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Media Contact:
Andrew Gray (202) 898-7192
angray@fdic.gov

FDIC Report Examines How An Orderly Resolution of Lehman Brothers Could Have Been Structured Under the Dodd-Frank Act

The FDIC on Monday released a report examining how the FDIC could have structured an orderly resolution of Lehman Brothers Holdings Inc. under the orderly liquidation authority of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act had that law been in effect in advance of Lehman's failure.

The report concludes that the powers provided to the FDIC under the Dodd-Frank Act to act decisively to preserve asset value and structure a transaction to sell Lehman's valuable operations to interested buyers -- which are drawn from those long used by the FDIC in resolving failing banks -- could have promoted systemic stability while recovering substantially more for creditors than the bankruptcy proceedings -- and at no cost to taxpayers. The report estimates that given the substantial, though declining, equity and subordinated debt of Lehman in September 2008 and the power for the FDIC to implement a prompt structured sale while providing short-term liquidity to continue value-adding operations, general unsecured creditors could have recovered 97 cents on every $1 of claims, compared to the estimated 21 cents on claims estimated in the most recent bankruptcy plan of reorganization. While there remains no doubt that the orderly liquidation of Lehman would have been incredibly complex and difficult, the report concludes that it would have been vastly superior for creditors and systemic stability in all respects to the bankruptcy process as it was applied.

FDIC Chairman Sheila C. Bair said, "This new report is an important step in ensuring that the public and market participants understand how the FDIC's new resolution authority for large systemic firms works. The powers to implement an FDIC liquidation of a systemic financial company during a future crisis give us the tools to end Too Big to Fail and eliminate future bailouts. Much work remains to be done, and we look forward to working with key stakeholders to ensure that this process is effective in achieving its goals. The Lehman failure provides an excellent model to contrast the tools available to the FDIC to effectuate an orderly resolution of a large financial institution against the process used in bankruptcy which, unlike our process, is not specifically designed to deal with the failure of a financial entity. I commend the professional staff for completing this comprehensive and rigorous analysis. It will add tremendous value to the public understanding of the FDIC's resolution process under Dodd-Frank."

Lehman's bankruptcy filing on September 15, 2008, was a signal event of the financial crisis. The disorderly and costly nature of the bankruptcy -- the largest financial bankruptcy in U.S. history -- contributed to the massive financial disruption of late 2008. The lengthy bankruptcy proceeding has allocated resources elsewhere that could have otherwise been used to pay creditors. Through February 2011, more than $1.2 billion in fees have been charged by attorneys and other professionals principally for administration of the debtor's estate.

The FDIC report concludes that Title II of the Dodd-Frank Act could have been used to resolve Lehman by effectuating a rapid, orderly and transparent sale of the company's assets. This sale would have been completed through a competitive bidding process and likely would have incorporated either loss-sharing to encourage higher bids or a form of good firm-bad firm structure in which some troubled assets would be left in the receivership for later disposition. Both approaches would have achieved a seamless transfer and continuity of valuable operations under the powers provided in the Dodd-Frank Act to the benefit of market stability and improved recoveries for creditors. As required by the Dodd-Frank Act, there would be no exposure to taxpayers for losses from Lehman's failure.

The powers provided under the Dodd-Frank Act are critical to these results. Among the critical powers highlighted in the report are the following:

- **Advance resolution planning:** The resolution plans, or living wills, mandated under Title I of the Dodd-Frank Act would have required Lehman to analyze and take action to improve its resolvability and would have permitted the FDIC, working with its fellow regulators, to collect and analyze information for resolution planning purposes in advance of Lehman's impending failure.

- **Domestic and International Pre-planning:** The Lehman resolution plan would have helped the FDIC and other domestic regulators better understand Lehman's business and how it could be resolved. This would have laid the groundwork for continuing development of improved Lehman-specific cross-border planning with foreign regulators to reduce impediments to crisis coordination.

- **Source of Liquidity:** A vital element in preserving continuity of systemically important operations is the availability of funding for those operations. The FDIC could have provided liquidity necessary to fund Lehman's critical operations to promote stability and preserve valuable assets and operations pending the consummation of a sale. These funds are to be repaid from the receivership estate with the shareholders and creditors bearing any loss. By law, taxpayers will not bear any risk of loss.

- **Speed of Execution:** The FDIC would conduct due diligence, identify potential acquirers and troubled assets, determine a transaction structure and conduct sealed bidding -- all before Lehman ever failed and was put into receivership under Title II. A suitable acquirer would be ready to complete the acquisition at the time of Lehman's failure. A critical element in quickly completing a transaction is the power, provided by the Dodd-Frank Act, to require contract parties to continue to perform under contracts with the failed financial company so long as the receiver continues to perform. This is particularly critical to avoid the lost value, as exemplified in the Lehman bankruptcy, when counterparties immediately terminate and net financial contracts and liquidate valuable collateral.

- **Flexible transactions:** The FDIC's bidding structure would provide potential acquirers with the flexibility to bid on troubled assets (e.g., questionable real estate loans) or leave them behind in the receivership. Similarly, creditors could receive advance dividends (i.e., partial payment on their claims) to help move money back out into the market and further promote financial stability. Advance dividends would not be provided if they would expose the receivership to loss.

These powers would enable the FDIC to act to preserve the financial stability of the United States and to maximize value for creditors by preserving franchise value and by rapidly moving proceeds into creditors' hands.

The very availability of a comprehensive resolution system, which sets forth in advance the rules under which the government will act following the appointment of a receiver, could have helped to prevent a "run on the bank" and the resulting financial instability.

The report was prepared using publicly available information about the events leading up to and following the filing of the Lehman bankruptcy petition. The report was prepared by FDIC staff from the Division of Insurance and Research, Office of Complex Financial Institutions, and the Legal Division.

The full report can be found here:
http://www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/lehman.pdf (PDF Help)

The FDIC's actions to date on the implementation of Dodd-Frank can be found here:
http://www.fdic.gov/regulations/reform/