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www.klgates.com

Contacts:

New York

Robert T. Honeywell

212.536.4863

robert.honeywell@klgates.com

Richard S. Miller

212.536.3922

richard.miller@klgates.com

Anthony R.G. Nolan

212.536.4843

anthony.nolan@klgates.com

Jeffrey N. Rich

212.536.4097

jeff.rich@klgates.com

Boston

Charles A. Dale III

617.261.3112

chad.dale@klgates.com

Gordon F. Peery

617.261.3269

gordon.peery@klgates.com

Washington

Robert A. Wittie

202.778.9066

robert.wittie@klgates.com

Seattle

Marc L. Barreca

206.370.7815

marc.barreca@klgates.com

Matthew S. Topham

206.370.7659

matthew.topham@klgates.com

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Lehman Proposes Procedures to Assign and Settle Derivative Contracts

On Thursday, November 13, 2008, Lehman Brothers Holdings, Inc. (“LBHI”) and its affiliated debtors¹ (collectively, the “Debtors”) filed a motion seeking permission from the United States Bankruptcy Court for the Southern District of New York (the “Bankruptcy Court”) to establish procedures for the settlement of certain derivative contracts.² The Bankruptcy Court will hold a hearing on the motion at **10:00 a.m.** on **December 3, 2008**. Any party wishing to object must do so on or before **4:00 p.m.** on **November 28, 2008**.

This Alert is intended to highlight the procedures proposed by the Debtors in the motion related to derivative contracts. According to the Debtors’ motion, derivative contracts that have not been properly terminated may be sold by the Debtors and assigned to a third-party purchaser upon five (5) business days’ notice to the applicable counterparty. ***Given the extremely short time frame within which counterparties must respond to a proposed sale or assignment by the Debtors of an open derivative contract, clients are strongly advised to, among other things, (i) take an immediate inventory of their open derivative positions with the Debtors (including any collateral that may have been posted in connection therewith), (ii) verify that the Debtors have their proper contact information to ensure that the notice is sent to the correct address, and (iii) assess the legal efficacy of prior efforts to terminate and close out those positions.*** Clients may consult with any of the attorneys whose names and contact information are listed herein to discuss these matters further.

Summary

According to the Debtors’ motion, the majority of counterparties to various derivative contracts have purported to terminate such contracts (and/or the trades which are the subject thereof) after LBHI filed for bankruptcy protection in September. The Debtors surmise in the motion that counterparties that have not yet exercised their contractual rights to terminate derivative contracts with the Debtors may have refrained from doing so where the non-defaulting counterparty would owe a net payment to the Debtors. The Debtors believe that such “in the money” derivative contracts are valuable assets that may generate interest in the market. As a result, the Debtors petitioned the Bankruptcy Court to approve procedures whereby “in the money” derivative contracts may be assumed and assigned to third parties on an expedited basis. If the motion is granted, the Debtors will not need to seek Bankruptcy Court approval of a separate motion for each contract or trade that they wish to assume and assign.

With respect to those counterparties that have already terminated applicable derivative transactions (or might do so in the future), the Debtors seek authority from the Bankruptcy Court to enter into “termination agreements” that would bring about the settlement of claims and the return or liquidation of collateral in connection with those transactions without the need to return to the Bankruptcy Court.

The Debtors allege that these streamlined procedures are necessary because they are parties to approximately 930,000 derivative contracts, of which approximately 733,000 have purportedly been terminated.

Proposed Assumption and Assignment Procedures

In their motion, the Debtors propose the following assumption and assignment procedures for open “in the money” derivative contracts:

1. For any derivative contract that the Debtors wish to assume and assign, without the consent of the counterparty, the Debtors will give the counterparty five (5) business days’ notice of their intention (the “Assignment Notice”) by overnight delivery, fax, or email. The Assignment Notice will identify the derivative contracts and either (i) state that the proposed assignee is “qualified” (meaning that it or its credit support provider shall have a Standard & Poor’s or Fitch credit rating equal to or higher than A- or a Moody’s credit rating equal to or higher than A3, or any equivalent thereof) or (ii) identify the proposed assignee and its credit support provider if neither is “qualified.” The Assignment Notice will also indicate the amount to be paid by the Debtors to “cure” existing defaults (other than defaults based solely on the Debtors’ bankruptcy filing, insolvency, or financial condition). The Debtors will be deemed to have provided adequate assurance of future performance, as required under the Bankruptcy Code, if the proposed assignee is “qualified” or if the Debtors will have no further payment or delivery obligation after paying the cure amount (other than those related to a Debtor option). The Debtors’ proposed procedures would do away with the need to obtain the counterparty’s prior consent for the assignment and assumption of derivative transactions, such as those included in standard over-the-counter derivative contracts (i.e., Section 7 of the ISDA Master Agreement).
2. If the contract is entered into pursuant to a master agreement, the Debtor must assume all of the contracts entered into pursuant to such agreement. This part of the proposed procedures could, if approved by the Bankruptcy Court, bring about the netting of multiple derivative transactions that are “in the money” and “out of the money” if the applicable master agreement provides for such netting.
3. If a derivative contract requires the return of posted collateral as part of the cure amount, the collateral will either be returned to the counterparty, or, if it is no longer in the Debtors’ possession, the collateral will be valued as of the last business day prior to service of the Assignment Notice. The valuation will be based on independent, third-party pricing services and the Debtors will pay this amount to the counterparty as part of the cure.
4. If a counterparty objects to the cure amount or to the assumption and assignment of the agreement on any other grounds (including because the proposed assignee is not “qualified”), the counterparty must serve a written objection on Debtors’ counsel (at two addresses) so that it is received no later than five business days after service of the Assignment Notice. If the counterparty disputes the cure amount, the objection must include detailed information on a transaction-by-transaction basis as to what the counterparty believes is the correct cure amount and whether any other defaults must be cured.
5. If no objection is timely served, the counterparty will be deemed to have consented to the cure amount and to the other terms of the assignment. Further, the counterparty will have waived any right to terminate the derivative contract for defaults that existed prior to the assignment.
6. If an objection cannot be consensually resolved, the Debtors may (i) seek authorization from the Bankruptcy Court to consummate the transaction or (ii) if the dispute solely relates to the cure amount, pay the undisputed portion to the counterparty and place the disputed portion in a segregated interest-bearing account pending resolution by the Bankruptcy Court or agreement between the parties.

7. Any termination notice sent by a counterparty with respect to a derivative contract will be deemed ineffective unless it is received by the Debtors prior to the consummation of an assignment in accordance with the procedures described above.
8. The Official Committee of Unsecured Creditors in the Debtors' bankruptcy case must consent to any proposed assignment, unless the Debtors solicit at least four (4) bids and select the "highest or best" bid.

Termination and Settlement Procedures

The Debtors have also proposed certain termination and settlement procedures for derivative contracts. These procedures are less detailed than those for assumption and assignment of "in the money" derivative contracts and offer few details other than that the Debtors "may" enter into such termination agreements, but are nonetheless important in providing counterparties with some direction. These procedures appear to be available for all of the Debtors' derivative contracts, both those already terminated and those still open.

The Debtors essentially seek authority to enter into and consummate termination agreements with various counterparties without the prior approval of the Bankruptcy Court. These termination agreements may cover resolution of the amounts owing between the Debtor and counterparty, provide a release to the counterparty where the Debtors deem it appropriate, and permit the return or liquidation of any collateral or margin in accordance with the derivative contract, an applicable master netting agreement, or the termination agreement itself.

The Debtor may enter into these termination agreements with (i) counterparties who have already purported to terminate their derivative contracts, but have not yet resolved the amounts owed between them or other issues and (ii) counterparties who have not yet exercised their rights. The Debtors may use termination agreements as a means to resolve disputes over the amount of termination payments. In this regard, it is important to note that derivative

contracts typically provide for termination amounts to be calculated by the non-defaulting party without consultation with the defaulting party (i.e. the Debtors) and that such contracts do not typically specify a mechanism for dispute resolution.

It should also be noted that these procedures are permissive only and are silent as to what happens if the parties cannot reach a termination agreement. Counterparties with claims under derivative contracts (whether or not terminated) should pay close attention to any procedures and deadlines for filing claims against the Debtors in these Chapter 11 cases.

Conclusion

Counterparties to derivative contracts with LBHI or any of its affiliated Debtors should carefully consider how their rights and obligations may be impacted by these proposed assignment and settlement procedures. Specifically:

- If you have not yet terminated your agreement and potentially owe the Debtors a net payment, you should evaluate whether it is appropriate to terminate the agreement now (or, assuming the motion is granted, before the expiration of the five business days after the Debtors serve the Assignment Notice) to avoid its later assignment to a third-party.
- In all instances (whether or not you have terminated), you should alert your staff about the possible receipt of an Assignment Notice from the Debtors (by overnight delivery, fax, or email), which will trigger the five business day period for serving an objection to the cure amount and the other terms of the proposed assignment.
- If you have already terminated your derivative contracts with the Debtors, but have not yet resolved outstanding issues, such as amounts owed to you by the Debtors, the return or liquidation of collateral, or any open disputes for which a release would be valuable, you should consider whether entering into a termination agreement is in your best interests. In this regard, you should consult with counsel to determine whether your prior termination efforts were legally effective.

If there are any issues in that respect, the Debtors may use the threat of assignment to a third-party as leverage in negotiating a termination agreement.

- Whether or not you have terminated your derivative contracts with the Debtors, you may be concerned about the accelerated procedures by which the Debtors propose to sell or assign open derivative contracts. Unless objections to the proposed procedures are filed with the Bankruptcy Court by 4:00 PM on November 28, 2008, they will be approved and your opportunity to complain about them will be lost.

If you would like to discuss any of the foregoing, or if you receive an Assignment Notice from the Debtors, please contact any of the attorneys listed herein for legal advice.

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Endnotes

¹ The affiliated debtors include the following entities: LB 745 LLC; PAMI Statler Arms LLC; Lehman Brothers Commodity Services Inc.; Lehman Brothers Finance SA; Lehman Brothers Special Financing Inc.; Lehman Brothers OTC Derivatives Inc.; Lehman Brothers Derivative Products Inc.; Lehman Commercial Paper Inc.; Lehman Brothers Commercial Corporation; Lehman Brothers Financial Products Inc.; Fundo de Investimento Multimercado Credito Privado Navigator Investimento No Exterior; Lehman Scottish Finance L.P.; CES Aviation LLC; CES Aviation V LLC; CES Aviation IX LLC; and East Dover Limited.

² See *Debtor's Motion for an Order Pursuant to Sections 105 and 365 of the Bankruptcy Code to Establish Procedures for the Settlement or Assumption and Assignment of Prepetition Derivative Contracts*.

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