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The Sale of the Century and Its Impact on Asset Securitization: *Lehman Brothers*[1]

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In the early morning hours[3] of Sept. 20, 2008, an order (sale order) was entered in the most important hearing ever conducted in a bankruptcy case.[4] Lehman Brothers Holdings Inc. (debtors)[5] had filed its chapter 11 petition five days earlier, and its sale motion only three days before entry of the sale order.

Prof. Stephen Lubben

The sale order approved the sale of the debtors' brokerage operation, primarily housed in the regulated entity Lehman Brothers Inc. (brokerage), to Barclay's Capital Inc. The amount of assets involved in the sale is somewhat unclear, but the sale order involved not less than $50 billion as noted by the debtors' counsel. The sale of the brokerage originally involved "a value of 70 — approximately $70 billion. And today [Sept. 19, 2008], Your Honor,

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About the Author

Stephen Lubben is a professor at Seton Hall Law School in Newark, N.J., and was the principal investigator under a $345,000 ABI Endowment grant that funded the most comprehensive, independent look at professional fees in chapter 11 cases to date.

1 Case number 08-13555, filed on Sept. 15, 2008, in the U.S. Bankruptcy Court for the Southern District of New York and assigned to the Hon. **James M. Peck**.

2 The author gratefully acknowledges the contributions of **C.R. "Chip" Bowles Jr.** (Greenebaum Doll & McDonald PLLC; Louisville, Ky.). He served as chair of ABI's professional fee study advisory board.

3 The hearing on the sale motion began at 4:00 a.m., Friday, Sept. 19, 2008, and involved several hundred attorneys and professionals. For further discussions of this unique hearing, see "In Lehman Bankruptcy, Judge Peck Packs a Punch," Sept. 29, 2008, *Wall Street Journal* and "Lehman Bankruptcy Hearing Held Surprises, According to Attorney Eyewitness," Sept. 24, 2008, Law.com.

4 Although one of the authors (the shorter one) is known for his extremely weak attempts at humor, this statement we believe is the absolute truth. See proffered testimony of Barry W. Ridings at Transcript, p. 146 — ("Any failure to consummate [the Barclay's sale] may potentially cause a major shock to the financial system") and the remarks of Judge Peck, Transcript at 171 ("in unrebutted testimony [Mr. Ridings] indicated through proffer that the markets, in effect, would tank [if the sale was not approved].")

5 A related entity, LB 745 LLC, also filed a chapter 11 case with Lehman Brothers Holdings Inc. and they will be hereinafter referred to as debtors. On Sept. 19, 2008, the brokerage was placed in a SPIC liquidation proceeding in the U.S. District Court for the Southern District of New York by the Securities Investor Protection Corporation (SPIC). The district court "removed" the SPIC proceeding to the bankruptcy court.

ABI Event Roundup

Restructuring and Consumer Bankruptcy Programs Highlight Busy November

A team from the Northwestern University's Kellogg Graduate School of Management won the Bettina M. Whyte Trophy at the Fifth Annual ABI Corporate Restructuring Competition, held Nov. 6-7 at Northwestern University in Chicago. The second-year MBA student winners

Retired Chief U.S. Bankruptcy Judge Helen S. Balick received a special tribute at the Delaware Views from the Bench and Bar conference in Wilmington when her portrait was unveiled during the luncheon.

Faculty advisor James B. Shein (c) poses with members of his winning Corporate Restructuring Competition team, Northwestern University's Kellogg Graduate School of Management, shown with the Bettina M. Whyte Trophy.

also shared a $6,000 cash prize. Students from the Dartmouth College Tuck School of Business won the second-place award of $3,500, with the University of Illinois College of Business receiving the $2,500 prize for third place.

The competition, which is co-sponsored by ABI and Houlihan Lokey, provided 11 of the nation's top MBA programs with a unique opportunity to learn by solving a real-world restructuring case problem. The

Freddie Mac Deputy Chief Economist Amy Crews Cutts keynoted the luncheon at the Detroit Consumer Bankruptcy Conference with a timely discussion on the economic and housing market outlook.

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we're only selling assets that have a value of $47.4 billion dollars." (Transcript of Sept. 19-20, 2008 at p. 47).

This article will not address any issue about the correctness of the Lehman sale order[6] or any other issues related to the Lehman bankruptcy. Rather, the authors will address the issue of what impact the sale order could have on bankruptcy sales in the future and the viability of "Special Purpose" (SPE) and "Bankruptcy Remote" entities.[7]

Quick Review of the "Special" Hypothetical Problem

SPEs have their origins in the early packaging and marketing of 1970s bundles of residential mortgages insured by Fannie Mae and Freddie Mac in the secondary home mortgage market.[8] By the 1990s, lenders and investors were using SPEs in order to secure investment collateral in entities that would find it difficult to file for bankruptcy.[9]

For several years, attorneys and financial professionals have worked to fully bankruptcy-proof SPEs.[10] Originally, these efforts were directed at creating provisions in the SPE's incorporation papers or bylaws to prevent these entities from filing voluntary bankruptcy petitions.[11] More recently, SPEs have been created with provisions that prohibit the SPE from:

- engaging in any business operations other than holding the assets that are collateral for the parties' investment or loan (collateral);
- owning any property other than the collateral;
- incurring any debt or guarantees, other than related to the investment for which the SPE is holding collateral;
- not co-mingling the SPE's assets with the assets of any other entity;
- maintaining separate books, records and financial accounts from other affiliates; and
- merging or combining with other entities.

These measures are designed to both legally and practically prevent both the SPE from voluntarily filing bankruptcy and third parties from placing the SPE in an involuntary bankruptcy.[12]

The purpose of these measures is to prevent parties that own and or control the SPEs from placing the SPEs' assets, as opposed to the parties' ownership interest in the SPEs, under the jurisdiction of a bankruptcy court.

The Lehman Sale Order

The debtors' case began on Monday, Sept. 15.[13] The first-day motions in the case were heard on Tuesday. On the third day of the case, the debtors filed their motion to: (1) schedule a sale hearing; (2) establish sale procedures; (c) approve a break-up fee;[14] and (4) approve the sale of assets and the assumption and assignment of contracts ("brokerage sale motion"). On the same day that the breakup fee and bid procedures were approved, the sale hearing began.

Before the hearing, more than 50 objections to the brokerage sale motion were filed by a wide variety of parties. On the morning of the sale hearing, the brokerages' Securities Investor Protection

[6] Because, under the truly unique circumstances of the world at the time it was entered, the findings made by the court in the sale order and the fact final sale orders are effectively impossible to challenge without a bond the authors believe that there is almost no chance that the sale order will be disturbed in any way on appeal. *See* 11 U.S.C. §363(m). *United States v. Salerno*, 932 F.2d 117, 123 (2d Cir. 1991).

[7] Numerous other factors including, adequate notice, proper marketing and the impact of prebankruptcy "no-shop" provisions, are among the myriad other interesting collateral issues that could also be analyzed in light of the Sale Order, but page limitations prohibit any discussion here.

[8] Venditto, "More Bad News For Structured Finance?," 25B No. 11 Bankr. Strategist 3 (2008); Shenker & Collette, *Asset Securitization: Evolution Current Issues and New Frontiers*, 69 Tx. L. Rev. 1369 (1991).

[9] Ellis, "Securitization Vehicles, Factual Rules and Bondholders Rights," 24 J. Corp. L. 295 (Winter 1999).

[10] Lubben, *Beyond True Sales – Securitization and Chapter 11*, 1 N.Y.U. J.L. & Bus. 89 (2004).

[11] *See, generally, In re Kingston Square Associates, et al.*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997) (discussing whether involuntary bankruptcy petitions, orchestrated by debtor's principals to circumvent restrictions in debtor's bylaws, preventing debtors from filing voluntary bankruptcy should be dismissed).

[12] Madison, Dwyer and Bender, *Law ----of Real Estate Financing*, 13:38 (2008); Stratten, "Special Purpose Entities and Authority to File Bankruptcy," Am. Bank Inst. J. 36 (March 2004).

[13] The Tale of the Brokerage in the debtors' bankruptcy case is also the *Tale of Solomon Grundy*, the mythical character in the 18th century nursery rhyme which goes:

Solomon Grundy/Born on a Monday (debtors filed), *Christened on Tuesday* (first day of motions), *Married on Wednesday* (brokerage sale motion filed), *Took ill on Thursday* (objections to brokerage sale motion), *Grew worse on Friday* (start of sale hearing), *Died on Saturday* (sale order entered), *Buried on Sunday*, (closing). *That was the end of Solomon Grundy* (Except it is now part of Barclays).

The taller part of your writing duo wondered why this was here, but did recognize its similarity to a verse in The Pogues' "Billy's Bones." See The Pogues, *Rum, Sodomy and The Lash* (MCA Records, 1985).

[14] $125 million including expense reimbursement.

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Corp. (SPIC) proceeding was commenced and removed to the bankruptcy court.[15] After an almost nine-hour hearing, the sale of the assets of the brokerage and other entities was approved. Two appeals have been filed on the sale order and at the time of this article they appear to be proceeding without the posting of a bond or the granting of a stay.

OK, and This Is Important Why?

The sale order is important to the world of asset securitization because of its scope. As a matter of black-letter bankruptcy law under §541, when a debtor files a petition, an estate is created comprised of "all legal or equitable interests *of the debtor* in property as of the commencement of the case" (emphasis added). If a corporation files the petition, the estate consists of all the assets directly owned by that corporate entity, including the shares of any subsidiaries. But the parent company's filing does not bring a subsidiary's office furniture, water cooler, leases and other "stuff" into the estate.[16] If the parent company wants to address the subsidiary's separate property and debts as part of the bankruptcy, the parent company must utilize its power under state corporate law to put the subsidiary into bankruptcy. And the entire concept of asset securitization is based on the effort to prevent the latter move.

> *Despite all of this, in the sale order, the bankruptcy court authorized the sale under §363 of the "purchased assets."*

Purchased assets were defined in the asset-purchase agreement to include not only brokerage assets owned by the debtors and brokerage, which were before the bankruptcy court[17] as a result of the SIPC proceeding, but also all assets owned by these companies' direct and indirect subsidiaries that were used in connection with the brokerage business.

Because the sale order makes clear that *all* of the brokerage assets would be sold both "free and clear" under §363(f) and also free of any successor liability claims, this was more than a mere sale of the three companies' shareholder interests in the subsidiaries. And to be sure, several additional Lehman subsidiaries did eventually file their own chapter 11 cases, but that was early October, more than 10 days after sale order was entered.

In short, it appears that the bankruptcy court approved the sale of assets that were not part of any then-existing bankruptcy estate. Indeed, the court not only sold these assets, but it "cleansed" the assets of future claims. Essentially the debtors' estates were expanded to include the brokerage assets, regardless of which entity formally owned these assets.

Is it time to revise the non-consolidation opinion? Unless you are certain that Lehman will be limited to its rather extreme facts, we suggest the answer must be "yes." And even if you do believe that Lehman will be limited to its facts, we believe that you at least have to anticipate that somebody will try to extend the principal to a situation involving the assets of a nondebtor SPE. They may not succeed, but even the risk of such litigation is something the SPE investors might like to know about. ■

15 See 15 U.S.C. §78eee(b)(4).

16 *See Fowler v. Shadel*, 400 F.3d 1016 (7th Cir. 2005) (in context of individual debtor being able to claim an exemption in wholly owned corporate property); *In re Russell*, 121 B.R. 16 (Bankr. W.D. Ark. 1990) (assets of nondebtor corporation owned 82 percent by debtor did not become property of debtor's estate).

17 *See* 15 U.S.C. §78fff(b) (providing for the application of title 11 in SIPC cases except where inconsistent with SIPA).

VFB v. Campbell's Soup *and the Solvency of Publicly-traded Debtors*

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activity threshold as distinguishing efficient from inefficient markets, however, this approach may clearly rule in or out highly active and inactive stocks while leaving a range of indeterminacy.

When examining the market efficiency of a particular stock, econometric testing provides more definitive results. Such tests traditionally employ a related cornerstone of financial economics: The Capital Asset Pricing Model (CAPM). The CAPM captures the economic understanding that, absent company-specific informational events, the returns on a particular stock in an efficient market will vary systematically with fluctuations in the overall market, with the stock's "beta" statistic measuring the magnitude of this covariance. Econometric "event studies" statistically examine whether "abnormal returns"—deviations from the returns predicted by the stock's beta—accompany informational events. The observation of statistically significant abnormal returns concurrent with relevant informational events is consistent with the expectations of the EMH.[8]

One does not expect to observe statistically significant results for all events. Markets may have anticipated some events and already priced these expectations into the stock's price. Some news events do not have unambiguously positive or negative implications. Even when a truly unambiguous "news" event occurs, the resulting market adjustment may be of insufficient magnitude to trigger statistically significant price adjustments. Looked at another way, an efficient market jostles a stock's returns on a daily basis, and while these movements constitute "abnormal returns" insofar as they represent deviations from strict covariance with the market, they are not all statistically noteworthy deviations. An event study of an *efficient market*, therefore, could fail to observe statistically significant abnormal returns simply because, in effect, it studied a boring period for the subject stock.

Such analyses demonstrate that while most public stocks trade actively and respond to information, many stocks, and in particular smaller listings, do not enjoy

8 A note on statistical nomenclature: One speaks of a statistical test rejecting or accepting a statistical hypothesis, but statistics are mum on whether the interpretation of the statistical result accepts or rejects the theoretical hypothesis.