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Client Alert

U.S. Sale of the Century: Five Days in September

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In September 2008 Lehman Brothers Holdings Inc. and Lehman Brothers Inc. (collectively, "Lehman") sold their historically coveted brokerage business to Barclays Capital Inc. Many believe the sale was necessary to prevent a worldwide economic meltdown given Lehman's tentacles throughout the global economy. In fact, Lehman's Chapter 11 filing on September 15, 2008 was valued at $639 billion, the largest Chapter 11 in U.S. history. It involved 7,000 legal entities and spawned 75 related insolvency proceedings throughout the world. Despite (or perhaps because of) the enormity of the Lehman Chapter 11, the sale of Lehman's brokerage business was accomplished in five days, an unprecedented accomplishment given the size, importance, and complexity of the assets being sold and the transaction itself. Lehman proceeded under Section 363 of the U.S. Bankruptcy Code (regarding sales of assets) to effect this transaction. However, the sale had none of the usual procedures and protections normally associated with a Section 363 sale. The sale followed an extremely truncated process involving only five days from Lehman's Chapter 11 filing to the closing of the sale. While the sale order referenced "competitive bidding" and other "qualified bids," Barclays was the only realistic buyer.

This "sale of the century" has spawned litigation and commentary around the globe. The most significant litigation that emerged from the sale was Lehman's own motion to have the terms of the sale modified, which is currently pending before the United States Bankruptcy Court in the Southern District of New York. The business and legal communities are closely watching the outcome of this litigation on the efficacy of the Section 363 sales process and the finality of Section 363 sale orders. Is Lehman trying to renegotiate the deal after the fact, or does the unprecedented magnitude and speed of this sale warrant a modification to the sale order to insure the original intent of the transaction?

According to Lehman's motion to modify the Section 363 sale order, there were material components of the transaction that were not disclosed to the Bankruptcy Court and the sale transaction that closed differed materially from the transaction approved by the Bankruptcy Court. Lehman's motion indicates that the original intent of the sale was a "wash" whereby Barclays would pay fair value for the assets it was acquiring, when in fact the deal was actually structured to give Barclays an immediate and enormous windfall of approximately $11 billion. This was accomplished because the key Lehman negotiators were also key employees who were transferring to Barclays as a result of the sale.

A controversial component of the transaction was the "Clarification Letter," which was signed after the sale order was entered. The "Clarification Letter," among other things, terminated a Repurchase Agreement between Lehman and Barclays where Barclays transferred $45 billion cash to Lehman in exchange for $50 billion of securities, subject to Lehman's repurchase of the securities at a later date for $45 billion. By terminating this agreement, Barclays received an undisclosed $5 billion discount. Lehman asserted that under Section 559 of the Bankruptcy Code (dealing with Repurchase Agreements), the excess of market prices over stated repurchase prices are property of Lehman's estate, and thus termination of the Repurchase Agreement violated the Bankruptcy Code. The terms of the "Clarification Letter" allegedly were not disclosed, and constituted a material alteration to the transaction approved by the Court.

In addition to the $5 billion discount, and due to the fear that the value of Lehman's assets were rapidly deteriorating, Lehman asserted that there was a scramble within Lehman to deliver to Barclays $5 billion of other assets without consideration or disclosure to the court. The additional assets included approximately $800 million of the so-called "15c3-3 assets," at least $1.9 billion of unencumbered assets in so-called "clearance boxes," and approximately $2.3 billion of additional assets.

Lehman further alleged that Barclays was to assume $2 billion in 2008 bonus liabilities to Lehman employees who transferred to Barclays, and another $1.5 billion for cure payments for assumed executory contracts. Lehman maintained that Barclays actually assumed no more than about $1.7 billion in liabilities, compared to the $3.5 billion it had agreed to assume. Lehman also highlighted that Barclays publicly announced in February, 2009 that it had enjoyed a gain of $4.2 billion "on acquisition" of Lehman assets. This immediate gain was attributable to "the excess of the fair value of net assets acquired over consideration paid … on acquisition." Lehman maintained the "gain on acquisition" was understated by at least $6 billion because of various post-closing asset and valuation adjustments. The immediate gain for Barclays was never disclosed to or approved by the Bankruptcy Court.

In response to Lehman's various assertions, Barclays has posited that Lehman is simply trying to rewrite the deal because it was "too good for Barclays." Moreover, Barclays maintains that Lehman's assertions are "a gross distortion" about the complex negotiations over the sale of Lehman's broker-dealer business, where once an agreement was struck, both sides continued to negotiate terms as Lehman's assets continued to deteriorate in the wake of its collapse. Barclays asserted that it received far less than the $50 billion in securities it was supposed to get in exchange for $45 billion in cash it advanced to Lehman. This short fall created "massive uncertainty and risk" for Barclays that was not resolved for months. Because the securities were actually worth only slightly more than $45 billion, the embedded gain of almost $5 billion was a fiction. Barclays' court filings asserted that had the deal turned out differently such that Barclays incurred a loss because the assets were worth less than anticipated, Barclays would not have the right to come back to court a year later to change the deal.

Lehman's legal arguments included the following: (1) the sale failed to maximize the value of the Lehman bankruptcy estate and the return to creditors, (2) under Section 549 of the Bankruptcy Code, there were unauthorized post-petition transfers of the debtor's assets of at least $8.2 billion, based on "secret agreements," which are unacceptable in bankruptcy as they deprive sellers of full market value, (3) Lehman executives colluded with Barclays to create a sweetheart deal for Barclays, and (4) through mistake, misrepresentation, and newly discovered evidence, it is clear that Barclays received an $11 billion discount and failed to assume liabilities for borrowers and executory contract cure payments.

The trial on Lehman's motion to modify the sale order, including Barclay's defenses, concluded in October, 2010. A ruling by the Bankruptcy Court is expected in the first quarter of 2011. Given the $11 billion at stake, there will undoubtedly be appeals to the United States District Court, the United States Second Circuit Court of Appeals, and perhaps the U.S. Supreme Court. The business and legal communities are closely watching the outcome of the Lehman-Barclays trial due to the potential impact on the sanctity of Section 363 sale orders. The Bankruptcy Court has a delicate balance of preserving the finality of sale orders and insuring the process, including adequate disclosure, generates the maximum value for creditors. If the Bankruptcy Court modifies the sale order as Lehman requests, many will use the Court's modification to challenge future Section 363 sale orders. While such a ruling would surely create some level of uncertainty for future Section 363 sales, perhaps Lehman will be "limited to its facts," and viewed as an extraordinary ruling regarding an extraordinary transaction in an extraordinary time in our economic history. In the Lehman case itself, a modification to the sale order is estimated to create a nearly 16 cents per dollar recovery for Lehman's creditors.

A fundamental policy of Chapter 11 is to preserve asset values for the benefit of the debtors' estates and their creditors. Bankruptcy Courts in the United States are accustomed to quick Section 363 sales to accomplish this purpose. What made the Lehman sale unique is that it was the largest such sale in bankruptcy history, and it occurred in only five days, in an effort to stabilize the United States' economy and world markets. It is impossible for a sale of this enormity to have all details resolved prior to sale approval or closing. Necessarily, the Bankruptcy Court approved a transaction with many details left for further negotiations. The Bankruptcy Court clearly gave Lehman and Barclays virtual carte blanche to consummate a deal to save Lehman's brokerage business and prevent a feared catastrophe in the global economic markets. While this strategy allowed a truly titanic Section 363 sale to be negotiated, approved, and closed in warp speed, the sale has predictably precipitated an $11 billion lawsuit challenging the terms of the transaction, and may alter Section 363 sales in the future.

We hope you have found this useful and informative. Please contact us if you have any questions about this or any other matter.

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