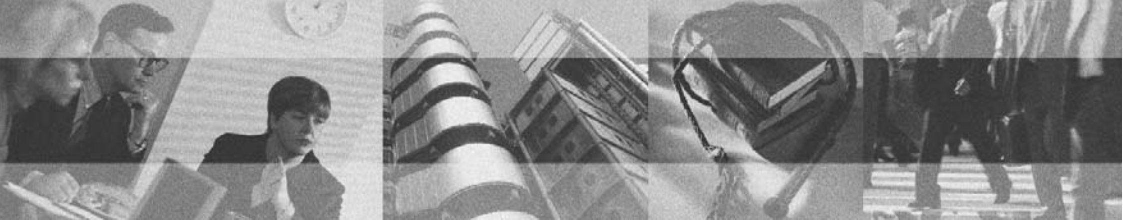

HOW ARE THE MIGHTY FALLEN

by
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At a conference at Lloyd's on 15 October the causes, consequences and implications for insurers of the financial crisis and the demise of Lehman Bros were considered by the British Insurance Law Association and the Professional Liability Underwriting Society.

Who/what was to blame?

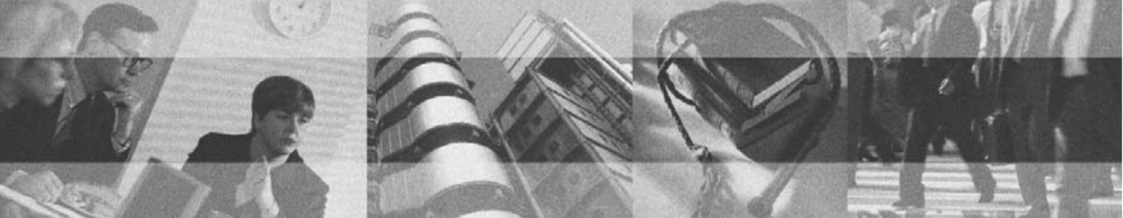
Surveying alleged causes of the crisis, Anthony Hilton of the *Evening Standard*, remarked that certainty about the causes has diminished rather than increased with the passage of time. Howard Davies's new book[3] on the subject had identified thirty-eight strands of argument, some complementary and some conflicting, ranging from bad policy and regulation to hormones on the trading floor, the media and a lack of whistle-blowers. Hilton addressed many of these, drawing comparisons with the insurance industry. In his view the core problem was that agent and principal functions were at the heart of the system but were now combined in the same entity. Hilton would reverse Big Bang and separate the functions so that there would be no potential for agents to gear up and no fundamental conflict of interest.

Valukas Report

Ned Kirk, partner in Clyde & Co US LLP, summarised the 2,208 page report of the Examiner appointed by the US Bankruptcy Court, Anton R Valukas, on his investigation and findings on the Lehman bankruptcy and potential claims against officers and directors and third parties. Lehman's response to its subprime debt problems had been the adoption of an aggressive countercyclical business strategy, acquiring illiquid assets from real estate and securitization business, and the disregard by senior management of risk managers, policies and limits. This was exacerbated by balance sheet manipulation, the Repo 105 program and auditors' failure to challenge financial statements.

Valukas found that Lehman's officers' exceeding risk limits on its illiquid principal investments fell within the "business judgment" rule (i.e. was not reckless or irrational), so did not breach their fiduciary duty to monitor Lehman's risk. Their disclosures to the Board on risk management were not so incomplete that they had misled the Board. As regards any claim for failure adequately to monitor Lehman's affairs, the directors' failure was not so egregious as to amount to breach of duties of loyalty or good faith: they could rely on the reports received from management.

Although the valuation of some real estate and equity investments had been unreasonable, there was insufficient evidence to support a "colorable claim" (a *prima facie* case) for breach of fiduciary duty on the part of directors or officers, that assets had been improperly valued intentionally or with "conscious recklessness".



There was inadequate evidence to support claims against directors and officers for breach of fiduciary duty in not diligently pursuing survival strategies, e.g. capital raising through public offerings, transactions with strategic partners and investors, and restructuring asset holdings.

However, Lehman had reduced leverage by the use of Repo 105 transactions to substitute cash for securities on its balance sheet, characterising the transactions as sale and purchase rather than secured short-term financing. It had failed to disclose the use of Repo 105s, the amount of cash it had borrowed in such transactions or the fact that it used the borrowed cash to pay down other liabilities. Failure to disclose tens of billions of dollars of Repo 105 transactions in its financial statements rendered them materially misleading because repurchase by Lehman of the securities was a known event reasonably likely to occur and would have a material effect on its financial condition. Valukas concluded that certain Lehman officers had breached their fiduciary duties by exposing Lehman to potential liability for filing those materially misleading reports, and that the auditors had been professionally negligent in allowing those reports to go unchallenged.

Valukas also concluded that there may be a colorable, if not strong, claim against JP Morgan (but not other counterparty banks) for making allegedly excessive collateral demands.
The upshot is the *In re Lehman Brothers Equity/Debt Securities Litigation*, in which the plaintiffs cite Valukas extensively. It is likely that the report will be relied on in other litigation, including insurance claims and claims against investment banks.

Client money

Robert Purves, a barrister specialising in financial services law and regulation, considered the FSA client asset rules in connection with MiFID business or designated investment business in the light of the Court of Appeal judgment in *Re Lehman Brothers (International) Europe (in administration)*.[4] The court decided that the statutory trust imposed by CASS 7 applied to all client money immediately on receipt by an investment firm and not only when the money was placed in a segregated account. When client money was pooled on the failure of Lehman the pool included not only the money in the segregated accounts but also all identifiable client money in the firm's house accounts. The entire pool should be distributed among clients by reference to the size of contractual claims they had to have their client money segregated rather than by reference to the amount of money actually segregated for them.

Purves emphasised that in the application of CASS the general default rules of trust law will apply rather than the normal rules of contractual or statutory interpretation. This may have been insufficiently appreciated in the drafting of CASS (including CASS 5, which applies to insurance intermediaries). Substantial redrafting will be required. The FSA announced on 20 October[5] a future comprehensive review of CASS, which can be undertaken only after the determination of the *Lehman* case, possibly in the Supreme Court or even the ECJ.

Insurance and reinsurance implications

The (re)insurance implications of Lehman were then discussed by Prof. Rob Merkin, the new President of BILA. He considered attempts to shift credit risk in reinsurance, and their efficacy. For reinsureds these could be ratings downgrade clauses, special termination clauses

(operating in the event of run-off, insolvency, or change in management of reinsurer) and cut-through clauses. For reinsurers, special termination clauses, cut-through clauses (to avoid having to pay twice in the event of liability to the direct assured) and premium warranties are used.

Merkin also classified current litigated claims and possible responses to them under D&O or PI policies. Insurers' defences might include: non-disclosure, on renewal, of potential claims; failure to notify circumstances insofar as later year cover excludes circumstances that could have been notified during the previous year; uninsurable losses; aggregation issues and *ex turpi causa*.

Lessons to be learned from the administration

Dan Schwarzmann gave a spellbinding factual account of his task as Joint Administrator of Lehman Brothers International (Europe). With no cash initially available, PwC had to borrow £100m to be able to assure crucial Lehman staff that they would be paid and had a future. Where some wanted large payments for explaining transactions for which they had been responsible the riposte was the invocation of powers under the Insolvency Act.

Features from the insurance world have been adopted in the administration, e.g. a claims resolution agreement developed in the *Independent Insurance* case, used to bind a large community of debtors and creditors.

Schwarzmann drew lessons for current management. These included a risk register for key clauses, pre-insolvency assignments to facilitate set-off, the preferred use of LoCs for collateral, regular insolvency fire drills, discretionary elements and key performance indicators in outsourcing contracts.

Warning signs might be the quality and attitude of management, alleged fraud, catastrophic losses, a significant change of business, rapid growth, an unidentifiable business advantage, poor stock market performance and reinsurance failure. If something looks too good to be true, it probably is.

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[2] www.insuranceday.com

[3] Howard Davies, "The Financial Crisis: Who is to Blame?", Polity Press, Cambridge, 2010

[4] [2010] EWCA Civ 917

[5] PS10/16