Close

Winding up Lehman Brothers

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Tony Lomas was dining out with his family at their local Chinese restaurant in Essex when he got the call about Lehman Brothers. It was from the investment bank's general counsel in the UK and it was brief: did Lomas or his firm have any conflicts of interest which would prevent them from working with Lehman? If not, could he bring a small team into the bank's Canary Wharf offices the next day?

As everyone in the business world knew by then, Lehman's chief executive, Dick Fuld, was in weekend meetings in New York trying to secure a suitor to save his bank. The previous day, Friday September 12, Lehman's shares had closed at just $4.22 – down more than 75 per cent from the start of the week. The bank's European team felt they ought to develop a just-in-case plan should their US counterparts be unable to pull off a deal.

Not that anyone expected that to happen. The executives who decided to bring in Lomas were simply performing their duty as directors. And Lomas, a 51-year-old father of two and head of PwC's restructuring and insolvency practice, had no idea that Sunday would stretch without sleep into Monday and Tuesday as the bank collapsed and his team took over the European leg of the biggest and most complex bankruptcy in history.

In many countries, bankruptcies are handled by lawyers, but in the UK, the lead roles go to accountants. PwC is the biggest of the international accounting firms, and with 900 of its 16,000 UK staff dedicated to restructuring work, it has the biggest practice. Though his name rarely makes the papers, Lomas is one of the biggest players in the UK restructuring industry. He was called in on such household-name bankruptcies as MG Rover and the European operations of Enron. He looks like your typical accountant – neat and well-dressed – but with none of the flash of the bankers and traders he is now in charge of. Asked about his hobbies, he has to search for an answer. I prompt him with one mentioned in an earlier profile – hiking. "Not hiking," he says, unwilling or unable to put up a replacement.

At midday on Sunday, Lomas arrived at Lehman's European headquarters, on Bank Street in Canary Wharf. Soon after, the rest of his team began to trickle in. Lomas might not have expected more than a quiet afternoon of work but after getting off the phone the night before he had begun assembling a heavyweight, seasoned team nonetheless.

Steve Pearson was first on his list. Pearson, a calm, analytical man, had worked on the Rover and Enron collapses, and had delved deep into the latter's complex trading instruments and strategies. He left his son's Sunday football match to come into Lehman's headquarters – and didn't leave Canary Wharf for a week. He sweats the details enough to be rueful about the £200 parking bill he ran up by leaving his car in the main car park the entire time. "I thought, 'I'll probably only be here for a few hours,'" he says.

Dan Schwarzmann was next. Chief executive of PwC's business recovery practice (Lomas is chairman), he too has experience with complicated financial companies, and in particular of investment trusts and "running off" – or closing down – insurance schemes. He loves the work: "I've not had one dull day in 20 years," he said, just days after agreeing the sale of Lehman's investment banking operations and its equities trading operation to the Japanese bank Nomura.

Mike Jervis, the last of the four partners brought in, has an impatient confidence. "A lot of accountants advise," he says, "but being an insolvency practitioner really puts your feet in the fire. When we sold the business to Nomura, it wasn't advising Lehman to do it – it was Tony, Dan, Steve and I doing it. And either thriving on or falling by the consequences."

By Sunday afternoon, the PwC team had settled into a conference room on the top floor of the bank. Gathered next door were Lehman's European executives. They were getting periodic updates from New York, where two deals were on the table – an offer from Barclays and one from Bank of America. London Lehman staff, dressed in casual clothes, devoted their afternoon to supporting the deals with data and number-crunching. It was a global group effort. The PwC team, meanwhile, aided by lawyers from Linklaters, began plotting a back-up plan – a Europe-only plan. While businesses may be run as global entities, the legal underpinnings differ region by region; if Lehman was a global enterprise in health, in bankruptcy each of its regional operations would face its own set of legal rights and responsibilities.

"You've got to be very sensitive," Lomas says when recalling that evening. "There was an emphasis placed on the fact that this [the PwC and Linklaters work] was just a contingency-planning exercise. Management doesn't want to demoralise staff."

Lehman Brothers staff at an emergency meeting, September 11 2008

But by about 6pm on Sunday September 14, the cat was out of the bag: the Barclays deal had run into problems and Bank of America had gone cold. As Monday would reveal, Bank of America was quietly doing a deal to buy Merrill Lynch, Lehman's bigger rival, whose chief executive, John Thain, had been part of the New York talks. By 11pm London time, 25 hours since Lomas had interrupted his family dinner to pick up the phone, New York had informed its subsidiaries it was filing for bankruptcy – and that the subsidiaries were on their own. In London, the so-called contingency plan was now the only plan.

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There are two basic forms of insolvency. The first and more common is cashflow insolvency. This is when a company finds itself unable to pay its debts as they fall due. The second is balance-sheet insolvency, in which liabilities outweigh assets. Lehman's European operations fell into the first category. Like many global corporations, the bank swept all the cash from its regional operations back to New York each night and released the funds the next day. The Friday sweep had taken about $8bn out of London. Without cash, the business could not meet its financial obligations on Monday morning. A thriving business of more than 5,000 staff and investments worth billions of dollars was suddenly flat broke.

Lomas and his team had learned about the nightly sweep on Sunday afternoon. After the 11pm call, they knew they were in a race to get the legal order that would appoint them as administrators before the London markets opened. Every day, Lehman dealt with thousands of companies, other banks and investment funds. Opening another day's London trading therefore ran the risk of destabilising the world's markets. Equally pressing, trading without the cash on hand to meet obligations – technically, trading when insolvent – is against the law.

There was a third reason to act fast: New York's intention to make its own bankruptcy filing in the US. Europe wanted its application approved first, to protect its operations from any claims its US parent might make. Lomas and team therefore had nine hours to come to terms with the wounded mammoth they would soon be running. There are more than 200 legal entities in the bank's European operations. The PwC team needed to identify which pieces ran the whole business, which assets needed immediate protection and which would actually be insolvent as a result of a lack of cash. As the night wore on, the partners gradually began to realise the true scale of what they were taking on. Schwarzmann settled down to look at the standard group structure. "Wow," he said, "that's quite complicated." Andrew Wright, Lehman's European finance director, turned round and answered: "That's just the summary."

Meanwhile the Linklaters lawyers, led by Tony Bugg, the head of their insolvency practice, got a judge on standby. At about 5am, the action shifted to the law firm's Silk Street offices as the filings were prepared and board meetings held by phone conference. At 7.56am, four minutes shy of the London market opening, the judge signed the administration orders. The music had stopped for Lehman Brothers' European operations.

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Going into bankruptcy is like flipping a switch. When a company is a going concern – an operation with both cash and plans to spend it and make more – it has business relationships that both sides value. A pub, for example, wants to work with its beer suppliers, and its beer suppliers want to work with the pub. But when the shutters come down, everyone becomes either a creditor or a debtor and every man is out for himself.

At Lehman, that meant Lomas's team had to act fast on a number of fronts – from dealing with more than 50 exchanges around the world to persuading the contracted canteen cooks to keep coming in. Harder still, they were starting from cold. Bankruptcies usually take weeks to materialise; administrators are generally brought in with a view to saving and restructuring an existing business, asking creditors for time to pull through, and lining up new sources of funding – be it through a loan, selling a partial stake or a complete takeover. Only after those efforts fail does a company go bust – by which stage administrators know the business in detail. At Enron, Lomas and Pearson had had two weeks to prepare. At Lehman, they had no notice. From 7.56am, four accountants who 24 hours previously had no detailed knowledge of the bank took sole executive power. Nothing could now be done without their approval.

Lehman, concedes Lomas, is an unprecedented case. Nonetheless, he is matter-of-fact about the process it involves. "We've done this dozens and dozens of times," he says. "It's not like somebody's dropped you into the deep end and you've never swum before."

Immediate tasks included securing the IT operations, notifying the thousands of exchanges and other counterparties which the bank dealt with, assessing the risks involved in its open trades, starting the search for cash, figuring out the way each division operated, discussing sales of business units with potential bidders and talking with the staff. Then would come the detailed work – still ongoing – of unwinding the bank's vast trading positions and unravelling exactly who was owed what and by whom.

The general process applies to any insolvency, but the fascination of Lehman comes with every little complication that a bank of its scale brings. This was especially the case for the European operations because of the sudden collapse; Lehman's main operations in the US, on the other hand, were kept out of bankruptcy for five days, giving them time to settle outstanding trades. Matters as simple as setting up a bank account caused problems. Having run most of its accounts through its New York parent, Lehman Europe had few deposit accounts of its own. Nor could it set up any with another bank, since that bank was likely to be a creditor or debtor and could try to seize any money parked with it. In the end, the Bank of England came to the rescue. The bankrupt bank now has more than 60 accounts with the central bank, covering currencies ranging from US dollars to Chinese renminbi to Norwegian krona. It expects to open still more.

In addition, Lehman was so central to the functioning of London's main markets that the Financial Services Authority has been closely involved and was present when the judge signed the administration orders. On average, the bank was responsible for 12 per cent of all trades on the London Stock Exchange. Its prime brokerage business, which serves hedge funds, was one of the biggest in London and held some $40bn of client assets.

"My kids asked me to explain what had happened that first day," says Bugg, "and I think the way I described it was, in small scale, you get a bicycle and you shove a stick in the back spokes and something nasty happens. Well, actually this was a big machine with lots of cogs, and someone put a stick in it and everything stopped."

When Dominic Gibb, financial controller for Lehman's European operations, returned to Lehman HQ after the judge signed the administration order, he was stunned by the scene that greeted him. "At this point we realised that the PwC staff had the most alarming rate of reproduction we'd ever seen; there were six or eight when I left, and when I got back, the top floor was teeming."

The 31st floor of Lehman's offices boasts amazing views across London; it was where bankers and executives would meet and lunch top clients. Accordingly, the rooms are quietly elegant, fitted out in dark wood panelling, plush carpets, marble floors and expensive art. On that Monday, a special reception area was set up to cope with the influx of staff cramming themselves round baize-covered dining tables and struggling to connect to the wireless network. Paper signs scrawled in marker pen were stuck on doors and walls to show where teams were sitting. Plastic in-trays held timesheets.

Both PwC and Linklaters say they have never before deployed teams of this size on a single case, nor ones spanning such a range of specialities. PwC has pulled in partners and staff from 17 departments while Linklaters has used staff from 14 departments and 15 countries.

Pearson describes the work of that first day as covering the "food chain" of a bank, learning how it works, from trading floor, or the front office, to back-office support operations. Key Lehman executives had to be identified and "marked" – literally followed around by a team of administrators who used this experience to get to grips with the business. The teams usually included a Linklaters lawyer and two PwC employees: a capital markets expert and a member of the insolvency team.

Pearson found a suitable position for himself one floor down, taking over the corner office of Jeremy Isaacs, the former European and Asian boss who had stepped down just a week before the collapse. "It's as much a visibility thing as a convenience thing," Pearson says. "It's really important when you come in to be clear to the people who are working here that all decisions come through you."

A staff member leaves the Lehman offices at Canary Wharf, September 15 2008

As much as Lomas's team needed to stamp their authority on the business, they also had to earn the trust of the employees, whom they needed in order to wind down the bank. Unlike in the Rover meltdown, where the factory staff had few other local employment options and were eager to stay on, Lehman bankers were besieged by headhunters. Lomas couldn't let them all go.

Yet the new management was not easy for many of the staff to accept. Stunned by the collapse of their employer, they were unsure of what it meant for them personally. Many did leave on Monday, but an e-mail was sent out late that day asking all staff to turn up as usual the next day. On Tuesday, the PwC team addressed the staff. Schwarzmann sums up the talk as: "There is no cash in the kitty but we're looking to remedy that. We'd like to keep the team together because that will be much more attractive for a buyer. So could you work with us to try and achieve a fast sale?" It wasn't easy: "When people are shell-shocked, that's quite a hard sell."

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By Wednesday, Lomas and Team were in a position to tell staff that a $100m loan would cover their salaries. Now the focus could shift to trying to sell as much of the business as possible and trying to unwind its trading positions. Here, one of the biggest challenges for PwC and Lehman staff was learning to understand one another. "A bank measures its risk and asks, 'Are we hedged?'", says Pearson (that's to say, is the risk covered?). "Whereas we're interested in assets and liabilities. So the whole language had to be translated. We had to define our objectives and then have our industry guys translate that for the people in the front office."

For many Lehman traders, the need to unwind the company intelligently meant a new pay package with a hefty bonus component if they managed to strike deals that were advantageous to the Lehman estate. Pearson knows he might come in for outside criticism for doling out these bonuses, since all funds are now owed to the bank's thousands of creditors. But he defends the move. "It's exactly what I did at Enron, so I knew exactly how I wanted to handle this. You've got a bunch of people here who know these markets so well, and with the right piece of information they can make you – or lose you – hundreds of millions of dollars," he says. "The last thing you can afford to do in these circumstances is be cheap, because if you're cheap, you can ruin the ship for a hap'orth of tar."

The juddering halt caused by the bankruptcy meant that the previous three days' trades were not fully settled. They weren't even fully recorded in the bank's systems. This wasn't an unusual time-lag, but one not helped by the fact that trading volumes had simultaneously shot up because of market panic, caused in part by fears about Lehman's health. The unsettled trades caused chaos in the markets as stock exchanges began to work through the deals to reach settlement. The securities traded by Lehman were simply left hanging during some of the most volatile days ever seen in the markets.

Then there were the cancellations, where counterparties such as banks or hedge funds with whom Lehman had traded rushed to trigger legal clauses to extricate themselves from some deals. Thousands of e-mail cancellations hit the bank. Either for itself or its clients, the bank held billions in securities such as stocks, currencies, commodities, bonds and various derivatives. On Friday, Lehman traders went home comfortable they had protected their risk on these holdings. Monday brought the realisation that the broken deals meant many hedges were no longer in place: the bank now had a book of holdings at risk of being crushed by the wild market swings.

To begin unwinding the "book", Pearson called on outside help and used other banks' trading teams operating under confidentiality agreements. These teams conducted the sales so the market would not know they were Lehman positions. If dealers had known that a particular trade was linked to the stricken bank, they could have tried to profit by pushing the price down, knowing Lehman had to sell.

In fact, some of these trades actually ended up making the bank hundreds of millions of pounds as the team rode the rollercoaster market moves. "We ended up catching both sides of the market," says Pearson. "We decided to close out some long positions [assets held in the expectation that prices would rise] when the market went up. We had some short positions [designed to profit from price falls], too, and the market then went down." He won't give exact figures but says: "Some positions that we moved, we made gains that exceeded the entire earnings of one of the divisions last year."

Then there were the client positions, where the bank held assets on behalf of its customers, or stored them with another bank. Since Lehman's collapse, hedge funds and others have been issuing increasingly frantic calls for the return of their assets – to no avail. This has produced some high-profile victims such as Luqman Arnold, head of the Olivant fund, whose entire 2.78 per cent stake in UBS is held by Lehman.

Certain hedge funds have claimed they are at risk of collapse because of trapped assets, which they cannot trade nor effectively hedge against, but PwC has warned it will take months before they can be returned. Even six weeks into the bankruptcy, the administrators were waiting on some of the 97 banks holding Lehman assets to clarify just what they held.

It's all complicated further by a process known as rehypothecation, which affects a substantial proportion of the hedge fund assets held by the bank. In these cases, the funds pledged collateral (usually stocks or other securities) in return for a loan, while agreeing to the bank's putting that collateral back in the market to make extra profits. With the music stopped, the hedge funds owed Lehman money in exchange for the collateral. To honour that, Lehman must itself go back into the market and unwind deals in which it reused the assets, paying out cash to get them back.

"There are so many trades that need to be closed and then evaluations validated and reconciled before we can say, 'are you a debtor or creditor'," says Pearson. "You can't form views without all the facts. The danger is if you form a view on two or three facts, that a fourth fact could fundamentally change your conclusion. And in a number of the positions that we've been looking at, we've discovered a fourth fact and we've gone from the situation being black to it being white in terms of the resolution." He adds: "We don't know if there's a fifth fact, by the way, because this diligence exercise has never been done before."

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UK administration prevents creditors from seizing assets, which gives the company and its administrators a little breathing space. Still, from that Monday morning, thousands of trade cancellations and other queries started to flood in to Lehman. Creditors and service providers used any number or e-mail address they could get hold of. As the names of Lomas, Pearson, Schwarzmann and Jervis reached the public, the four administrators found they could no longer use their own e-mail accounts or phone lines: they were completely jammed. PwC's PR team, whose numbers and names were also public, were fielding calls threatening to cut off phone lines and other services to the bank unless they got immediate assurance that bills would be paid.

Confusion began to clear in the following days. Pearson and Lomas used their contacts to find the $100m – unsecured – emergency funding. Pearson and Jervis began the work of unwinding the bank's vast and complex trading positions. Schwarzmann pursued outside interest in the investment banking and trading teams and in the second week secured a deal – with Nomura, for just $2 in cash. That deal put the Japanese bank in charge of half the staff, while allowing PwC to keep working on unwinding Lehman's trading book. The arrangement had two advantages: Lomas's team retained, for the time being, the expertise it needed, and Nomura got a bargain on an established London-based investment bank.

It's not clear how long this arrangement will last – nor is it clear how long the PwC administrators have until creditors get antsy enough to sue for their money. This coming Friday, Lomas has hired out the O2 centre's 2,000-seat Indigo theatre for the first and only creditors' meeting. This is a court-mandated event which will set the tone for the rest of the unwinding and select a five-person creditor committee to oversee the administrators in the coming years. Seven years after its collapse, Enron Europe's liquidation is still not finally wrapped up. There is no reason to believe Lehman's demise will be any quicker.

So far, only one hedge fund has gone to court to try to speed up the return of its assets. The judge told it to give Lomas and his team more time. This is likely to be the response most creditors receive for some time, not least because who owes what, and to whom, is still far from clear. The final goal is to get as much money to creditors as possible. Only when the lawsuits stop rolling in will Lomas and his team know they are done.

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While Lehman Europe currently stands as the most complicated bankruptcy ever handled, unrelenting market turmoil means it may not be the record-holder for long. On a mild, cloudy morning late last month, Lomas took a break from his work to mull over the experience. He suggests every bank should develop a detailed contingency plan – like the continuity plans companies have for events such as a fire or a terrorist attack – in case it should fail.

"Nothing changed with regard to this company's physical status," he says. "But because its legal status changed, there were massive implications. If we had walked in here on that Sunday, and there had been a manual there that said, 'Contingency plan: If this company ever needs to seek protection in court, this is what will happen' – wouldn't that have been easier? At Enron, we had two weeks to write that plan. That wasn't long enough, but it did give us an opportunity to hit the ground running. Here, we had no time to do that."

In the end, is Lomas surprised by the scale and complexity of what he is now dealing with? He thinks carefully. Not in terms of complexity, no. What did surprise him, though, was that Lehman's collapse had been allowed to happen in the first place. "I was surprised that it had gone down and that authorities elsewhere in the world hadn't found a way to avoid it going down – precisely because I could anticipate the complexity that there would be here.

"Surely others had seen just how big and ugly this was going to be?"

Jennifer Hughes is the FT's financial correspondent

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What's happening elsewhere with Lehman...

US

It took just two days from the US parent's bankruptcy filing for Barclays to agree a deal for the bank's US broker-dealer business – about half its US operations – for just $1.75bn. That figure included assets but not liabilities, the bank's technology and most of its staff, plus its Times Square headquarters, valued at up to $900m. The biggest outstanding unit is now its asset management division, subject of a fight between private equity giants. Bain Capital and Hellman & Friedman last month agreed to buy it at a knockdown price of $2.15bn. But after a complaint from rival Carlyle, the unit will now be sold through an auction later this month.

Asia

Like the European operations, Lehman's Asian businesses, totalling about 3,000 staff, were left in limbo by their parent's collapse. By Wednesday, KPMG had been appointed as liquidators to a number of its Hong Kong and Chinese units. Half its staff were, however, based in Tokyo, where it had used its trading might to become the biggest equities dealer – similar to London's domination. A week after the bank collapsed, Japanese rival Nomura swooped on Lehman's entire Asian business for $227m – and then moved on to take over the largest part of the European operation.