The Deal Pipeline

When final isn't

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Nothing has been straightforward and controversy-free in the colossal bankruptcy of Lehman Brothers Holdings Inc. It should come as no shock, therefore, that the multibillion-dollar sale of the North American investment bank and brokerage assets of its Lehman Brothers Inc. unit to Barclays Capital is still making waves more than four years later.

The Managed Funds Association has filed an amicus brief in appeals court, decrying a district court ruling against Lehman that it said would hurt investor confidence in Section 363 sales. The ruling is tied to ongoing appeals related to the Lehman sale order and a subsequent clarification letter that question whether three groups of assets were included in the Sept. 20, 2008, deal.

"MFA members allocate a fair amount of capital," says Steven D. Pohl of Brown Rudnick LLP, counsel to the advocacy group of hedge funds with $879 billion in assets under management as of July. "People rely on notice, transparency, the public nature of the sale and an open court. ... You rely on that, assuming there's no back-room negotiation. If you can't rely on that process, you lose some of your confidence in those proceedings. You take that capital and you allocate it somewhere else, maybe somewhere outside the distressed world."

Immediately after approval of the sale, Lehman and Barclays filed the clarification letter, which was not on its own approved by the bankruptcy court. Nevertheless, it contained language that led to contention over more than $5.9 billion in assets. The letter, which both parties presented as viable after the sale order, asserted, among other things, that Barclays was to receive "exchange-traded derivatives '(all of the assets of the seller used primarily in the business or necessary for the operation of the business).' " Lehman Brothers later alleged the sale gave Barclays a "secret windfall" of as much as $7 billion in seeking the return of as much as $12 billion in assets.

Judge James M. Peck of the U.S. Bankruptcy Court for the Southern District of New York in Manhattan ruled in a memorandum on Feb. 22, 2011, that he would not reconsider the transaction because it was a fair deal. Peck said he would have approved the sale even if the parties involved had recognized the scope of the letter, as there was no better alternative at the time and that there was no deliberate misrepresentation on behalf of Lehman or Barclays.

Peck also found Barclays owned $1.9 billion from Lehman's clearance boxes, a type of custodial account, despite Lehman's belief that no cash was to be transferred to Barclays. Finally, Peck determined two other asset classes, $4 billion in margin assets held at financial institutions and $769 million in so-called 15c3-3 securities, were the property of the Lehman estate.

Judge Katherine B. Forrest of the U.S. District Court for the Southern District of New York on June 5 and July 16, 2012, affirmed Peck's decisions regarding the clearance boxes and the securities but reversed his ruling on the margin assets, finding them to be covered by the sale order and the letter. In her amended opinion, Forrest said Peck had not determined if the clarification letter materially altered the deal he approved in September 2008. Instead, Peck "decided to superimpose ambiguity onto the terms of the letter" to "end up with only those terms that the bankruptcy court believed the letter should contain."

Forrest, however, found the sale order and the letter called for the transfer of the margin assets to Barclays because Peck had ruled the clarification order was an enforceable contract. Peck should have adhered to "long-standing and clear principles of contract interpretation" and not let extrinsic evidence — namely, representations made by the sale parties in court that the deal would transfer no cash — alter his decision, the district court judge wrote.

James W. Giddens of Hughes Hubbard & Reed LLP, Securities Investor Protection Act trustee for Lehman Brothers Inc., respectively appealed Forrest's original and amended rulings on June 7 and July 18 to the U.S. Court of Appeals for the 2nd Circuit. Barclays, meanwhile, on July 19 filed an appeal seeking the $769 million in securities.

The MFA joined the fray in its Sept. 27 amicus brief, asserting the bankruptcy court had never approved the transfer of the margin assets under the sale order and that Forrest ignored the public record of the sale hearing and "the unique and critical due process protections and procedures of a Section 363 sale."

The MFA continued: "Once a sale is approved, material modifications may not be made absent further Section 363 public notice, review and approval by the bankruptcy court. Here, instead of reviewing the matter under the Section 363 standards governing public asset sales, the district court engaged in a narrow contract analysis concerning a document [the clarification letter] created in a manner that two parties to a private, bilateral negotiation would follow."

The MFA requested the appeals court reverse Forrest's decision on the margin assets.

Other attorneys are split on the issue.

Steven H. Silton of Hinshaw & Culbertson LLP says he does not see a problem with the possibility of altering a sale after the fact. Silton refers to bankruptcies such as Lehman Brothers and General Motors Co. as "black swan" cases that are not necessarily representative of Chapter 11 cases as a whole.

"I don't see anything wrong with being able to modify terms of the sale post-sale as long as creditors in the case are represented," the Minneapolis partner says. "You want to encourage individuals to purchase assets outside of bankruptcy, to get assets into the hands of the people who can make the most out of it. ... Better in the hands of the buyer than in the hands of the debtor."

Daniel H. Reiss of Levene, Neale, Bender, Yoo & Brill LLP, however, says the amicus brief makes a valid point regarding the sale process.

"The finality of the 363 sale is essential to attract buyers that are interested in purchasing assets in a bankruptcy case," the Los Angeles partner says. "If orders are subject to second-guessing based on hindsight of a year or more later, that can potentially chill the interest of buyers to engage in the process of doing due diligence and participating in a competitive bidding process. On the debtor side, uncertainty regarding the finality of a 363 sale order could make Chapter 11 less attractive if the purpose of a filing is primarily to sell the debtor's assets."

Still, Reiss says the impact of the Lehman-Barclays dispute might not be as significantly damaging as thought to the market as a whole due to the unusual size of the case. "If the district court opinion is upheld, the impact on other cases could be limited due to a number of unique circumstances involving the sale to Barclays. This includes, but is not limited to, the size and scope of the sale, the representations on the record at the sale hearing, the significance of any purported disclosure issues and the materiality of the clarification letter."

On the other hands, Reiss adds that the decision could make a big difference regionally. "Although any decision by the 2nd Circuit will not be binding on the rest of the country, it could have significant national impact because New York-based financiers of distressed deals are highly sensitive to finality issues in 363 sales," Reiss says.

Jonathan Schiller of Boies, Schiller & Flexner LLP, counsel to Barclays, says the issue in the case, though, is not the finality of the sale process.

"What MFA ignores is that if Barclays had not made that investment in September 2008, there would have been no debt for sale. It would have been gone. Everyone in the market would have been far worse off than they were following the Barclays purchase," the New York managing partner says. "Parties are complaining today about something they very clearly understood at the time of the sale." Barclays was granted permission on Nov. 16 to file an oversized brief in response to the assertions in the amicus brief. The bank has yet to do so.

It was unclear from court papers when the 2nd Circuit might consider the appeals from both sides.