THE CURRENT FRAMEWORK FOR RESOLVING GLOBAL SIFIS LACKS AN ADEQUATE DISPUTE RESOLUTION MECHANISM

by

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> "As long ago as pharaonic Egypt, societies have tracked the high-water mark of rivers that periodically flood – and have always prepared accordingly, apparently assuming that floods will not rise higher than the existing high-water mark. Images of a worse disaster do not come easily to mind." – Daniel Kahneman, *Thinking, Fast and Slow*

The MS Costa Concordia is an Italian passenger cruise vessel carrying more than 4.800 passengers and crew that rolled over on its side on Friday, January 13, 2012, hitting a rock in the Tyrrhenian Sea just off the shore of Isola del Giglio near the west coast of Italy. For days after this calamitous event, the news media alternated hourly footage of the Concordia lying on its side with clips of James Cameron's film *Titanic*. Subsequent coverage of the accident focused on the fact that the ship's captain, Francesco Schettino, had brought the ship within shouting distance of the island in order to "salute" a retired captain, Mario Palombo, who lived on the island. Ultimately, it emerged that the practice of "saluting" has been a maritime custom and known to regulators even in the cruise industry for years. As the Italian government was taking up consideration of legislation to ban the practice of saluting, the only major incident, perhaps, of reckless conduct that caused the sinking of a vessel, that anyone could recall was the Titanic catastrophe in 1912. Despite this statistical reality, according to the 2012 annual report of Carnival Corporation PLC, the individual owner of the Concordia, because of the Concordia tragedy, booking volumes for group declined in the mid-teens compared to the prior year.

The response of regulators and the public is only natural. Psychologists refer to this as the availability heuristic. The response to Lehman's failure on September 15, 2008 has been no different. The legislative and regulatory response – embodied in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] – has been to minimize "systemic impact" of the next Lehman-like failure through the creation of an entirely new process for the resolution of systemically important financial institutions ("SIFIs"). Under this new regime, the Federal Deposit Insurance Corporation ("FDIC") may be appointed as the receiver for a failing SIFI, and may act expeditiously to save the SIFI's systemically important business lines from peril through a sale to a third party,[2] or a transfer of such business lines to a "bridge financial company" that is created, owned and controlled by the FDIC.[3] The FDIC has stated on many occasions that this mechanism enables the FDIC to conduct the same rescue operation that is has successfully conducted in the past with respect to failed insured depository institutions.

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[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010) (the "Dodd-Frank Act").

[2] § 210(a)(1)(G).

[3] § 210(h)(5)(A), § 210(h)(2)(G).

The OLA is the legislature's response to the "Lehman weekend" now immortalized in Andrew Ross Sorkin's *Too Big To Fail*. Time will tell if these mechanisms will adequately facilitate a rapid transfer of assets and concurrently avoid a meltdown of the financial markets. An expeditious sale of a SIFI's assets is now known to be within the realm of possibility; Lehman was able to effect the sale of its North-American capital markets business to Barclays Capital Inc. within five days of the commencement of its chapter 11 case in conjunction with a companion proceeding under the Securities Investor Protection Act for its broker-dealer subsidiary, Lehman Brothers Inc. ("LBI"). Much of the North American capital markets business was operated through LBI. But for whatever reason – perhaps because the five days that followed Lehman's bankruptcy case did not qualify for footage in the movie version of *Too Big To Fail* – the architects of the OLA concluded that a new mechanism was necessary in order to accomplish the same type of transaction.

There is a great deal that happened, however, in the three years following Lehman's chapter 11 bankruptcy that has escaped the attention of the popular media and, as a result, never been addressed in the current OLA framework. The Lehman enterprise was, in many ways, a powder keg that could have erupted at any moment. One of the great successes of the Lehman chapter 11 has been the way in which the US debtors, led by Alvarez & Marsal North America LLC, have avoided the eruption of this powder keg through the tireless pursuit of compromises and settlements, and the establishment of alternative dispute resolution ("ADR") procedures. The current OLA framework lacks any reliable framework for dispute resolution. If the first OLA is anything remotely like the Lehman cases, the lack of such a framework may prove disasterous – perhaps not in the first five days of the receivership, but more likely, the many years that follow.

Of the 67,000 claims that were filed in Lehman's chapter 11 cases, many were based on highly esoteric and opaque derivatives and other financial products. Through the implementation of procedures that were approved by the Bankruptcy Court on September 17, 2009, Lehman initiated alternative dispute resolution procedures ("ADR") and served 208 notices requiring 225 counterparties to participate in ADR. Through this process, the debtors have recovered more than $1 billion from counterparties whose contracts were out of the money. Settlements have been achieved in 173 ADR matters involving 182 counterparties, and 69 ADR matters have been sent to mediation, of which 64 have been settled in mediation. Similar ADR procedures have been established for non-derivatives related claims, with a similar degree of success.

As to their largest derivatives counterparties, the so-called "Big Banks" who asserted approximately $22 billion in claims, the debtors proposed a common settlement approach for the allowance of derivatives claims pursuant to standardized, uniform and transparent principles and methodologies that they called the "Derivatives Framework." The Derivatives Framework established, among other things, (i) common dates and times for calculation of mid-market values; (ii) a uniform approach to portfolio aggregation to derive groups of netted exposures; and (iii) a methodology for the calculation of allowable additional charges. The Derivatives Framework established a common set of rules, and then individual creditor claims were analyzed under these rules. Ultimately, the debtors entered into settlements with 9 of the 13 largest banks based on the Derivatives Framework, thus avoiding years of potentially protracted and expensive litigation that would have cast a cloud of uncertainty over the future of the Lehman chapter 11 cases.

The potential for years of extended, fact-intensive litigation among Lehman's foreign affiliates also threatened to infinitely prolong the chapter 11 cases. Over many years–in some cases, decades–the relationships among the US debtors and their foreign affiliates developed into a complex web of intercompany funding balances and custodial and contractual relationships that were documented and managed through Lehman's integrated financial and operating systems to allow Lehman to operate effectively its global enterprise in a seamless, expedient, and efficient manner. The commencement of separate insolvency proceedings for more than one-hundred (100) foreign affiliates gave rise to a multiplicity of potentially daunting intercompany challenges and potentially debilitating disputes, in particular as to the nature and validity of intercompany claims. It took two years of grueling negotiations, but ultimately, Lehman achieved nine comprehensive settlements with the court-appointed administrators of 87 of its foreign affiliates, resulting in an 81% reduction in the aggregate claims asserted by the foreign affiliates (from $327 billion to $61.4 billion).

Finally, the Lehman debtors achieved a comprehensive settlement, through their chapter 11 plan, of the most highly controverted issue in their chapter 11 cases – whether the equitable doctrine of substantive consolidation should be applied to Lehman and certain or all of the foreign and domestic affiliates, to create a *de facto* single merged entity of pooled assets and liabilities. Although this judicially created doctrine has developed in the context of cases pending under the Bankruptcy Code, it is by no means a well settled proposition that the creditors of a SIFI and its affiliates could not commence a legal action in the federal courts seeking an equivalent remedy.

The days leading up to Lehman's chapter 11 cases were certainly high drama – but it was in the three years that followed that the real story of Lehman cases emerged. The Lehman cases have been, above all, an exercise in resolving disputes among the creditors of the 23 debtor entities, each of whom filed a chapter 11 petition in the US, and of more than 100 other Lehman legal entities subject to their own insolvency proceedings throughout the world. Most people do not know this; unlike James Woods playing Richard Fuld in the movie version of *Too Big To Fail*, the images that come to mind when one thinks of the Lehman cases do not include hundreds of lawyers in conference rooms negotiating settlements. Not surprisingly, the regulatory framework that has been instituted as a result of Lehman's demise does not contemplate the need to deal with the unprecedented and fact-intensive disputes that are likely to arise within the context of any colossal SIFI failure. The only provision in the OLA that addresses any type of litigation or dispute resolution – specifically, for disputed claims – merely provides that creditors who disagree with the FDIC's determination of their claims may file an action in federal court to adjudicate their claims.[4]

The reason this is troubling is that although the Lehman cases are undoubtedly the largest and most complicated bankruptcy cases in history, there is no reason to think that the next "Lehman" – and the disputes that arise from it – will not be significantly larger and more complicated. As the trader / philosopher Nassim Taleb notes, "[f]inancial institutions have been merging into a

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[4] § 210(a)(4).

smaller number of very large banks….We have moved from a diversified ecology of small banks, with varied lending policies, to a more homogeneous framework of firms that all resemble one another." As a result, Taleb posits that "we will have fewer but more severe crises."[5]

It is likely that the first OLA will be characterized by more severe, fact intensive, legally complex, and highly contentious disputes among creditors, and in particular, among national regulators and the court appointed administrators of a SIFI's foreign affiliates around the world. Yet if one thing is strikingly absent from the current resolution framework, it is an adequate mechanism for resolving such disputes – particularly for disputes with cross-border implications. The amounts at stake in the Lehman chapter 11 bankruptcy were in the hundreds of billions, and implicated unprecedented cross-border issues and potentially conflicting judgments by courts overseeing the US debtors and their foreign affiliates. If Taleb is right, then the amounts in dispute under the first OLA will be multiples of those in Lehman, and the cross-border implications will make the Lehman cases seem quaint in retrospect. As in the Lehman chapter 11 cases, these disputes will threaten to suffocate the receivership in litigation. The litigation will require substantial funding. It will delay the FDIC's ability to make distributions to creditors and close the receivership for an extended period. If the receiverships in foreign countries become ensnared in such litigation, the expense and delay with extend to their proceedings as well.

If there is any "unfinished business" in the current framework, it is the development of a flexible, cross-border dispute resolution mechanism that will adequately contain the conflicts that are likely to arise during the next crisis. Through the rulemaking process or otherwise, national regulators both in the US and other countries should turn their attention to this underdeveloped aspect of the current framework, and engage in meaningful dialogue concerning these lessons of the Lehman cases. In the words of the Bankruptcy Court, the consensus that was ultimately achieved among Lehman's creditors "borders on the miraculous."[6] We cannot expect such a miracle to occur again.

[5] Nassib Talem, *The Black Swan* (Penguin 2006) at 226.

[6] August 30, 2011 Hr'g Tr. at 53:22.