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DRIVING BUSINESS SUCCESS
ISSUE 5 VOLUME 6 MAY 2010

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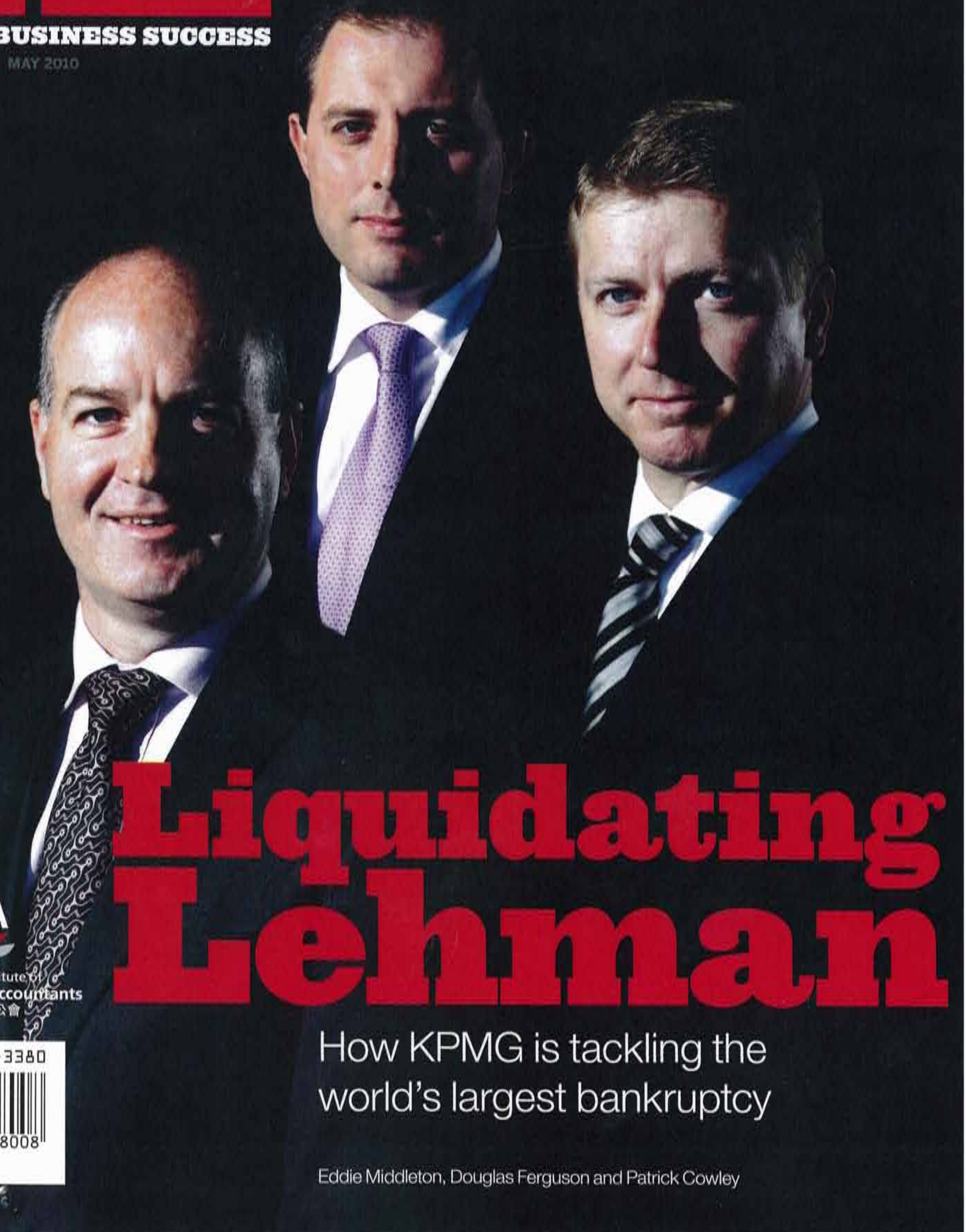

Liquidating Lehman

How KPMG is tackling the world's largest bankruptcy

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ISSN 1815-3380
9 771815 338008
HK$70.00

Liquidating Lehman

KPMG liquidators tell Heda Bayron tougher battles lie ahead in the world's biggest and most complex bankruptcy

Photography by Brian Ching

Eddie Middleton landed in Hong Kong in 1992 to liquidate Bank of Credit and Commerce International, one of the world's largest bank failures. Today, he is cracking a much bigger and tougher case – unwinding Lehman Brothers.

"I can't think of anything that's exercised my brain matter more than this," says Middleton, who heads the restructuring services practice at KPMG in China. "In pretty much every job you do, there's something that you've never come across before, but with Lehman there are so many things that at every turn challenge our understanding."

It has been 19 months since the High Court named Middleton, Paul Brough, KPMG's regional senior partner, and Patrick Cowley, a restructuring services principal, as provisional liquidators of eight Lehman Brothers entities in Hong Kong, and just over a year since their official appointment.

Since then, KPMG has realized US$1.5 billion from the sale of Lehman assets. It sold all but two real estate positions in China, raising US$270 million, and helped negotiate the US$225 million sale of the bank's Asia Pacific franchise to the Japanese investment bank, Nomura Holdings Inc., a week after Lehman Brothers Holdings Inc. filed for Chapter 11 bankruptcy protection in New York on 15 September 2008.

So far, all seems to be going well, but Middleton is anticipating bigger challenges. "In a job of this scale, you achieve a lot in the first 18 months to three years, and then you get into the depths. Like any other liquidation, you end up with the hard core of assets that are very difficult to realize and the hard core liabilities that are difficult to quantify and litigate."

Indeed, the challenges are plenty. There's an intricate web of intercompany transactions – derivatives, repos, reverse repos and other trades – left to be untangled and resolved with other Lehman entities. There's the matter of returning clients' money. And there are at least three lawsuits against the estate arising from liquidating assets overseas.

Confusion and complication

Amid the turmoil in September 2008, the liquidators' first priority was to get comprehensive data of the bank's operations and its assets and liabilities.

"It was very important for us to very quickly identify and understand what those assets were, who their counterparties were, what structure the loans were created under and what the legal obligations were," recalls Douglas Ferguson, transactions advisory partner at KPMG and part of the Lehman liquidation team.

Unlike some U.S. Lehman entities, which remain in operation today, the immediate sale of the Asia Pacific parts to Nomura transferred Lehman's employees, information technology systems and offices to the Japanese company. KPMG was largely on its own to figure out the bank's accounts, even as Nomura and former Lehman staff cooperated with the liquidators.

"We quickly formed a team with a mixed skills set, including due diligence professionals and people who are really good at making sense of disjointed information. We also had our own valuations team and tax teams heavily involved," Ferguson says.

In Hong Kong alone, Lehman Brothers Holdings Inc., the ultimate parent of all Lehman entities worldwide, had eight registered companies: Lehman Brothers Asia Holdings, Lehman Brothers Asia, Lehman Brothers Futures Asia, Lehman Brothers Securities Asia, LBQ Hong Kong Funding, Lehman Brothers Nominees (H.K.), Lehman Brothers Asia Capital Co. and Lehman Brothers Commercial Corporation Asia. At the time of bankruptcy, these entities had combined assets and liabilities of around US$58 billion.

As liquidators, KPMG's mandate to preserve and maximize the recovery of these companies' assets in order to pay the creditors is dizzyingly complicated. Creditors, confusingly, are mostly other Lehman entities. Worse yet, the Hong Kong entities are also the creditors of the same entities and and a number of other affiliates.

Typically, creditors are asked to prove their claims item-by-item from the beginning of their relationship with the failed company. But Middleton says if you tried that in Lehman's case, it would take many years, if it was at all possible. "You are talking about millions of transactions, with balances brought forward over a number of years. It's not sensible to expect to prove the claim from the bottom up," says Middleton.

He says determining who owed what to whom was "frighteningly difficult" at first. Lehman's Hong Kong entities had around 2,500 listed equity investments and about 2,700 derivative trades at the time of bankruptcy. Lehman Brothers Asia Holdings, for example, had US$12.6 billion of intercompany accounts receivable, the largest of which was from Lehman Brothers Japan. Last November, the Hong Kong liquidators filed 268 claims against Lehman Brothers Holdings Inc. and 19 U.S. debtors worth US$11.7 billion, which included failed trades and intercompany non-trading claims.

LEHMAN BROTHERS' LIQUIDATION TIMELINE

1850

Lehman Brothers founded in Montgomery, Alabama

Photo: David Shankbone/Wikipedia

15 September 2008

Lehman Brothers Holdings Inc. filed for Chapter 11 bankruptcy protection in New York – the largest bankruptcy in history.

17 September 2008

KPMG's Eddie Middleton, Patrick Cowley and Paul Brough appointed by the High Court as provisional liquidators of eight Lehman entities in Hong Kong.

22 September 2008

Nomura Holdings agreed to buy Lehman's Asia Pacific franchise. Hong Kong entities realized U$164 million from the sale.

March 2009

Middleton, Brough and Cowley officially appointed as Lehman's Hong Kong liquidators.

KPMG

Even now, the 70-strong team working full time on the liquidation has a tough job to do. Making sense of how Lehman entities operated in more than 40 countries and how the bank's more than 900 subsidiaries and affiliates conducted business among themselves remains a tall order.

For example, Middleton says the way Lehman treated its repurchase or repo transactions – short-term borrowings in which an asset is sold and later bought back at a fixed price – makes it hard to determine which entity at a point in time owned those assets.

"It's a question of legal construction of the documentation between different Lehman entities, how the trade was conducted and how it was reflected in the books of the estates," he says, noting that what is on paper may contradict practice.

"The way Lehman structured itself and dealt with itself add another thick layer of confusion and complication," he says. Moreover, derivative positions are difficult to value because there is no longer an active market for those positions.

Closing real estate positions

What was also worrying early on was the declining value of the collateral of Lehman's real estate loans as Asia's property markets fell. KPMG flew in its U.K. real estate corporate finance advisory team to lend a hand with Lehman's large Asia property portfolio.

"We were getting valuations that were reflecting sometimes 50 percent diminution in value from valuations that Lehman had obtained nine months or 12 months earlier. So that's a very big impairment if it had to be recognized," Ferguson explains.

Some 17 percent of Lehman's global commercial real estate assets were in Asia. The primary vehicle for these investments was Lehman Brothers Commercial Corporation Asia, whose assets had a total estimated par value of US$1.26 billion. It had joint venture agreements with about 44 developers and provided loans for construction projects secured against hotel, residential, retail and commercial properties. Assets in China accounted for about 40 percent of Lehman's real estate positions, while the rest are scattered mostly across Southeast Asia.

Despite the market downturn, KPMG sold in June last year more than US$200 million worth of real estate-related loans and convertible bonds in the mainland, mostly back to borrowers, at an average discount of 17 percent.

"I think even seasoned investment bankers would give that a nod of respect. It's a solid result given that we didn't have the opportunity to sit around and ride it out for four or five years," says Ferguson.

For example, KPMG let Hong Kong-listed Capital Strategic Investments (renamed CSI Properties Ltd. in January) pay HK$236.5 million to get out of a HK$434 million three-year loan from Lehman Brothers Commercial Corporation Asia to build the International Capital Plaza in Shanghai.

"The main reason for them accepting that was, at the time, the value of the property itself had dropped. So from a lender's point of view, the loan itself could go into default, if the owners – which is ourselves and also Lehman because they were our joint venture partner – decided not to proceed in finishing the construction and the recovery rate could be even lower," explains Hubert Chak, chief operating officer of CSI Properties.

Protecting asset value

To protect the value of the assets, KPMG chose to negotiate with borrowers directly to allow them sufficient time to find refinancing to take out the Lehman positions.

"This was preferred because it was private and it enabled the borrower to self-refinance along with our assistance in a manner that didn't destroy value unnecessarily," says Ferguson.

An alternative was to hold a private auction involving handpicked potential bidders, while the least preferred option was to legally enforce against loan security in order to get control over the physical assets and sell them, which the liquidators believed would have taken a long time and risked even more deterioration in value.

May 2009

Liquidators and administrators of Lehman subsidiaries and affiliates representing more than 26 proceedings worldwide signed an insolvency protocol.

June 2009

KPMG secured more than US$200 million for creditors by selling seven real estate loan positions in China.

November 2009

Hong Kong liquidators filed 268 claims against Lehman Brothers Holdings Inc. and 19 U.S. debtors worth US$11.7 billion.

March 2010

KPMG sold another real estate loan in China, bringing the total cash raised from mainland positions to US$270 million.

April 2010

U.S. court approved reorganization plan for Lehman Brothers Holdings Inc.

Ferguson says convincing the creditor committee to settle at a discount was difficult. "You need to be able to demonstrate that you have a very solid rationale for justifying a compromise or a discount. You have to understand the real estate market very well and the tax implications," he says.

In March, KPMG recovered 100 percent of another real estate loan in China, leaving only two positions – a bridge loan and equity in a Hong Kong listed company with mainland real estate activities. The firm has so far recovered 94 percent of the total principal value of all real estate assets in the mainland at the time of its appointment as liquidator.

Ferguson says unwinding the bridge loan is complicated by the borrower's behaviour and the presence of a large convertible bond consortium.

"We're working through a long and complicated process at the moment, potentially one of the most intensive of all the assets in terms of effort required but it's a reasonably small amount in Lehman's overall book," he says.

Sued in Thailand

While KPMG's liquidation work has been successful in China, the firm is facing legal tussles in Thailand, where Lehman had around 30 real estate positions with par value of US$850 million.

Lehman Brothers Commercial Corporation Asia, for example, committed to finance the construction of the Crowne Plaza hotel and several luxury condominiums in Bangkok as well as resorts in Phuket.

Gary Murray, president of Destination Properties, a joint venture partner, says construction of four resort projects stopped following Lehman's bankruptcy because funding dried up. This forced his company to file a US$230 million civil lawsuit in Bangkok against the Lehman affiliate.

"We paid our own half of the interest, but it was their inability to pay their own half of the loan that caused the loan to default," Murray says. "They tried to enforce on the obligations of the joint venture that they themselves defaulted on and they tried to take that collateral. Our lawyers said this is a criminal act in Thailand because it's basically absconding property that is really not yours."

The company also filed a fraud case and a civil case against Lehman Brothers Commercial Corporation Asia and another civil case against the individual KPMG liquidators. Middleton, Brough and Cowley have been issued with summonses by Thai police to answer the complaint, but they declined to discuss the case.

The Lehman affiliate already faced a lawsuit from Grande Asset in November 2008, claiming damages of Bt2.605 billion for failing to subscribe to bonds worth Bt10.4 billion agreed to in December 2007.

"What the liquidators are having to grapple with are borrowers who are unscrupulous and who are willing to use every obstacle that they can to compel the liquidators to accept a proposal, which is very difficult to justify to creditors relative to the value of the asset," says Melvin Sng, a partner at Linklaters in Hong Kong, the legal advisor of the liquidators.

"But the problem gets exacerbated in a market like Thailand... The borrowers would take advantage of the connections that they have, which are perhaps of dubious provenance, in order to bring pressure to bear on the liquidators," he says. At least two positions in Thailand have been settled.

A joint effort

Because of the bankruptcy's complexity, cooperation among liquidators and administrators around the world is paramount to an orderly resolution.

"The way Lehman operated as a single homogenous enterprise is fine when you're a going concern. But when the music stops, that enterprise gets cut up into each separate legal entity and that creates difficulty in a sense of having to unwind all the multitudinous intercompany relationships... Getting to grips with that position is most challenging," says Middleton, adding that the team had to take a crash course on bankruptcy laws in different jurisdictions.

Far from over: Cowley, Middleton and Ferguson

A major breakthrough occurred last year when 13 affiliates representing more than 26 liquidation or restructuring proceedings worldwide agreed to a cross-border insolvency protocol to facilitate speedy resolutions and to try to avoid litigation between affiliates.

Middleton says he had doubts at first as to how well the protocol could work. "It's not something that we've done before. I'm not aware of anybody else in Hong Kong who has entered into anything as all-encompassing in the sense that it included so many administrators from different jurisdictions – appointed under different types of processes – whose first obligation is to the law of the jurisdiction that they've been appointed," he says.

Nevertheless, Middleton soon became a convert. He is the co-chair of the group, which meets quarterly. Its most recent meeting was held in Hong Kong last month.

"If there's a proposed course of action, as co-chair I literally point the finger and go around the room asking, 'Yes or no?' And that drives the behaviour under a degree of peer group pressure. Nobody wants to be the stick in the mud," he says.

One of the group's biggest achievements so far was agreeing to use Lehman's books as of 14 September 2008 as a basis for intercompany claims. The group also agreed on a valuation methodology for intercompany trades such as stock loans, over-the-counter derivatives and repos.

While Middleton takes pride in what KPMG Hong Kong has achieved so far, he says further progress depends on the advances of other Lehman estates.

"It's difficult to get ahead of everybody else because you're so intertwined. We have to move at the same pace because we are looking at the two ends of the same transaction. I can't decide in isolation from what London or Tokyo decides," he says.

Despite the global protocol, Middleton and Sng say litigation is unavoidable.

"The interests are so diverged and you can't reach a consensus particularly because the liquidators of one estate feel they are not comfortable reaching a compromise on certain terms as that exposes them to potential claims and liabilities to creditors and to the court," says Sng.

The finish line?

Last month, Lehman Brothers Holdings Inc. signalled a possible early exit from bankruptcy. The New York bankruptcy court accepted a plan to create an asset management company to hold all commercial real estate, private equity, corporate debt, derivatives and other assets outside of the bankruptcy proceeding. The plan aims to recover more for creditors over time rather than sell assets at fire sale prices today.

Lehman said unsecured creditors could recover between 15 percent and 27 percent of their claims, while secured creditors could be paid in full. Alvarez & Marsal, the firm in charge of Lehman's restructuring in the United States, presented the reorganization plan during the global protocol group's meeting in Hong Kong last month.

Meanwhile, Lehman Brothers International (Europe), through its administrator, PricewaterhouseCoopers, said it has returned about US$17 billion to creditors.

As to the Hong Kong liquidation, Ferguson agrees with Middleton that it will only get tougher.

"There are certain specific issues that need to be dealt with in other countries, Thailand and Malaysia principally, that may slow our progress, but the effort continues," he says.

Middleton looks back at his work on Bank of Credit and Commerce International 18 years ago as a reference to how Lehman's liquidation could turn out. BCCI, which operated in more than 100 countries, collapsed in 1991 because of fraud. By 1998, creditors of the Hong Kong branch were paid in full, including accrued interest, yet the bank is still in liquidation today.

"I got a phone call from the IRS (U.S. Internal Revenue Service) in Texas a year or so ago noting that BCCI Hong Kong has the charge over a property that it wanted to seize against the tax liability in the States," he says. "I'm sure there will be things like that that would keep Lehman going for a very long time." A