# The credit crunch: the collapse of Lehman Brothers – and a Hong Kong scheme to handle Lehman claims

by Anthony Connerty

September 2010 marks the second anniversary of the bankruptcy of Lehman Brothers – the largest bankruptcy in American history that would lead to a global financial crisis.

This article looks at the collapse of Lehman Brothers, and:

– the background to the Lehman collapse;

– claims related to the collapse;

– an example of a credit crunch claim – and a criminal prosecution;

– a Hong Kong mediation and arbitration scheme aimed at dealing speedily with Lehman Brothers-related claims;

… and some final thoughts.

## BACKGROUND – THE COLLAPSE OF LEHMAN BROTHERS

Lehman Brothers – a Wall Street institution that could trace its origins back over 150 years – declared itself insolvent by filing for chapter 11 protection against its creditors in the early hours of Monday, September 15, 2008. One report spoke of a gathering – in a first-floor conference room at the Federal Reserve Bank of New York – of a huddle of senior Lehman Brothers executives who realised that their firm was in serious difficulties: "A last - ditch effort to get Barclays to buy Lehman had failed: the British were not coming".

Bankruptcy was the only card left to play: "People were enormously upset," recalls Rodgin Cohen, a partner at the law firm Sullivan & Cromwell. He was advising Lehman on its bankruptcy on the afternoon of Sunday, September 14, 2008. "But this was a group of professionals. There was anger but there wasn't any screaming or running around. Everybody had been living this 24/7 so, really, there was an element of exhaustion" (Andrew Clark, guardian.co.uk, September 4, 2009).

It was to be the biggest bankruptcy in US history. President Bush would later sign an emergency order providing government insurance to the $3.5 trillion that was tied up in money market funds. The Lehman collapse affected not only the United States: it triggered a global financial crisis. An account of the sub-prime fiasco and the collapse of Lehman Brothers is contained in Alex Brummer's book *The Crunch: how greed and incompetence sparked the credit crisis*, published in 2009 by Random House Business Books.

What led to the collapse of institutions like Lehman Brothers? I suggest that there were at least four contributing factors.

### *Breach of a classic rule of banking*

The traditional UK building society takes in deposits from investors and uses those deposits to lend out money to house purchasers, taking a mortgage on the property to secure the money loaned. Care is taken in valuing the property to be purchased and in checking out the borrower: are the borrower's circumstances – job/wages/commitments, and so on – such as to indicate that the borrower will be able to finance the loan: a loan which may well be repayable over something like 25 years?

The same approach applied in the United States, as Alex Brummer (supra) explains on page 19:

> *"America's traditional housing market, dealing with prime borrowers, had worked along well-established lines for many*

*years. Banks financed mortgages through deposits received from customers. At the same time, potential home buyers were scrutinised closely for their ability to make repayments, and there was a vigorous valuation of the house they planned to buy. In other words, proper precautions were taken. Lenders would extend home loans only to those who were deemed good risks."*

Lehman Brothers breached the classic banking rule in two ways. First, by lending recklessly to borrowers who were a bad risk: the so-called sub-prime borrowers. Second, by lending – not out of deposits from bank customers – but by borrowing in the market. They borrowed short (at high interest rates in the market) and lent long (at comparatively lower interest rates to their sub-prime borrowers). This latter manoeuvre – leverage – is fine: until interest rates rise.

## Reckless lending: sub-prime mortgages, liar loans – and leverage

### The sub-prime game

There were millions of people in America who could not satisfy the strict criteria for borrowing long-term to buy a home. But low interest rates might help them to get onto the housing ladder. So the sub-prime mortgage was invented: "Prime mortgages went to the better off; sub-prime went to the far end of the market, to those who had never qualified for a mortgage before (Alex Brummer, supra, p 17)."

These type of loans were high-risk. Ben S Bernanke, at a speech made at the Federal Reserve Bank of Chicago's 43rd annual conference on Bank Structure and Competition, Chicago, Illinois on May 17, 2007 said:

> *"Subprime mortgages are loans made to borrowers who are perceived to have high credit risk, often because they lack a strong credit history or have other characteristics that are associated with high probabilities of default. Having emerged more than two decades ago, subprime mortgage lending began to expand in earnest in the mid-1990s, the expansion spurred in large part by innovations that reduced the costs for lenders of assessing and pricing risks. In particular, technological advances facilitated credit scoring by making it easier for lenders to collect and disseminate information on the creditworthiness of prospective borrowers. In addition, lenders developed new techniques for using this information to determine underwriting standards, set interest rates, and manage their risks."*

Lending money is easy. Getting it back may be more difficult. Lending to those who would normally not be considered for a loan might be an acceptable practice while property values were rising - and interest rates were low. The problems start when property prices fall – particularly with borrowers who had little chance of repaying their mortgages.

These were the borrowers to whom the so-called "ninja loans" or "liar loans" might have been made. A ninja loan is a type issued to borrowers with "No Income, No Job, and No Assets". The similar liar loan refers to a category of mortgages known as low-documentation or no-documentation mortgages. These type of loans opened the door for unethical behaviour by borrowers – and by lenders and mortgage brokers.

Many of the sub-prime borrowers were from the trailer parks and the inner cities of the United States. The impact on these borrowers – some faced with initially low interest rates on their mortgages that would later increase alarmingly – could be devastating.

The *Wall Street Journal Online* in an article in October 2007 (http://online.wsj.com/public/article_print/SB119205925519455321.html) gave an example of the human problems arising from sub-prime mortgages:

> *"Last September, Darla Ball, a printer and copier saleswoman, purchased a $460,000 home in Las Vegas using an adjustable-rate subprime loan with an initial rate of 8.2%. At the time, she says, she expected to refinance before her interest rate resets to 14% next year, which will raise her monthly payments to $8,000 from $3,700. But in the past year, she says, prices of comparable homes in her subdivision have fallen to $310,000, which means she would not qualify for a new $460,000 mortgage, unless home values go back up to that level, an unlikely scenario. She says she has stopped paying her mortgage and is trying to negotiate with her lender. 'I'm going to lose my home anyway,' she says, 'so why pay?'"*

Those jumping on the bandwagon to make money from the sub-prime market included some unsavoury characters:

> *"Sub-prime lending has been likened to selling used cars in bad neighbourhoods – that is to say it is definitely not for those with delicate scruples or refined manners. From this vantage point it can be seen as a seedy tale with a sleazy cast: a bunch of snake – oil salesmen, hucksters and crooks fleecing millions of vulnerable Americans in an attempt to keep the housing bubble going, to make themselves fat commissions, to create new financial instruments that could be used as speculative plays on Wall Street…"*

The demand for mortgage brokers acting between borrower and lender in the sub-prime market was so great that in Las Vegas "every stripper, waiter and bartender on the Strip had a broker's licence." (Alex Brummer, supra, pp24/34)

### Liar loans in the UK

In October 2009 the UK's Financial Services Authority (FSA) decided to take steps to eliminate the use of the liar loan, as an article by Katherine Griffiths and Rebecca O'Connor published in The Times on October 13, 2009 makes clear:

> *"The multi-billion self – certification industry, in which customers are not required to provide proof of income, is set to*

*be banned by the financial regulator. Dubbed 'liar's loans' by critics, self-cert loans were blamed for playing a large part in the housing bubble and ensuing financial crisis. The (FSA) is effectively planning to kill off self-cert home loans by introducing a rule compelling lenders to insist that customers provide evidence of their income…the loans have been vilified as being at the heart of the banks' toxic loans problem because some customers have lied about their income."*

### *Leverage*

What made reckless lending in the sub-prime market worse was that Lehman was providing finance for that market – not by using money banked by its depositors – but by borrowing in the money market. Gearing up – borrowing money to invest – enables an investor to increase its returns. Fine when interest rates are low. But when rates rise the picture is different.

A cautious bank might have leverage of, say, 10 times: so for every £1 million of cash/assets it will lend £10 million. Lehman got to the stage where it was leveraged over 44 times. Lehman had $18 billion of equity on its balance sheet, but had investments – home loans and other investments – of nearly $800 billion. Analysis of loan data by the *Wall Street Journal* Online 2007 (supra) indicates that:

*"from 2004 to 2006, when home prices peaked in many parts of the country, more than 2,500 banks, thrifts, credit unions and mortgage companies made a combined $1.5 trillion in high-interest-rate loans. Most subprime loans, which are extended to borrowers with sketchy credit or stretched finances, fall into this basket."*

Lehman's shares would fall from a peak of $85 to 10 cents.

### *Securitisation: slicing and dicing*

A third factor contributing to the collapse of institutions like Lehman Brothers was securitisation: the practice under which lenders package up mortgage loans and sell them on to investment banks in the form of mortgage-backed securities: and in the process getting the loans off the lenders' balance sheets. George Soros observed on page 117 of *The Crash of 2008 and What it Means,* published by PublicAffairs, New York: "…banks were anxious to avoid holding loans on their balance sheets; they preferred to package them and sell them off to investors who were not subject to supervision and persuasion by the regulatory authorities."

New products were created out of the securitisation of mortgages: "credit derivatives." Lehman Brothers was amongst the American institutions that operated in this area: "Tens of thousands of mortgages were placed in pools to spread out the risks and then divided into slices, known as tranches, based on quality (Alex Brummer, supra, p 40)."

But at the end of the day much of the backing for these sophisticated financial instruments was still the sub-prime mortgage. With rising interest rates and the fall in property values many of those sub-prime mortgages were not worth the paper they were written on.

### *Credit rating agencies*

Part of the securitisation process relied on credit agencies. The packaging process whereby bundles of mortgages could be sold on and traded as securities on the market – just like company shares – depended on those packages of home loans gaining a credit rating.

*"Endorsing these loans were the credit rating agencies … which lent their stamp of approval to packages of structured mortgage debt. The alchemy was now complete. Sub-prime mortgages had been disguised as first-class assets…" (Alex Brummer, supra, p 38).*

## CLAIMS RELATED TO THE LEHMAN COLLAPSE

Various losers in the so-called "credit crunch" triggered by the collapse of Lehman Brothers may have claims in relation to investments that have gone radically wrong: claims, for example, against Lehman Brothers itself.

Those entitled to make such claims will include investors, shareholders, trustees, liquidators and receivers. The claims may be against investment banks that devised securities deriving from sub-prime mortgages; underwriters; pension funds; and salesmen. Those claims could be based on negligent mis-statement, misrepresentation, breach of contract or the tort of deceit.

## AN EXAMPLE OF A CREDIT CRUNCH CLAIM – AND A CRIMINAL PROSECUTION

The financial crisis triggered by the collapse of Lehman Brothers has led to claims in the US civil courts - and to a criminal prosecution. Two examples are given – a civil claim involving Dick Fulds, the former chairman of Lehman Brothers; and a criminal prosecution against former Bear Stearns hedge fund managers: the first major criminal trial arising out of the sub-crime mortgage fiasco.

### *Fogel Capital Management, et al v Fuld, et al*

Case number 08-CV-08225, filed on September 24, 2008 in the United States District Court, Southern District of New York: Judge Stein.

Stanford Law School describes the basis of the case: the claim alleges misstatement in a prospectus in relation of the impact on Lehman Brothers of under performing sub-prime related products (see http://securities.stanford.edu/1041/LEHMQ_01/).

The class action lawsuit was filed on behalf of all persons who purchased the preferred series "J" stock of Lehman Brothers Holdings Inc. The claim was against certain officers and directors of Lehman and certain underwriters of the offering, and was made pursuant to sections 11 and 15 of the Securities Act of 193315 U.S.C. ss 77k, 77l and 77o.

The underwriters included Bank of America Securities LLC, Citigroup Global Markets Inc, Merrill Lynch, Pierce, Morgan Stanley & Co Inc, UBS Securities and Wachovia Capital Markets.

The complaint asserted that Lehman's prospectus contained both material misstatements and omissions which the plaintiff and the class relied upon to their detriment. The representations made in the company's prospectus were materially false and misleading because, at the time of the offering, Lehman was already suffering from several adverse factors that were not revealed and/or adequately addressed in the document: these included the failure to set aside adequate allowances to cover the company's ever-increasing portfolio of under-performing sub-prime related products and to adequately write-down commercial and residential mortgage and real estate assets.

These factors were already causing a material adverse affect on Lehman's business and directly led to Lehman's September 15, 2008 announcement that it was seeking protection under the Federal Bankruptcy Code in the largest bankruptcy filing in US history. The complaint alleged that the defendants could have – and should have – discovered the material misstatements and omissions in the company's prospectus prior to its filing with the SEC and distribution to the investing public. Instead, they failed to do so as a result of a negligent and grossly inadequate due diligence investigation.

On September 15, 2008, Lehman filed a voluntary petition to reorganise under chapter 11 of the Federal Bankruptcy Code in the US Bankruptcy Court for the Southern District of New York in the largest bankruptcy filing in history. The investment interests of the class were largely wiped out.

As a result of the dissemination of the false and misleading statements set out in the Complaint, the market price of Lehman preferred J was artificially inflated during the class period. In ignorance of the false and misleading nature of the statements described in the complaint, the plaintiff and the other members of the class relied, to their detriment, on the integrity of the market price of Lehman preferred J. Had the plaintiff and the other members of the class known the truth, they would not have purchased the securities, or would not have purchased them at the inflated prices that were paid.

### *USA v Cioffi & Tannin, US District Court for the Eastern District of New York No 08-415*

Two former Bear Stearns hedge fund managers, Ralph Cioffi and Matthew Tannin, managed two funds "crammed with subprime mortgage-backed securities, that lost institutional and individual investors a total of $1.6 billion when the funds collapsed in mid-2007 at an early phase of the Wall Street market meltdown."

The case, described as the first major prosecution arising from the collapse of major US financial institutions "was seen as a litmus test of whether a jury, presented with evidence from emails between money managers and conference calls with investors, would convict individuals for corporate collapses."

Much of the government's evidence in the case was focused on: "emails among the two men, other colleagues at Bear Stearns and investors. The government said investors were lied to or misled on at least two conference calls with investors."

But the defence lawyers argued that prosecutors "took snippets of emails and presented them out of context, a point that appeared to resonate with the jury." Cioffi and Tannin were acquitted of all charges on the second day of deliberations by a jury in the US District Court in Brooklyn, New York: the jury acquitted both men of conspiracy, securities fraud and wire fraud (see Reuters, November 11, 2009).

## A HONG KONG MEDIATION AND ARBITRATION SCHEME AIMED AT DEALING SPEEDILY WITH LEHMAN BROTHERS-RELATED CLAIMS

### *The scheme: an overview*

In October 2008 the Hong Kong Monetary Authority (HKMA) announced that the Hong Kong International Arbitration Centre (HKIAC) would administer a Lehman Brothers-Related products dispute mediation and arbitration scheme.

Cases may proceed to mediation under the scheme in two circumstances. The first is where an investor's complaint in relation to Lehman products has been referred by HKMA to the Securities and Futures Commission (SFC). Here, the SFC will decide what further action is required. The second is where bank and customer have themselves agreed to go to mediation under the scheme.

HKMA stated that, under the scheme, the mediation process would be a confidential, voluntary, non-binding and private dispute resolution process "in which a neutral person (the mediator) helps the parties to reach a negotiated settlement or to narrow the issues in dispute. Successful settlement through mediation will obviate the need for costly and lengthy litigation."

If mediation under the scheme is not successful, the parties involved may agree to binding arbitration by the HKIAC: "a separate person is appointed as arbitrator, using as far as possible a documents-only process. The arbitrator decides the claim and the decision is final."

The purpose of the Scheme is to help resolve "questions of compensation between investors in Lehman-Brothers-related products and licensed banks." The HKMA is to pay half of the fee for the service provided by the scheme, the other half being paid by the bank in question.

In cases subsidised by the HKMA, the complainant and the bank are reminded of the availability of the mediation service and informed of the procedures. Once the two parties have agreed to mediation, the parties may agree on a mediator from a list to be provided by HKIAC: alternatively, HKIAC will appoint a mediator from that list.

The mediator is to commence the mediation process as soon as possible after appointment and is to "use best endeavours to conclude the mediation within 21 calendar days of appointment." If a settlement is reached, the mediation process ends (and the process is also terminated if the mediator considers that further attempts at mediation are no longer justified – or if either party gives written notification of the termination of the mediation).

If settlement is not achieved, the parties can then consider whether to move to arbitration under the scheme. If the parties do agree to arbitrate, they may either choose an arbitrator from a list provided by the HKIAC, or the HKIAC will itself appoint an arbitrator from that list. The parties obviously have the option to litigate in the courts if they cannot agree on arbitration.

The arbitrator is to conduct a "documents-only" arbitration under the scheme. Legal representation is not permitted for either party. The arbitrator is to aim to conclude the arbitration within 21 calendar days.

## *The mediation/arbitration scheme*

As mentioned earlier, the purpose of the scheme is to help resolve questions of compensation between investors in Lehman Brothers-related products and "distributing banks".

### *Definitions*

Section 1 of the HKIAC Scheme contains definitions. "Respondent" is defined as a licensed bank authorised under section 16 of the Hong Kong Banking Ordinance and against which a claim is made under the Scheme. "Mediation" is defined as the process of mediation of a claim referred by the HKMA to the scheme.

### *Mediation*

Section 2 contains the provisions relating to mediation. The mediator is to be appointed by HKIAC from its list of scheme mediators, after taking into account any preferences of the parties.

The mediation may be conducted in any manner that the mediator considers appropriate, taking into account the circumstances of the case, the wishes of the parties and the need for a speedy resolution of the dispute. The mediation should be completed within 21 days [rule 1].

The mediator may see the parties together and in separate "caucus" sessions or private meetings. The writer's experience as mediator – and as counsel in mediations – is that the caucus sessions are of enormous benefit in seeking to help the parties reach a settlement in commercial disputes. In those sessions, information given to the mediator in confidence by a party will only be revealed to the other party provided the mediator has express permission to reveal that information. The caucus sessions help the mediator to explore with the parties possible ways of resolving the dispute.

If there is no settlement the mediator is to help the parties to agree common facts that can be used in any subsequent arbitration or court hearing [rule 2]. Legal representation is not permitted in the mediation [rule 3]. If agreement is reached, the parties are to sign a settlement agreement [rule 4]. As mentioned earlier, the rules provide that the mediation will also be terminated if the mediator considers that further attempts to reach agreement are not justified. Either party may terminate the mediation at any time by serving notice.

The process is confidential, and opinions and the like relating to the mediation are not to be revealed unless the parties and the mediator agree in writing or they are "compelled by law" [rule 5]. The language of the mediation is to be decided by the mediator [rule 6].

The mediator may not be appointed as arbitrator, counsel or expert in any subsequent arbitration [rule 7].

### *Arbitration*

Section 3 contains the provisions relating to arbitration. If no settlement has been reached - and provided that the mediation has been terminated in accordance with rule 4 and the parties have agreed to arbitrate under the scheme - either party may serve notice requiring the dispute to go on to arbitration.

This is to be a "documents-only" arbitration, and the rules state that arbitration is not to be used in circumstances where there are complex issues or where there will be "substantial examination of witnesses": the scheme is designed for use in arbitrations only where the issues in dispute are "limited in number" [rule 9]. (Paragraph 2(b) of the notes to the scheme makes it clear that, on failure to reach agreement under the mediation process, the parties may agree to proceed to a documents-only arbitration. However, such arbitration is not to be used in all types of disputes, and in particular is not intended to deal with complex issues).

The arbitrator is to be appointed by HKIAC from its list of scheme arbitrators, again after taking into account any preferences indicated by the parties [rule 10].

Rule 11 contains provisions for the conduct of the arbitration. The arbitrator is to decide the claimant's case on the basis of "the documents submitted and evidence provided", and is to ensure that the parties are treated with equality and that each party is given a fair opportunity to present its case, give its reasons and provide evidence.

The arbitrator may call for further information, documents and statements. And whilst the arbitration is described as "documents-only", the arbitrator may call the parties to an informal hearing for the purposes of seeking further clarification.

And again, whilst the rules state that there are to be no "in-person" hearings (and those are defined as including teleconferences, video conferences and web conferences), nevertheless in exceptional circumstances the arbitrator can call for a hearing – provided the parties are prepared to shoulder the additional costs involved.

The arbitral award is to be rendered within 21 days of the appointment of the arbitrator – but the time limit may be extended. As in the case of mediation, no legal representation is permitted in the arbitration, and matters arising in the arbitration are not to be disclosed in any subsequent proceedings unless agreed in writing, or unless *"compelled by law"*.

### *Operation of the scheme*

Within a short time of the launch of the scheme, the Hong Kong Monetary Authority had referred over 300 Lehman-Brothers-related cases to the Securities and Futures Commission. Those cases involved 16 banks.

As at August 2010 the number of cases referred by HKMA had exceeded 1,000. A total of 88 cases had proceeded to mediation, of which 77 had achieved full settlement: a settlement rate of around 88 per cent.

There are believed to have been a number of cases settled by direct negotiation between the parties following the request for mediation.

## SOME FINAL THOUGHTS

The collapse of Lehman Brothers triggered a financial crisis worldwide. Governments in many countries were obliged to consider pumping considerable funds into banks to prevent their collapse. At the root of many of the problems faced by the banks was the fallout from the sub-prime mortgage fiasco. Irresponsible lending caused problems for lenders and borrowers. Those problems were worsened by the effect of complex financial instruments created out of the packaging of bundles of often worthless sub-prime or "toxic" loans.

Court actions have been launched by those who have suffered losses as a result of the financial crisis that followed the collapse of Lehman. There has not perhaps been the flood of litigation that was expected in the UK, but in the United States at any rate class actions are on the move. And the first major criminal prosecution relating to sub-prime mortgages has already taken place in America.

In one jurisdiction – Hong Kong – a possibly unique method of dealing with Lehman Brothers claims has been launched. The Hong Kong Monetary Authority announcement that the Hong Kong International Arbitration Centre would administer a Lehman Brothers-related products dispute mediation and arbitration scheme may set an example that other jurisdictions might usefully follow. Litigation in the civil courts (and prosecutions in the criminal courts) may be inevitable. But arbitration and mediation have much to offer: not least in potential savings in time and cost. And both methods of dispute resolution offer a degree of confidentiality.

Perhaps Hong Kong is showing other jurisdictions an alternative method for dealing with Lehman Brothers claims.

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