

# MISCONCEPTIONS ABOUT LEHMAN BROTHERS' BANKRUPTCY AND THE ROLE DERIVATIVES PLAYED

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On November 4, 2011, Lehman Brothers' creditors voted on Lehman Brothers' liquidation plan, with approval from the bankruptcy court to follow on December 6, 2011. In the three years since the bankruptcy of Lehman Brothers, which was the largest bankruptcy filing in U.S. history, Congress enacted the Dodd-Frank Act to prevent the failure of another systemically important financial institution. Lehman Brothers' bankruptcy offered a unique opportunity to understand the linkages among financial institutions and the broader economy, but few policymakers delved into the actual causes of the bank's collapse. Most instead pointed to derivatives as the cause. This Essay offers a brief overview of some of the most persistent misconceptions regarding Lehman Brothers' bankruptcy and the role that derivatives played in it.

## *A. Misconception #1: Derivatives Caused Lehman Brothers' Failure*

The world's largest financial institutions trade derivatives. Derivatives are instruments that derive their value from fluctuations in the price of an underlying asset such as a stock or a commodity. Financial institutions, asset managers, corporations, and governments use derivatives to manage volatility in assets that their respective enterprises are exposed to. At the time of its bankruptcy, Lehman Brothers had an estimated \$35 trillion notional derivatives portfolio. The 2,209 page autopsy report prepared by Lehman Brothers' bankruptcy examiner, Anton Valukas, never mentions derivatives as a cause of the bank's failure.<sup>1</sup> Rather, poor management choices and a sharp lack of liquidity drove the narrative of Lehman Brothers' bankruptcy.

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1. *See generally* Report of Anton R. Valukas, Examiner, *In re* Lehman Bros. Holdings Inc., No. 08-13555 (JMP) (Bankr. S.D.N.Y. Mar. 11, 2010), *available at* <http://lehmanreport.jenner.com>.

Three primary factors drove Lehman Brothers into bankruptcy, and derivatives trading is not one of them. First, Lehman Brothers consistently ignored its own risk thresholds through its commercial real estate investments. In July 2007, for example, thirty real estate transactions breached the individual transaction risk limits established by the bank's risk managers. Each time, Lehman Brothers' senior management waived the breach and its regulator, the SEC, ignored the bank's disregard of those risk limits.<sup>2</sup> In addition, the bank's stress testing omitted the inclusion of its riskiest assets, its commercial real estate portfolio. As Mr. Valukas testified, "The SEC was aware of these excesses and simply acquiesced."<sup>3</sup> Second, the liquidity of the investment bank was alarmingly low despite statements five days before its bankruptcy filing that its liquidity pool was \$41 billion. In fact, the bank's liquidity pool included assets used as deposits with its clearing banks, which was a clear breach of regulatory guidelines. The SEC knew of this breach but again acquiesced.<sup>4</sup> Third, the bank relied on a quarter-end approach to lower its leverage ratio by moving certain assets off its balance sheet on a temporary basis. The SEC never appears to have inquired about this practice, despite the fact that most other banks had ceased using this approach.

Derivatives, by contrast, did not play a role in Lehman Brothers' failure. Lehman Brothers did not engage in the one-sided selling of credit protection on mortgages like the AAA-rated AIG. Moreover, during the three years following Lehman Brothers' bankruptcy, it is the principal U.S. derivatives trading entity, Lehman Brothers Special Financing (LBSF), which has added the most value to the estate's coffers.

B. *Misconception #2: Regulators Lacked Information About Lehman Brothers' Financial Condition*

The Valukas report was explicit that regulatory agencies sat on mountains of data but took no action to regulate Lehman Brothers' conduct. In 2005, Lehman Brothers became a "consolidated supervised entity," or "CSE," giving the SEC regulatory authority over Lehman Brothers Holdings Inc., the parent company, as well as its broker-dealer subsidiary and other affiliates. No regulator ever suggested that senior officials with Lehman Brothers failed to provide any requested information; congressional testimony was offered on this point. Yet, regulators stated that they were unable to obtain an accurate depiction of Lehman Brothers' financial health and thus were unable to intervene.<sup>5</sup>

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2. Statement of Anton R. Valukas before the Committee on Financial Services, U.S. House of Representatives, April 20, 2010, 9.

3. *Id.* at 2.

4. *Id.* at 9.

5. *Public Policy Issues Raised by the Report of the Lehman Brothers Bankruptcy Examiner: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong (2010). (statements of

Quite the contrary. Not only did Lehman Brothers' CSE status provide the SEC with unfettered access to data, but the bank's participation in the derivatives market offered another source of information. In 2006, Lehman Brothers participated, along with 200 other financial institutions in the launch of the Depository Trust and Clearing Corporation's Trade Information Warehouse. The warehouse is a repository of all derivatives trading details. Within a few months of its establishment, over 900 participants recorded their derivatives transactions in the warehouse. Regulators could avail themselves of the extensive data stored in this warehouse. Therefore, ample opportunity to view derivatives risk existed two full years before Lehman Brothers filed for bankruptcy.

C. *Misconception #3: Derivatives Caused the Destruction of \$75 Billion in Value*

The architect of Lehman Brothers' bankruptcy filing, Harvey Miller, testified that a massive destruction of value could have been averted if an automatic stay had been in place for derivatives contracts upon bankruptcy. U.S. Treasury Secretary Timothy Geithner commented, "The market turmoil following Lehman's bankruptcy was in part attributable to uncertainty surrounding the exposure of Lehman's derivatives counterparties."<sup>6</sup> Both are mistaken.

Under the Bankruptcy Code, creditors of a failed entity are stayed or prohibited from seizing that entity's assets. Since 1978, however, Congress has exempted derivatives counterparties from the automatic stay and permitted the termination of the derivatives contracts. Congress wanted to prevent a cascade of bankruptcies of financially interconnected entities by permitting counterparties to terminate derivatives transactions with a bankrupt entity, thereby preserving liquidity for non-defaulting counterparties and enhancing the financial system's stability. In the case of Lehman Brothers, not one of its derivatives counterparties filed for bankruptcy in the aftermath of its failure. Neither did the derivatives market grind to a halt after Lehman Brothers' bankruptcy filing.

When Lehman Brothers filed for bankruptcy, the estate reported that it was a counterparty to 906,000 derivatives transactions documented under 6,120 ISDA Master Agreements.<sup>7</sup> Lehman Brothers' derivatives portfolio represented

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Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System, and Mary L. Schapiro, Chairman of the U.S. Securities and Exchange Commission).

6. *Public Policy Issues Raised by the Report of the Lehman Brothers Bankruptcy Examiner: Hearing Before the H. Comm. on Fin. Servs.*, 111<sup>th</sup> Cong. 168 (2010) (statement of Timothy Geithner, U.S. Treasury Secretary).

7. Lehman Brothers Holdings Inc. First Creditors Section 341 Meeting, slides 19-20 (Jan. 29, 2009), *available at* <http://www.lehmanbrothersestate.com/LBH/Project/default.aspx#L>. Note that the Lehman Brothers Holdings Inc. The State of the Estate, slide 28 (Nov. 18, 2009), reports a slightly different figure of 6,355 contracts.

roughly 5 percent of derivatives transactions globally at that time.<sup>8</sup> Approximately 80 percent of Lehman Brothers' derivatives counterparties terminated their transactions within five weeks of bankruptcy.<sup>9</sup> The estate was successful, almost immediately post-bankruptcy, in capturing receivables. On September 14, 2008, LBSF, the primary U.S. derivatives business, had a then-current cash position of \$7 million and within three and a half months, its cash position was \$925 million.<sup>10</sup> By February 1, 2011, LBSF had \$8.79 billion in current cash and investments.<sup>11</sup> At present, LBSF represents about 40 percent of all cash and cash investment positions in the entire Lehman Brothers estate.<sup>12</sup>

Before this year ends, an important milestone in the resolution of Lehman Brothers' bankruptcy will occur as creditors vote on the liquidation plan. The settlement of the derivatives portfolio is an important component of that plan. Lehman Brothers' initial liquidation plan maintained the corporate distinction of each Lehman entity that had filed for bankruptcy, ensuring that each of its affiliates would make payments to its creditors on the basis of its own asset base. Creditors of the parent company, however, argued that parent company guarantees of affiliates such as LBSF meant that more debt resided at the parent level while more assets were at the subsidiary level. For example, Lehman Brothers Holdings Inc. reported \$2 billion in cash and investments on June 30, 2010, whereas LBSF had \$7.35 billion in cash and investments at that time.<sup>13</sup>

In response, on January 25, 2011, Lehman Brothers amended its liquidation plan and proposed to reallocate payments owed to derivatives counterparties to creditors of the parent company. This proposal coincided with the estate's effort to reconceive how derivatives transactions were settled. Under the terms of the ISDA Master Agreement, the governing contract for virtually all derivatives transactions, the non-defaulting counterparty calculates the amounts owed upon termination. Here, the estate decided that the defaulting party should rely on a standardized methodology to value remaining derivatives claims.<sup>14</sup> Ultimately, then, the largest bankruptcy filing in U.S. history has shown that resolution can be achieved in just over three years, and that derivatives caused the largest enhancement to the bankruptcy estate. The allegation

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8. *Semiannual Over-The-Counter (OTC) Derivatives Markets Statistics*, BANK FOR INTERNATIONAL SETTLEMENT (June 2009), <http://www.bis.org/statistics/derstats.htm>.

9. Debtors' Motion for an Order pursuant to Sections 105 and 365 of the Bankruptcy Code to Establish Procedures for the Settlement or Assumption and Assignment of Prepetition Derivatives Contracts, *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Nov. 13, 2008).

10. First Creditors Section 341 Meeting, *supra* note 4, at slide 16 (reflects figures as of January 2, 2009).

11. Monthly Operating Report February 2011, *In re Lehman Brothers Holdings, Inc.*, No. 08-13555 (Mar. 18, 2011).

12. Lehman Brothers Holdings Inc. The State of the Estate, slide 10 (Sept. 22, 2010), available at <http://www.lehmanbrothersestate.cpm/LBH/Project/default.aspx#L>.

13. *Id.*

14. LAMCO, DERIVATIVES CLAIMS SETTLEMENT FRAMEWORK 5 (May 31, 2011).

that derivatives destroyed value is flatly at odds with the fact that derivatives were the biggest contributor to boosting recoveries for Lehman's creditors.

D. *Misconception #4: Insufficient Collateralization*

Policymakers focused on collateralization as a derivatives risk mitigation technique. Collateralization of derivatives, however, has existed for twenty years. Before the economic crisis began, the gross amount of collateral in use was \$1.335 trillion, with 59 percent of mark-to-market credit exposure collateralized.<sup>15</sup> The largest financial institutions held 80 percent of all collateral.<sup>16</sup> By the end of the first quarter of 2011, the Office of the Comptroller of the Currency reported that U.S. banks held collateral, overwhelmingly in cash, against 93 percent of their counterparty exposure.<sup>17</sup> The annual ISDA Margin Survey includes U.S. and non-U.S. financial institutions and reports a 70 percent collateralization rate across all OTC instruments, with 93.2 percent for credit derivatives.<sup>18</sup>

E. *Misconception #5: The Bankruptcy Code Is Not Optimal for Systemically Important Bankruptcies*

The Chairman of the Board of Governors of the Federal Reserve, the U.S. Secretary of the Treasury, and the Chairwoman of the Federal Deposit Insurance Corporation (FDIC) contend that the Bankruptcy Code is not capable of working effectively for failed systemically important entities. Rather, these regulators argue that the FDIC is best situated to utilize its new orderly liquidation authority to avoid government bailouts and the cumbersome Bankruptcy Code process.

This vision seems clouded by reality. With regard to derivatives, banks engage in the vast majority of trading. Prior to and after Dodd-Frank, a failed bank's derivatives portfolio is subject to a one-day stay before counterparties can terminate transactions. In addition, the FDIC's ability to transfer assets to another entity begs the question of whether an institution actually could be persuaded to take on a failed institution's \$35 trillion notional derivatives portfolio without sufficient time to conduct due diligence.

Moreover, it is not clear that the FDIC's orderly liquidation authority would necessarily produce faster results than the bankruptcy process would. In bankruptcy, the administrator has a fiduciary duty to maximize the size of the

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15. ISDA MARGIN SURVEY 2007 at 4 (2007), available at [http://www.isda.org/c\\_and\\_a/pdf/ISDA-Margin-Survey-2007.pdf](http://www.isda.org/c_and_a/pdf/ISDA-Margin-Survey-2007.pdf).

16. *Id.*

17. OCC'S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES FOURTH QUARTER 2010 at 8 (2010).

18. ISDA MARGIN SURVEY 2010 AT 13 (2010), available at [http://www.isda.org/c\\_and\\_a/pdf/ISDA-Margin-Survey-2010.pdf](http://www.isda.org/c_and_a/pdf/ISDA-Margin-Survey-2010.pdf).

estate for the benefit of all creditors. In Lehman Brothers' case, this has meant that each derivatives transaction is considered with this principle in mind. Accordingly, the estate contended that the process was too slow and proposed the settlement framework mentioned above. It is arguable that if the FDIC, operating in its new Dodd-Frank role, transferred a failed bank's derivatives portfolio to another entity, choices would still have to be made as to each transaction's value, whether such transaction could be terminated, and, if not, what collateral levels would be required. In contrast, under the current settlement framework, Lehman Brothers' bankruptcy will be resolved in just over three years—a remarkable timeframe given that Enron's resolution took a decade.

Policymakers also focused on the wrong entities for failure. Banks, the most likely candidates for application of Dodd-Frank's orderly resolution authority, have in fact been the least likely to experience failures due to derivatives losses, in part because of their efforts to hedge exposures. The largest derivatives failures to date involved non-bank entities such as Orange County, the hedge fund Long-Term Capital Management, and AIG Financial Products—entities with fewer risk management and legal resources than banks and which are less likely to hedge exposure. These types of entities are not covered by Dodd-Frank.

#### CONCLUSION

An alternative vision for policymakers in the aftermath of Lehman Brothers' bankruptcy would have involved greater consideration of how liquidity can become constrained so quickly, as in the commercial paper and repo markets, and an effort to mandate the type and amount of collateral provided in these asset classes. In addition, a clarion call mentality among regulators with respect to critical issues such as the size and makeup of a bank's liquidity pool and an insistence on adherence to banks' self-established risk tolerances should be actionable. Instead, policymakers overlooked some of the principal causes of Lehman Brothers' bankruptcy. As George Santayana so famously remarked, "Those who do not understand history are doomed to repeat it."