Act.<sup>74</sup>

### *The Likely Treatment of Creditors*

As mentioned earlier, by September of 2008, LBHI's book equity was down to \$20 billion and it had \$15 billion of subordinated debt, \$85 billion in other outstanding short- and long-term debt, and \$90 billion of other liabilities, most of which represented intra-company funding. The equity and subordinated debt represented a buffer of \$35 billion to absorb losses before other creditors took losses. Of the \$210 billion in assets, potential acquirers had identified \$50 to \$70 billion as impaired or of questionable value. If losses on those assets had been \$40 billion (which would represent a loss rate in the range of 60 to 80 percent), then the entire \$35 billion buffer of equity and subordinated debt would have been eliminated and losses of \$5 billion would have remained. The distribution of these losses would depend on the extent of collateralization and other features of the debt instruments.

If losses had been distributed equally among all of Lehman's remaining general unsecured creditors, the \$5 billion in losses would have resulted in a recovery rate of approximately \$0.97 for every claim of \$1.00, assuming that no affiliate guarantee claims would be triggered. This is significantly more than what these creditors are expected to receive under the Lehman bankruptcy. This benefit to creditors derives primarily from the ability to plan, arrange due diligence, and conduct a well structured competitive bidding process.

The Dodd-Frank Act provides a further potential benefit to creditors: earlier access to liquidity. As described above, the acquirer would have provided a combination of cash and a note to the receiver. Under the Dodd-Frank Act, the FDIC could have promptly distributed the cash proceeds from the sale of assets to claimants in partial satisfaction of unsecured creditor claims.<sup>75</sup> The FDIC would also have been able to borrow up to 90 percent of the fair value of the note available for repayment—together with the fair value of any assets left in the receivership available for repayment—from the orderly liquidation fund and advance those funds to the

receivership.<sup>76</sup> These borrowed funds could have been made available to creditors immediately in the form of advance dividends to satisfy a portion of creditor claims based upon the total expected recovery in the resolution. This is in contrast to the actual circumstances of the LBHI bankruptcy, in which there has been no confirmed plan of reorganization or cash distribution to unsecured creditors of LBHI more than two years after the failure of Lehman.

### **Conclusion**

Title II of the Dodd-Frank Act provides “the necessary authority to liquidate failing financial companies that pose a systemic risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard.”<sup>77</sup> These powers and authorities are analogous to those the FDIC uses to resolve failed insured depository institutions under the FDI Act. In the case of Lehman, following appointment by the Secretary of the Treasury, the FDIC could have used its power as receiver and the ability to facilitate a sale under Title II of the Dodd-Frank Act to preserve the institution's franchise value and transfer Lehman's assets and operations to an acquirer. The FDIC would have imposed losses on equity holders and unsecured creditors, terminated senior management responsible for the failure of the covered financial company, maintained Lehman's liquidity, and, most importantly, attempted to mitigate and prevent disruption to the U.S. financial system, including the commercial paper and derivatives markets. The very availability of a comprehensive resolution system that sets forth in advance the rules under which the government will act following the appointment of a receiver could have helped to prevent a “run on the bank” and the resulting financial instability. By maintaining franchise value and mitigating severe disruption in the financial markets, it is more likely that debt holders and other general creditors will receive greater recoveries on their claims under the Dodd-Frank Act than they would have otherwise received in a Chapter 7 liquidation or a Chapter 11 reorganization.

The key to an orderly resolution and liquidation of a systemically important financial institution is the ability to plan for its resolution and liquidation, provide liquidity to maintain key assets and operations, and preserve financial stability. During the planning phase, the FDIC, working in tandem with the Federal Reserve and

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<sup>74</sup> See section 210(b)(1) of the Dodd-Frank Act, 12 U.S.C. § 5390(b)(1).

<sup>75</sup> See “The Orderly Resolution of Covered Financial Companies—Special Powers under Title II—Advance Dividends and Prompt Distributions,” *supra*, for a discussion of the ability to make both prompt distributions and advance dividends in a Title II receivership.

<sup>76</sup> See footnote 44 and accompanying discussion, *supra*.

<sup>77</sup> Section 204(a) of the Dodd-Frank Act, 12 U.S.C. § 5384(a).

the SEC, would have been able to identify problem assets; require management to raise capital or find an acquirer; gather information about the institution's structure, organization, and key operations; prepare the resolution transaction structure and bids; and seek potential acquirers. During this phase, the FDIC would have contacted the relevant foreign and domestic regulatory authorities and governments to coordinate the resolution. Through this process, the FDIC would have minimized losses and maximized recoveries in the event the systemically important financial institution failed and was put into receivership.

Perhaps most importantly, the Dodd-Frank Act provides the means to preserve systemically important operations and reduce systemic consequences while limiting moral hazard by imposing losses on the stockholders and unsecured creditors of the failed systemically important financial institution rather than on the U.S. taxpayer. In so doing, the FDIC is able to fulfill its statutory mandate to preserve financial stability and serve the public interest.

### Afterword

This paper has focused on how the government could have structured a resolution of Lehman under Title II of the Dodd-Frank Act following the failure of such firm. In so doing, we have made a number of assumptions and caveats to provide a framework for the analysis and to maintain consistency with the historical record. That is, while we have assumed that the Dodd-Frank Act had been enacted pre-failure, and that the FDIC would have been able to avail itself of the pre-planning powers available under Title I, including having access to key data of subject institutions through resolution plans and on-site monitoring, we have not assumed-away the failure of Lehman.

The orderly liquidation authority of Title II would be a remedy of last resort, to be used only after the remedies available under Title I—including the increased informational and supervisory powers—are unable to stave off a failure. In particular, it is expected that the mere knowledge of the consequences of a Title II resolution, including the understanding that financial assistance is no longer an option, would encourage a troubled institution to find an acquirer or strategic partner on its own well in advance of failure. Likewise, on-site monitoring and access to real-time data provided under Title I is expected to provide an early-warning system to the FDIC and other regulators well in advance of a subject institution's imminent failure.

We have also stuck closely to the facts in identifying the most likely acquirer of Lehman as Barclays, while also discussing the potential role played by Bank of America and KDB. Lehman, while a complex firm, had value primarily as an investment bank. Thus, its resolution was focused on keeping the investment bank's operations intact in order to preserve its going-concern value. In other cases, a large financial firm with many pieces such as a large commercial bank, an insurance company, and a broker-dealer, might represent a financial firm that is no longer too big to fail, but may be too big to continue to exist as one entity.<sup>78</sup> Over the longer term, the development of resolution plans will enable the FDIC to prepare to split up such a firm in order to facilitate a Title II liquidation. The FDIC could pursue a number of alternatives instead of a whole financial company purchase-and-assumption transaction, including a spin-off of assets, an initial public offering, a debt-to-equity conversion, or some other transaction that would satisfy regulatory concerns about concentration while minimizing losses to the failed company's creditors.

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<sup>78</sup> See e.g., Simon Johnson & James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (2010); Michael McKee and Scott Lanman, "Greenspan Says U.S. Should Consider Breaking Up Large Banks," *Bloomberg*, Oct. 15, 2009, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aJ8HPmNUfchg>; Lita Epstein, "Breaking up 'too big to fail' banks: Britain leads, will U.S. follow," *DailyFinance*, Nov. 2, 2009, available at <http://www.dailyfinance.com/story/investing/breaking-up-banks-too-big-to-fail-britain-leads-but-will-u-s/19220380/>. The Dodd-Frank Act includes provisions intended to prevent the creation of ever-larger financial companies, including section 622 thereof, 12 U.S.C. § 1852. See footnote 60, *supra*.