

# Client Advisory

November 17, 2008

## Lehman Seeks to Establish Expedited Procedures for Assumption, Assignment and Termination of Derivative Contracts

On November 13, 2008, Lehman Brothers Holdings Inc. and its U.S. affiliates in bankruptcy, including Lehman Brothers Special Financing and Lehman Brothers Commercial Paper (collectively, "Lehman") filed a motion asking that certain expedited procedures be put in place to allow Lehman to assume, assign or terminate the thousands of executory derivative contracts to which they are a party. If Lehman's motion is granted, counterparties to transactions that have not been terminated will have very little time to react and will likely find themselves with new counterparties and no further recourse to Lehman because, by assigning contracts to third parties, Lehman will effectively receive, by normal operation of the Bankruptcy Code, a novation.

As proposed, these procedures would not apply to Lehman Brothers Inc., which is in a separate insolvency proceeding conducted under the Securities Investor Protection Act.

The proposed procedures recognize that Lehman is not free to simply "terminate" a derivatives contract that is "in the money" unless its counterparty has defaulted and Lehman would have been able to terminate the contract outside of bankruptcy. Rather, in order to realize the benefit of being in the money, Lehman must either formally assume the agreement in question or assume and assign it to a third party that is willing to pay Lehman for the contract. Because the value of its derivatives positions may fluctuate significantly, especially with volatile market conditions, Lehman believes it needs a streamlined process to put this into effect.

Under the proposed procedures:

- No prior consent of the counterparty to assignment is required. This is consistent with bankruptcy law that, in general, makes anti-assignment provisions unenforceable.
- Lehman will provide written notice by overnight delivery, email or fax to the last known address of the counterparty identifying the amount necessary to cure existing defaults under the derivatives contract (measured as of the previous day) and either (i) identifying the assignee or (ii) stating that the assignee is a "qualified assignee" (meaning an entity having, or supported by a credit support provider having, an S&P or Fitch rating of at least A- or Moody's rating of at least A3). The procedures suggest that if the assignee is a qualified assignee, Lehman is not required to notify the counterparty of the identity of the assignee until the assignment actually takes place. Thus, a counterparty that dealt with a Lehman entity in the United States could find itself with a foreign assignee and possibly obligated for an indemnifiable tax or have its contract assigned to an entity that, even though highly rated, is objectionable in some other respect. For example, it may be objectionable to have a new counterparty outside the jurisdiction of the U.S. courts.
- A counterparty wishing to object to an assignment will have to file a formal written objection with the bankruptcy court and serve copies of the papers on Lehman's counsel within five business days of service of the above-described notice (effectively giving the counterparty no more than four business days to prepare and file the objection). Any objection could not be based on the identity of the counterparty as long as such counterparty is a "qualified assignee" as described above.
- Failure to file and serve an objection constitutes the counterparty's consent to the assignment and the asserted cure amount.
- Lehman is not seeking to "cherry pick" particular contracts entered into under a master agreement. The assignment of an ISDA or other master agreement will include the assignment of all contracts executed under the master

agreement. (The notice of such an assignment would identify the master agreement and not each and every contract entered into under it.)

- Lehman must cure monetary defaults and will set the proposed cure amount as of the day before notice of the assumption and assignment is sent to the counterparty. If Lehman does not have possession of collateral that it is required to return as part of the cure, it can instead return the cash value of that collateral as determined by an independent third party source.
- Should there be a dispute as to cure amount, Lehman may nonetheless proceed with the assignment by escrowing the disputed portion of the cure amount and litigating with the counterparty over the disputed cure amount (and any interest that may be due).
- Once Lehman cures and assigns, the counterparty may no longer terminate based on Lehman's prior defaults and Lehman no longer has any liability with respect to future performance of the contract.

Some counterparties might find particularly objectionable the fact that the proposed procedures do not require Lehman to identify its proposed assignee if it is a "qualified assignee." Accordingly, if the proposed procedures are approved, the only basis for objection to an assignment to a qualified assignee would be an objection to the cure amount.

Counterparties may also take issue with the tight objection deadline, which effectively allows only four business days to prepare and file an objection—particularly where calculation of cure amounts is required and the counterparty first needs to hire counsel.

Some counterparties also may object to the dispute resolution process, which can take weeks or more if litigation is involved (for example, over the qualifications of the assignee). Theoretically, the counterparty to an executory contract is entitled to a cure payment as of the date of the assumption of the contract. It is not clear who, if anyone, would be responsible for market movements during the time it takes to litigate or resolve a dispute if cure would require a payment larger than the amount that was determined the day before the original notice was sent.

The motion also contains proposed termination and settlement procedures. These procedures are consensual and, therefore, should be far less controversial than the assignment procedures. Generally, under the proposed procedures Lehman would be free to enter into and consummate a termination agreement with the counterparty without seeking the court approval that might otherwise be required when an entity in bankruptcy is settling a dispute and to settle claims where the counterparty has already terminated. A termination agreement can resolve amounts owing between the parties, provide for a release of the counterparty, and permit the collateral or margin held by Lehman or the counterparty to be liquidated or returned in accordance with the derivatives contract, a master netting agreement or the termination agreement itself.

Objections to the proposed procedures are due **Friday, November 28 by 4:00 p.m.** For more information or to object, please contact any of the following attorneys:

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