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Lehman Brothers' ADR Procedures for Resolving Its Derivative Contracts in Bankruptcy

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Lehman Brothers' bankruptcy case was the largest and most complex Chapter 11 case in history. Among other complexities, when Lehman filed for bankruptcy on Sept. 15, 2008, it was a party to approximately 1.2 million derivative transactions with approximately 6,500 counterparties. Lehman had entered into derivative transactions through a number of wholly owned subsidiaries, both in a trading capacity and as an end-user. No Chapter 11 debtor had had as many or as complex a collection of derivative contracts. Disputes relating to the contracts threatened to become a quagmire of extensive and costly litigation. However, Judge James Peck, overseeing the Lehman bankruptcy, approved alternative procedures, proposed by Lehman's bankruptcy counsel (Weil, Gotshal & Manges), to resolve these disputes. This approach to these issues undoubtedly contributed to Lehman's ability to resolve its bankruptcy case with a consensual plan in less than three-and-a-half years.

Assessing the Situation

Lehman's bankruptcy filing constituted an event of default under most (if not all) of its derivative contracts. As a result, the vast majority of its counterparties terminated their transactions with Lehman (by election or automatic termination), accelerated amounts owed, and exercised rights of setoff against collateral in their possession. Although Sections 362 and 365(e)(1) of the Bankruptcy Code generally prohibit the termination of contracts as a result of a bankruptcy filing, certain financial contracts are exempted by the "safe-harbor" provisions of the Bankruptcy Code. Some counterparties, however, did not exercise their termination rights.

In many instances, terminating counterparties owed Lehman money, and non-terminating counterparties would have owed Lehman money under the contracts. These "in-the-money" derivative contracts constituted significant assets of Lehman's bankruptcy estate. However, disputes arose regarding amounts owed under the terminated contracts, and, in those cases in which counterparties did not elect to terminate the derivative contract, the value of the contract was trapped unless Lehman could assume and assign it, the counterparty defaulted, or the contract expired on its own terms. Additionally, in some instances, counterparties refused, based upon alleged defaults, to make ongoing payments due to Lehman under the derivative contracts.

As of March 31, 2011, however, according to Lehman's Chapter 11 Plan Disclosure Statement, Lehman had reconciled the universe of all trades between itself and a particular counterparty under 99% of its derivative contracts, had valued 99% of the contracts, and had finally settled 58.5% of them. Through Dec. 31, 2010, Lehman had collected more than $12.2 billion from counterparties to derivative contracts and expected to collect another $5.2 billion, though actual recoveries could vary materially. Lehman achieved these results through a variety of efforts to protect its large portfolio of derivative contract assets.

Assumption and Assignment

Lehman's first effort to monetize its open "in-the-money" contracts was to market and sell those contracts to third parties. Approximately two months after Lehman filed for bankruptcy, it asked the bankruptcy court to approve procedures to reduce costs associated with assuming and assigning its "in-the-money" derivative contracts, and settling claims arising from terminated derivative contracts. Over the next several months, the bankruptcy court entered several orders establishing expeditious procedures providing

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Lehman with flexibility to agree on amounts owed, expediting the consensual resolution of derivative contract disputes, and authorizing Lehman to enter into transactions to hedge the loss of value embedded in its open, "in-the-money" derivative contracts.

A Request for ADR Procedures

Then, in July 2009, Lehman asked the Bankruptcy Court to approve a set of alternative dispute resolution (ADR) procedures with respect to its "in-the-money" derivative contracts. Lehman sought procedures that would: 1) allow it to capture the value of its "in-the-money" derivative contracts; and 2) streamline the process and promote judicial efficiency. Lehman estimated that there were approximately 250 counterparties with respect to these contracts, and that many of them would have common issues such as the appropriateness of setoff, termination, valuation, computation of termination payments, and notice. The counterparties ranged from big financial institutions to smaller educational and healthcare entities.

Without the ADR procedures, Lehman likely would have been forced to commence and prosecute hundreds of adversary proceedings or contested matters. Such a process would have been expensive and time-consuming, would have delayed the administration of Lehman's bankruptcy case, and would have risked the loss of value embedded in the contracts. In their most basic form, however, these disputes were simply collection actions against parties that owed Lehman money.

Legal Bases for ADR Procedures

The legal bases for Lehman's requested relief were Section 105(a) of the Bankruptcy Code and the Southern District of New York Bankruptcy Court's Standing Order with respect to ADR.

Section 105(a) of the Bankruptcy Code grants bankruptcy courts the "equitable power to 'issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.'"

The Standing Order permits bankruptcy courts to assign any adversary proceeding, contested matter, or other dispute to mediation "upon its own motion, or upon a motion by any party in interest or the U.S. Trustee." The current Standing Order, M-390, was entered on Dec. 1, 2009, and amended, restated, and combined two prior Standing Orders, M-143 (entered in 1995) and M-211 (entered in 1999), which had separately addressed mediation, early neutral evaluation, and med/arb. *See also* S.D.N.Y. Local Bankr. R. 9019-1 (stating alternative dispute resolution shall be governed by standing order).

In prior bankruptcy cases in the Southern District of New York (and elsewhere), ADR procedures have been used, for example, with respect to over 900 adversary proceedings commenced against preference defendants (*In re Ames Department Stores, Inc., et al.*, Case No. 01-42217 (REG) (Bankr. S.D.N.Y. June 25, 2007) [Docket No. 3195]); personal injury, tort, product liability, and other claims (*In re Motors Liquidation Company et al.*, Case No. 09-50026 (REG) (Bankr. S.D.N.Y. Feb. 23, 2010) [Docket No. 5037]); and adversary proceedings regarding trading disputes (*In re Enron Corp., et al.*, Case No. 01-16034 (ALG) (Bankr. S.D.N.Y. March 4, 2003) [Docket No. 9533] and (Bankr. S.D.N.Y. March 20, 2003) [Docket No. 9862]).

Objections to the ADR Procedures

In response to Lehman's request for ADR procedures, several parties objected, stating that, despite these sources of authority, the bankruptcy court lacked power to order ADR. In that regard, parties argued that, among other things: 1) the ADR procedures should apply only to adversary proceedings; 2) their contracts do not provide for mediation; 3) mediation is inconsistent with a centralized decision-making process that bankruptcy usually entails; 4) Lehman's claims may be non-core proceedings that must be heard by an Article III judge; and 5) the court lacked personal jurisdiction over counterparties outside the United States.

Other objections centered on parties' substantive rights, the applicability of sanctions, the scope of the procedures, mediation logistics, and special needs for indenture trustees.

ADR Procedures Approved

In response, Lehman modified some of the procedures. As to those objections that remained, the Bankruptcy Court overruled them and on Sept. 17, 2009, entered an order approving the ADR procedures. The procedures establish a method by which Lehman can commence an ADR matter prior to filing litigation and which includes a notice and response phase. If the dispute cannot be resolved during this first phase, the next phase is a mediation conducted by one of four individuals appointed to serve as mediators under the procedures. The mediation phase entails a briefing process and in-person meeting, after which the mediation may end upon the request of a party and concurrence by the mediator.

Participation in the process is mandatory, though parties are not required to settle nor do they waive any substantive rights, procedural rights, or defenses by participating. The entire process is confidential — nothing is provided to the court except for a monthly report indicating the number of notices served, settlements reached after mediation, mediations pending, mediations terminated without settlement, and the dollar amount of settlements reached with counterparties after service of the notices.

Tier 2 Procedures Proposed

Approximately one year after entry of the order establishing the

ADR procedures, Lehman asked the bankruptcy court to approve "Tier 2" ADR procedures for contracts in which Lehman's claim was $1 million or less. (The Bankruptcy Court recently approved Lehman's request and Lehman filed a motion to increase this amount to $5 million.) The Tier 2 procedures are intended to streamline the ADR procedures to increase speed and effectiveness and to minimize costs. Although Lehman retains the flexibility to decide whether to use the initially approved procedures or the Tier 2 ones, Lehman estimated that the Tier 2 procedures would impact disputes with at least 100 counterparties (though not any deals involving indenture trustees). No parties objected to the motion, and the Bankruptcy Court granted the motion on Sept. 27, 2010. The changes in procedures included, among other things, shortened response times, limitations on the lengths of mediation briefs, and a different group of four mediators to oversee the Tier 2 mediations.

SPV Procedures Proposed

Shortly thereafter, on Nov. 24, 2010, Lehman asked the bankruptcy court again to modify the ADR procedures as they relate to Special Purpose Vehicle (SPV) counterparties. Lehman proposed specific SPV procedures because of the difficulty it had in bringing SPV counterparties to the negotiating table. The procedures require mandatory participation by SPV counterparties, which are parties to pending adversary proceedings or will be named as defendants in future actions. Thus, the procedures apply only after the commencement of litigation against the SPV counterparty. In large measure, the procedures are consistent with the prior approved procedures, but are designed to accommodate the unique aspects that face SPVs, in particular with respect to identifying and involving a representative who has settlement authority on behalf of the SPV.

On March 3, 2011, after Lehman modified its proposed order to account for parties' objections and after overruling other parties' objections to the procedures, the bankruptcy court entered an order approving the SPV-specific ADR procedures.

Results

According to Lehman's most recent monthly report filed with the Bankruptcy Court on May 14, 2012, Lehman had achieved settlements in 202 ADR matters involving 224 counterparties — all of which were achieved prior to the commencement of any litigation with respect to the contracts in dispute. Upon the closing of the most recent settlements, Lehman will have received an aggregate total of over $1.1 billion for its bankruptcy estate. Of the 77 ADR matters that reached the mediation stage and have been concluded, 73 have been settled in mediation and only four have terminated without settlement. Thirteen additional mediations have been scheduled over the next several months, and Lehman's Chapter 11 Plan Confirmation Order provides that the ADR procedures continue to apply and are binding on all parties.

The ADR procedures in the Lehman case serve as an example of how mediation can successfully limit litigation, even after the parties have failed to negotiate an agreement between themselves. Parties often enter a mediation asserting litigation positions which can be millions or tens of millions of dollars apart. Moreover, in these disputes, Lehman is essentially operating as a bill collector, and the mediation is a single-issue dispute — how much money is owed. Such single issue disputes can be difficult to mediate (as opposed to adjudicate whether in arbitration or court proceedings). Nonetheless, the mediations being conducted in Lehman's case have been working — particularly following tweaks that Lehman and the court made for smaller disputes and SPV disputes.

One downside to the process is that because the process is confidential, the derivatives marketplace may not benefit from the public identification and resolution of common issues that arise from ambiguities in the relevant ISDA and Bankruptcy Code provisions. In addition, Lehman's experience with these ADR procedures highlights the challenges of pursuing ADR procedures with SPVs and indenture trustees whose settlement authority may be far from clear.

Nonetheless, the ADR procedures appear to be well structured and effective in achieving settlements for Lehman. The results have significantly decreased the stakes of litigation that may eventually be brought to adjudicate issues arising in unsettled disputes. In future complex Chapter 11 cases, bankruptcy courts likely will be receptive to similar procedures to benefit the estate.