



Asset recovery

Making business sense

Asset recovery is a 21st century phrase, favoured by politicians wanting to look tough on criminals and by businessmen boasting of their sustainability credentials, but what does it really mean?

A phrase that has several meanings, asset recovery can mean the sale of assets that are at the end of their life, or are otherwise unused or unwanted or simply excess to requirements.

One noteworthy example of the latter is the sale by military bodies of 'army surplus' clothes and equipment that spawned a whole new movement in fashion, which led to clothes being manufactured in military style and sold as army surplus, when in fact, they had never been anywhere near an army base.

Asset recovery can mean the demolition of unwanted property and the sale of land or the sale of assets on liquidation of a business. It can also mean the recovery of assets from criminals, where the assets represent the proceeds of crime, as undertaken by the UK's Asset Recovery Agency, set up in 2003 and later merged into the Serious Organised Crime Agency.

This last meaning of asset recovery is a specialised one with little in common with the other types described above. The owners of surplus or unwanted assets are generally keen to dispose of them at a good price, but the criminals targeted by the SOCA often resist disgorging their ill-gotten gains as illustrated recently by the case of north London criminal Terry Adams that he was 'too poor' to pay back his illegal profits.

The other types of asset recovery can all be considered as a form of sustainable business, a type of recycling, as they all involve transferring an asset from an owner that is no longer using it to one that sees it as having value. This article will consider two topical examples of asset recovery in very different fields.

The field of asset recovery employs a large number of specialists, whether they are experts in the safe scrapping of IT equipment, the

demolition of obsolete buildings, the re-use of industrial machinery or the liquidation of the assets of bankrupt companies. The two examples of asset recovery considered by this article both stand out for the outstanding work done by the specialists employed on them.

The first case to look at is that of the liquidation of Lehman Brothers following the largest corporate bankruptcy in the history of the world. In that case the first of the three main stages of classic asset recovery – (i) asset identification (and classification); (ii) asset divestment/disposal and (iii) asset redeployment – represented the major part of the job.

On the date of filing Lehman Brothers had \$639 billion in assets and \$613 billion in liabilities. At first sight, this might seem like an easy task, as the assets exceeded the liabilities. However, once the bankruptcy papers were filed numerous

institutions filed new claims against the group, and these ultimately amounted to approximately \$1,200 billion or double the assets available.

The first stage of the process, to identify and classify the assets, was extraordinarily complex because of the number of different legal entities involved, both in the Lehman Brothers Group and its counterparties of various types, and because of the intricacy of the transactions in which they had been involved.

The process was further complicated by the large number of jurisdictions involved and the conflict of laws that this created.

Litigation is inevitable in this sort of situation, particularly where US institutions are involved, and courts in different countries often come to different conclusions (as they did in this case - see below).

A major complication in the liquidation of financial institutions such as Lehman Brothers is the classification of the assets by ownership.

On the date of its bankruptcy, Lehman Brothers International Europe was holding a very large quantity of assets as a broker on behalf of its clients. Those assets belonged to the clients, not to Lehman Brothers and were thus not available to satisfy Lehman's creditors.

The classification of the assets, a large proportion of which were tradable securities, into those owned by clients and those owned by Lehman Brothers was a massive task.

Lehman Brothers had a very large derivatives business and the bank was a counterparty to many thousands of swap transactions. In its simplest form these involve the bank swapping one cash flow, e.g. a fixed rate of interest, for a different cash flow, e.g. a floating rate of interest.

These cash flows could well have been in different currencies and could also have been linked to other transactions between different counterparties, all of whom would be claimants in the liquidation.

Under normal, (i.e. non-investment) banking bankruptcy cases, the liquidator enforces debts owed to the bankrupt company while not paying its creditors, so in the swap example, the liquidator might claim the fixed rate cash flow payments from the counterparty but refuse to make the floating rate swap payment.

The risk of this happening is seen as unacceptable in the financial markets, so to prevent it happening, market practice is to include 'close-out netting' clauses in derivatives contracts, which provide that all the cash flows due under a contract are netted off against each other and only the net balance becomes payable. The principle to be applied is clear, but agreeing what is actually set off against what may be more complicated.

A major role in the financial crisis was that of Collateralised Debt Obligations (CDOs). These are bonds issued by Special Purpose Vehicles where payment is secured on a package of assets such as residential mortgages. The cash flows from these secured assets were often swapped with banks such as Lehman Brothers.

In normal circumstances, a party to a swap transaction has first call on secured assets if its counterparty becomes insolvent. So another bank entering into a swap with Lehman Brothers would normally expect to have first bite at the cherry of the asset package after Lehman went bankrupt.

However the rating agencies, which had been asked to rate these CDOs with the highest AAA credit rating, would only agree to do so if the bonds included a clause reversing this normal priority and instead giving bondholders the first call on the security package. This became known as the 'flip clause' as it only operated on the bankruptcy of the bank.

The swap agreements were governed by English law, but a number of the entities involved, including of course the main Lehman Brothers company, were based in the US.

The US bankruptcy judge who was seized with the bankruptcy case, held in January 2010 that the flip clause was unenforceable under a doctrine of US bankruptcy law, thus going against an earlier ruling in the English High Court which said that the clause was valid.

After an appeal to the English Court of Appeal, the case ended up in the Supreme Court of England & Wales, which held in July 2011 that the clause was enforceable.

By now the extent of the task facing the bankruptcy managers of Lehman Brothers in the US, Alvarez & Marsal, and the liquidators in Europe, PwC, should be clear.

The litigation over the flip clause was merely one of a host of legal actions that had to be dealt with in parallel to negotiations with claimants over which claims could be accepted and which rejected.

It is therefore remarkable that the trustee has been able to confirm that brokerage clients of Lehman Brothers will recover all the property belonging to them held by the bank, possibly even with interest.

After negotiation with claimants, \$309 billion of claims have been allowed out of the initial \$1,200 billion, and those claims are likely to be paid at over 26 cents in the dollar even after the considerable costs of the bankruptcy proceedings have been met.

This is an excellent result considering that previous estimates of recovery were in the region of 18 to 21 cents per dollar. Also noteworthy is the relatively short time, five years, in which this asset recovery has taken place. By contrast, resolving other big financial bankruptcies such as BCCI, took much longer.

The second example is in an entirely different field. It is the raising of the liner Costa Concordia from the seabed off the Italian island of Isola del Giglio. This asset recovery also involved a large number of specialists from various countries all working together to achieve the largest marine salvage operation of its kind.

What was remarkable about this operation and how was it achieved? To understand the size of the achievement it is necessary to assess the risks that the salvage team were facing and the technical difficulties they faced.

The main task of the salvage, the essence of success as it were, was to pull the liner into an upright position without the ship breaking up, so that it could later be re-floated and towed to a ship breakers to be cut up for scrap.

The reason why bringing the ship up in one piece was so important was the risk of ecological disaster if she broke up. The Isola del Giglio is situated in the Arcipelago Toscano national park, and the local economy is dependent on tourism with travellers being drawn to the area by the unspoiled natural beauty.

The Costa Concordia is a diesel powered vessel and the wreck contained a large quantity of contaminants including the sewage produced by 4,880 passengers and crew and a vast quantity of rotten food and other soft commodities. The prospect of these toxic substances escaping into the sea, the damage that it would cause to the ecosystem and the cost of the clean-up, were too awful to contemplate.

Other important considerations included the need to be sensitive to the fact that the bodies of two victims of the sinking are believed to remain within the ship and the obvious need to avoid further injury or loss of life.

Given the need to right the ship in one piece and the fact that such an operation had never been attempted before, what was the approach taken by the salvage team, bearing in mind that the ship weighed 114,000 tonnes and was never designed to be hauled up?

The key to the operation and to dealing with such knotty problems as welding wet steel to bear such huge weight, was the ability to model all possible outcomes in computer simulations.

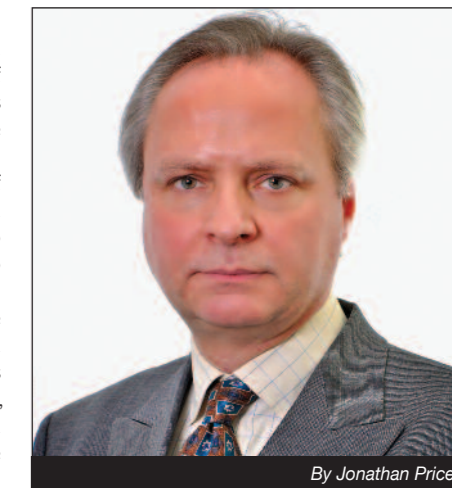
The team took every imaginable scenario of weather, temperature, accident, breakage, sea movement and such and modelled the outcome. This undertaking enabled them to foresee the likely consequences of each action and to plan the best possible course to minimise risk and maximise the chances of success. Such an analysis would not have been possible even five years ago.

The result was a tremendous success for all concerned. The ship was righted in one piece with minimal leakage of contents.

So what do Lehman Brothers and the raising of the Costa Concordia have in common?

Both were rescue operations designed to minimise loss and to recover the maximum value from the assets involved. Both succeeded because of the creativity and dedication of the asset recovery specialists and both illustrate the practical application of the principles of sustainability to business disasters.

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By Jonathan Price