



CLIENT ALERT

DECEMBER 1, 2008

Numerous Objections Filed in Response to Lehman Motion on Derivative Contracts

-- Hearing Scheduled for Wednesday, December 3rd

Since the filing by Lehman Brothers Holdings Inc. (LBHI) and certain of its affiliated debtors of a motion to establish procedures for assigning and settling various "Derivative Contracts", more than 80 parties have filed objections to the motion with the relevant bankruptcy court in New York. The deadline for objections was Friday, November 28, 2008. A hearing on the LBHI motion is scheduled to take place on Wednesday, December 3, 2008 at 10 a.m. (EST). A summary of the objections filed is provided below.

Background on Lehman Motion re: Derivative Contracts

LBHI and its affiliated debtors in bankruptcy proceedings under chapter 11 of the Bankruptcy Code (collectively, the "Lehman Debtors")¹ estimate that they are party to approximately 930,000 "Derivative Contracts", consisting mostly of "securities contracts", "forward contracts", "repurchase agreements" and "swap agreements". Most counterparties have taken action to terminate these contracts in response to the bankruptcy filings by the Lehman Debtors. However, the Lehman Debtors claim that over 197,000 Derivative Contracts (approximately 20% of the total) have not been terminated and remain outstanding.

Consequently, the Lehman Debtors filed a motion on November 13, 2008 seeking an order (the "Order") from the Bankruptcy Court of the Southern District of New York (the "Bankruptcy Court") that would permit the Lehman Debtors, in accordance with proposed procedures, to:

- (1) enter into final settlement agreements with counterparties that have terminated Derivative Contracts with the Lehman Debtors; and
- (2) assign Derivative Contracts that have yet to be terminated to third parties in order to realize their value.

¹ The "Lehman Debtors" do not include Lehman Brothers, Inc., which is subject to a separate liquidation proceeding under the Securities Investor Protection Act (SIPA). A trustee appointed under SIPA is administering LBI's estate. In contrast the Lehman Debtors referenced in the motion described in this alert are authorized to operate their businesses and manage their properties as debtors in possession pursuant to the Bankruptcy Code.

Lehman Proposal re: Settlement of Terminated Derivative Contracts

The Lehman Debtors would like the ability to settle Derivative Contracts that purportedly have been terminated by counterparties without the need for court review and approval in each instance in order to allow for efficient processing of settlement agreements. The Lehman Debtors therefore are requesting the ability to directly enter into final termination agreements with counterparties and proceed with settlement and return of collateral. Below is a summary of the procedures proposed by the Lehman Debtors for approval by the Bankruptcy Court in order to achieve this result.

Final Settlement Procedures Proposed by Lehman

- (1) A Lehman Debtor may enter into a termination agreement that fixes the amounts owing between the parties to a terminated Derivative Contract.
- (2) A Lehman Debtor may provide a release to the counterparty if appropriate.
- (3) A termination agreement may permit the collateral or margin held by either party to be liquidated or returned in accordance with any Derivative Contract, Master Netting Agreement or termination agreement.

Objections to Lehman Proposal re: Settlement of Terminated Derivative Contracts

The principal objections to the Lehman Debtors' proposed procedures for the final settlement of terminated Derivative Contracts are summarized below. Several objections maintain that the proposed procedures are unduly vague and request that the Bankruptcy Court clarify how the procedures will apply to the settlement of terminated Derivative Contracts. Assuming the Lehman Debtors' motion is granted, parties would like the Bankruptcy Court to make the following clarifications in its Order, among others:

- Specify that termination payments and expenses should be calculated in accordance with the relevant master agreement.
- Specify timeframes in which parties will submit information in support of their calculation of the appropriate termination payment due.
- Allow for Bankruptcy Court intervention and an opportunity to be heard to the extent a settlement cannot be reached consensually within a specified timeframe, or provide for a separate resolution procedure.
- Assure the release of counterparties that enter into a termination agreement with a Lehman Debtor.
- Clarify that the Order is merely authorizing the Lehman Debtors to take certain actions without further Bankruptcy Court approval with respect to such settlements only, and that the Bankruptcy Court is not altering or affecting the rights and obligations of the Lehman Debtors and their counterparties under the terms of a Derivative Contract, including rights of setoff and recoupment and rights to return of collateral.
- Clarify that relief granted in response to the Lehman Debtors' motion will not negatively impact the rights of counterparties with terminated Derivative

Contracts to pursue remedies that are enforceable in the Lehman Debtors' bankruptcy proceeding or to commence or continue any related civil proceeding.

Lehman Proposal re: Assumption and Assignment of Outstanding Derivative Contracts

The Lehman Debtors believe that certain counterparties are not exercising their rights to terminate Derivative Contracts because their contracts are "in-the-money" to the Lehman Debtors and termination would require such counterparties to pay a termination payment to the relevant Lehman Debtor. In addition the Lehman Debtors claim that many counterparties are refusing to perform and make ongoing payments under the outstanding Derivative Contracts on the basis that the Lehman Debtors' bankruptcy proceedings alleviate them of these obligations.

As a result, the Lehman Debtors claim that they are unable to realize the value of these "in-the-money" Derivative Contracts (unless the relevant counterparty defaults or the contracts expire and require settlement in accordance with their terms), and many of these contracts may be valuable assets of their estates. The Lehman Debtors therefore want the ability to assign some or all of these Derivative Contracts to third parties, thereby allowing them to realize their value in the near term and ensure that market fluctuations do not reduce the value of these contracts over time.

In this regard the Lehman Debtors contend that the Bankruptcy Code "authorizes the Debtors to assume and assign contracts over an objection of the Counterparty if the Debtors satisfy the requirements set forth under section 365 of the Bankruptcy Code" (dealing with the requirement to provide adequate assurance of future performance). Therefore the procedures proposed are intended to permit the Lehman Debtors to avoid protracted negotiations with counterparties with respect to Derivative Contracts that require consent to assignment.

Assumption and Assignment Procedures Proposed by Lehman

- (1) A Lehman Debtor would be required to serve notice (an "Assignment Notice") to counterparties at least five business days prior to a proposed assumption and assignment.
- (2) The Assignment Notice would contain, *inter alia*:
 - a. Either (i) a statement that the assignee or its credit support provider has a Standard & Poor's or Fitch credit rating of A- or higher or a Moody's credit rating of A3 or higher (a "Qualified Assignee"), or (ii) the identity of the assignee in the event neither the assignee nor its credit support provider is a Qualified Assignee, and
 - b. Amounts proposed to be paid by the relevant Lehman Debtor to cure any existing defaults (the "Cure Amount").



- (3) Adequate assurance of future performance, as required under section 365 of the Bankruptcy Code, would be deemed to have been met if the proposed assignee or its credit support provider is a Qualified Assignee or if the Lehman Debtor has no payment or delivery obligations under the contract (other than pursuant to the exercise of an option by the relevant Lehman Debtor/assignee).
- (4) A Lehman Debtor would be required to return any posted collateral held pursuant to a Derivative Contract being assigned or pay an amount equal to such collateral's value (valued as of the business day prior to delivery of the Notice of Assignment) if the Lehman Debtor is no longer in possession of the collateral.
- (5) Any objections (based, *inter alia*, on the Cure Amount, a default other than the bankruptcy or the failure of the assignee or its credit support provider to qualify as Qualified Assignees) would have to be received by the Lehman Debtor within five business days of delivery of the Assignment Notice. Failure to object will be deemed: (i) consent to any calculated Cure Amounts, (ii) agreement that adequate assurance of future performance was provided, (iii) agreement that all defaults under the contract have been cured, (iv) waiver of early termination rights, and (v) agreement that the terms of the Order shall apply to the assignment.
- (6) If a dispute arises, the Lehman Debtor would be able to request that the Bankruptcy Court consummate the assignment or make a determination as to amounts owing.
- (7) If the Lehman Debtor does not solicit bids from four potential assignees and select the highest or best bid, the Lehman Debtor would be required to request consent from the relevant creditors' committee to be able to assign pursuant to the Order.
- (8) A counterparty would not be able to terminate a Derivative Contract after an assignment has been consummated. Any termination notice would need to be received before consummation of the assignment.
- (9) If a Derivative Contract is subject to a master agreement, all transactions under the master agreement would need to be assigned (no cherry-picking).
- (10) To facilitate the assignment, the Lehman Debtor would be able to agree to make payments to or for the benefit of the assignee.

If there are no objections to the assignment, the Lehman Debtor would be authorized, but not obligated, to proceed with the assignment.



***Objections to Lehman Proposal re: Assumption and Assignment
of Outstanding Derivative Contracts***

The principal objections to the Lehman Debtors' proposed procedures for the assumption and assignment of outstanding Derivative Contracts are summarized below.

- **Objection to standards for satisfying adequate assurance of future performance:**
 - In accordance with Section 365 of the Bankruptcy Code a debtor may only assign a contract if it provides “adequate assurance of future performance” by the assignee of such contract. As stated above, the procedures proposed by the Lehman Debtors provide that the requirement to provide adequate assurance of future performance by the assignee will be deemed satisfied if the assignee or its credit support provider is rated A- or higher by Standard & Poor's or Fitch, or A3 or higher by Moody's. Parties' primary objections on this point are that:
 - The ratings criteria do not take into account limitations on a swap counterparty's ability to enter into swap agreements with a proposed assignee, whether due to its internal policies, applicable regulations, contractual covenants in related documentation, or otherwise.
 - An assignee's credit rating is not sufficient evidence of the assignee's ability to perform under a Derivative Contract.
 - The parties may have a higher credit rating requirement in their master agreements.
 - As the Lehman Debtor would not be obligated to disclose the identity of the Qualified Assignee until such assignment is complete, a counterparty will not be able to assess the creditworthiness of the proposed assignee, or have sufficient information to evaluate whether it needs to object the assignment.

- **Objection to the proposed period of time to object to an Assignment Notice:**
 - Five business days to object to an assumption and assignment is not commercially reasonable considering the complexity of the issues that need to be considered in order to determine the need for an objection.
 - The consequences for failing to meet the proposed five business day deadline are in violation of counterparties' due process rights.

- **Objection to limitations on the grounds upon which a party may object to the assignment:**
 - Counterparties should be able to object to an assignment of a Derivative Contract on any grounds, not just on the limited grounds specified in the motion (e.g., the proposed Cure Amount, the need to cure a default, or the adequate assurance of future performance if the assignee is not a Qualified Assignee).

- **Objection to limitation on contractual rights to terminate, accelerate or set-off post-assignment:**
 - Sections 560 & 561 of the Bankruptcy Code expressly state that the contractual right of a non-defaulting party to a swap agreement to cause the liquidation, termination or acceleration of the agreement or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation or acceleration of one or more swap agreements shall not be stayed, avoided, or otherwise limited by *any* provision of the Bankruptcy Code or by order of the Bankruptcy Court.

- **Objection to assignment without counterparty consent:**
 - Underlying swap contract (see Section 7 of the ISDA Master Agreement) requires counterparty consent to an assignment.
 - Sections 365 (c) and (f) of the Bankruptcy Code prohibit the debtors from assigning executory contracts over the objection of counterparties and require assignees to take assignment of the contract as written.

- **Objection to assignment of ISDA Master Agreement entered into in connection with a loan:**
 - ISDA Master Agreement was a prerequisite, and thus indivisible from, a loan where a Lehman Debtor was the lender and therefore cannot be assigned because the loan is not an executory contract capable of assumption and assignment under Section 365 of the Bankruptcy Code as there are no further obligations due from the Lehman Debtor entity.

- **Objection to application of assumption and assignment procedures to validly terminated contracts:**
 - Assumption and assignment procedures should not apply to or revive validly terminated Derivative Contracts.

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If you have any questions regarding the motion and objections described above or would like further information regarding the status of the Lehman proceedings, please contact one of the following:

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