SEWARD & KISSEL LLP

DISTRESSED DEBT REPORT

Winter 2010

A publication of the Distressed Debt Group

LEHMAN TRADE CLAIMS 2010 FORECAST

The market for Lehman trade claims has been steadily expanding following the commencement of the Lehman Brothers insolvency proceedings in September 2008. Key factors that have been negatively impacting the trading volume of Lehman claims are the difficulty in accurately pricing such claims and the uncertainty as to how the claims will be administered in the United States and United Kingdom bankruptcy and insolvency proceedings. The third quarter of 2009 saw a significant number of sales of very sizeable Lehman claims, which has made pricing Lehman trade claims increasingly less problematic. The volume of Lehman trade claims is expected to increase dramatically in 2010 and will likely dominate the secondary market for trade claims. In addition, as described below, significant progress has been made as to how the Lehman assets will be administered in the United States and United Kingdom proceedings.

Investors who have an appetite for complexity may recognize substantial rewards from these trades in 2010.

Currently, the most heavily traded Lehman claims arise in connection with ISDA Master Agreements between creditors and certain Lehman entities. ISDA claimants typically entered into master agreements with either Lehman Brothers Special Financing, Inc. (LBSF) in the U.S. or Lehman Brothers International (Europe) (LBIE) in the U.K., pursuant to which such creditors participated in various derivative transactions. The obligations of LBSF and LBIE under the master agreements were generally guaranteed by the parent company, Lehman Brothers Holdings Inc. (LBHI). Consequently, most ISDA-based claims include both a direct claim against either LBSF or LBIE and a corresponding guarantee claim against LBHI, and such claims are typically purchased in tandem.

In the future, depending upon the result of various proceedings involving Lehman prime brokerage arrangements, we believe that prime brokerage trade claims may also be widely traded. U.S. creditors with prime brokerage arrangements with Lehman Brothers typically entered into a set of agreements with both Lehman Brothers Inc. (LBI) and LBIE, pursuant to which LBI transferred securities to LBIE, which securities were, in many cases, rehypothecated by LBIE to third parties. Many creditors with prime brokerage-related claims against Lehman filed customer claims against LBI in the liquidation proceeding taking place in the U.S. under the Securities Investor Protection Act (SIPA). Many of these prime brokerage creditors made demands against LBIE in its U.K. insolvency proceeding for the return of assets LBIE purports to have in its possession, as well as general unsecured claims in respect of securities that have been rehypothecated (and are thus irretrievable).

All of the claims deadlines for the Chapter 11 Lehman Brothers bankruptcy cases (which include the cases of LBSF and LBHI) elapsed by early November of 2009. On November 18, 2009, in their "State of the Estate" presentation, the Chapter 11 Lehman debtors indicated that they had received over 64,000 claims, totaling over $820 billion in the aggregate, including many claims in unliquidated amounts. More than 6,000 of those claims, approximating $111 billion in value, were filed in connection with ISDA Master Agreements and derivative contracts or guarantees thereof.

The Chapter 11 Lehman debtors anticipate that they will begin initial claim objections in the near future. In the meantime, they have been entering into "Termination Agreements" with many derivative contract claimants in order to compromise the allowed amounts of their ISDA claims.

As of November 6, 2009, the date of its last report, the SIPA trustee had made determinations with respect to 265 of the 1,162 prime brokerage claims filed against LBI. It is our understanding that the SIPA trustee has denied all of the prime brokerage claims filed by LBI customers whose securities were delivered to LBIE. Many of those customers have filed objections to these denials, and litigation over the validity of these claims and, in particular, the right of the claimants to "customer" status under SIPA is expected to be contentious.

The joint administrators for the LBIE administration indicated in their progress report in October 2009 that there are over 2,000 derivative contracts creditors with potential claims against LBIE. The progress report further noted that LBIE has almost 1,300 creditors with claims related to prime brokerage agreements, representing approximately $9.1 billion in value.

The LBIE joint administrators proposed in early 2009 to enact a "scheme of arrangement" under U.K. insolvency law with respect to non-cash customer assets. The objective of the scheme was to effectuate the return of securities still in LBIE's possession (often in connection with customer prime brokerage accounts) to the creditors that owned them. If the scheme had been approved by a requisite majority of impacted creditors and sanctioned by the U.K. High Court, it would have been binding upon all of LBIE's creditors. However, in August of 2009, the High Court ruled that it lacked the jurisdiction necessary to approve such a scheme, and in November, the administrators' appeal of the High Court's judgment was denied by the U.K. Court of Appeal.

In response to the failure of the scheme of arrangement, the LBIE joint administrators devised and recently obtained approval from more than 90% of the trust asset claimants for the Claim Resolution Agreement (CRA), which substantially achieves the goals of the original scheme by returning assets belonging to LBIE's customers that are currently in LBIE's possession. Claimants who have elected to participate in the CRA, many of whom own securities held by Lehman in connection with prime brokerage arrangements, will have until March 19, 2010 to submit claims in respect of such securities. The LBIE administrators have stated that they expect to begin making distributions of those assets currently under their control shortly after the March deadline.

The LBIE joint administrators have also asserted that they will return securities presently held by LBI, currently in administration under SIPA in the U.S., to the appropriate customers/claimants (*i.e.*, those LBI prime brokerage customers who had authorized the transfer of their securities to LIBE) once the administrators receive such assets from LBI.

The LBIE administrators have announced that creditors with general unsecured claims against LBIE (including ISDA claimants and creditors whose securities were rehypothecated by LBIE) will have until December 31, 2010 to submit claims, along with necessary supporting documentation. The administrators have asserted that they will begin making initial distributions in respect of these general unsecured claims within two months after the December 31 deadline.

Ion Media Networks Bankruptcy Case

On November 24, 2009, the Bankruptcy Court for the Southern District of New York issued a decision in the *Ion Media Networks* bankruptcy case that limits the ability of second lien lenders to challenge the liens held by first lien lenders and the plan of reorganization. This decision could have an impact on distressed debt traders' investment strategies in the second lien loan market. The Court also implied that a second lien lender who attempts to object to these terms could be liable for damages for breach of the intercreditor agreement.

> ***"This decision could have an impact on distressed debt traders' investment strategies"***

In 2005, the *Ion Media Networks* debtors incurred indebtedness secured by liens on their assets, which were alleged to include certain FCC licenses. On May 19, 2009, after reaching an agreement with a majority of the holders of first lien debt to swap their debt for nearly all of the equity in a newly capitalized company, the debtors filed for Chapter 11 bankruptcy protection to implement the restructuring.

Cyrus Select Opportunities Master Fund Ltd. (Cyrus), a second lien lender, objected to the assertion that the FCC licenses were part of the first lien lenders' collateral package and also objected to the proposed plan of reorganization. Cyrus argued that the FCC licenses did not belong exclusively to the first lien lenders, and that their value should be shared proportionally with all of the unsecured creditors, regardless of status. Cyrus also argued that FCC rules prevented anyone from having a security interest in FCC licenses, and therefore such licenses could not be included in the definition of collateral. The Court held that the Intercreditor Agreement contained clear language prohibiting Cyrus, as a second lien lender, from objecting on either ground.

The Court held that the FCC licenses were part of the collateral package because language included in the Intercreditor Agreement granted a first lien security interest "regardless of actual perfection." The Court pointed to language prohibiting the second lien holders from challenging "any nonperfection of any lien purportedly securing" the debtors' obligations. The apparent implication of this ruling is that any property purported to be collateral in a Chapter 11 plan will be deemed to be collateral to the same extent as any asset that truly fits the definition of collateral unless such property is specifically excluded as collateral under an intercreditor agreement.

The Court also did not allow Cyrus to object to the reorganization plan in its capacity as a general unsecured creditor. The Court relied on a provision in the Intercreditor Agreement that prohibited the second lien lenders from opposing or objecting to any party's plan of reorganization which awarded priority to the first lien lenders unless the first lien lenders were paid in full.

Driving the Court's decision was a desire to prevent what it considered to be unnecessary litigation. The Court also reasoned that interpreting the language of the Intercreditor Agreement in an unambiguous way would lead to more predictability in reorganizations and, therefore, more economic stability.

The decision heavily favors first lien lenders (and the debtors that make a deal with them) and significantly limits the options of "silent" second lien lenders in Chapter 11 bankruptcy cases. It also suggests that intercreditor agreements should state specifically what asset classes are to be excluded from the definition of collateral so that parties will know precisely what assets are subject to lien subordination and what assets are not. The decision broadly restricts a second lien lender's rights (even when acting in its capacity as a general unsecured creditor) to contest to a plan of reorganization supported by the first lien lenders.

The *Ion Media Networks* decision means that distressed debt traders who are active in the second lien loan market will have to carefully review the terms of the intercreditor agreement with the first lien lenders in order to determine precisely what leverage, if any, they will have to contest the priority given to the senior lenders' claims in a Chapter 11 plan.

Washington Mutual Bankruptcy Case

On December 2, 2009, the Delaware Bankruptcy Court held that a group of noteholders in the *Washington Mutual* case was acting as an *ad hoc* committee representing multiple creditors and was therefore required to make public disclosures under Federal Rule of Bankruptcy Procedure Rule 2019 ("Rule 2019") (which requires members of an *ad hoc* committee representing multiple creditors to publicly disclose details of their holdings). The Court also noted that similarly situated creditors forming a group or *ad hoc* committee to act collectively may owe fiduciary duties to other similarly situated creditors. While the decision has been appealed, if upheld it could require greater disclosure by distressed debt traders if they join such committees.

On September 26, 2008, Washington Mutual, Inc. filed for Chapter 11 bankruptcy. The WMI Noteholders Group, comprised of 23 different entities which collectively held over $1.1 billion of notes issued by the Debtor, actively participated in the Debtor's case and engaged counsel to represent the group as a whole. JP Morgan Chase Bank, National Association, which had purchased the assets of one of the Debtor's subsidiaries, filed a motion to compel the WMI Noteholders Group to comply with Rule 2019 and disclose their individual positions in the WMI Notes. The WMI Noteholders Group opposed the motion on the grounds that the WMI Noteholders Group was not an "entity or committee representing more than one creditor" and was therefore not subject to Rule 2019.

The Court disagreed. It held that, under the plain language of Rule 2019, the WMI Noteholders Group was in fact an *ad hoc* committee and therefore subject to the Rule 2019 disclosure requirements. According to the decision, *ad hoc* committees like the WMI Noteholders Group can exercise significant influence over Chapter 11 cases by combining each member's holdings and acting collectively. This decision is of particular concern for distressed debt traders and other investors who are looking to take active positions in Chapter 11 cases by participating in a group or on an *ad hoc* committee, and prefer to keep their positions out of the public eye. Rule 2019 was enacted in response to concerns regarding the "actual economic interest" of parties holding considerable (at times controlling) positions in Chapter 11 cases. The Court noted that it is particularly important for members of *ad hoc* committees that leverage their individual holdings to assert greater influence over Chapter 11 cases and other large creditors who obtain "multiple stakes in the capital structure of debtors" to disclose their interests.

> ***"This decision is of particular concern for distressed debt traders and other investors who are looking to take active positions in Chapter 11 cases and prefer to keep their positions out of the public eye"***

By making such parties subject to Rule 2019, they will now be required to disclose, among other things, the amount and time of acquisition of their claims or interests, and the price paid to purchase such claims or interests. Moreover, these initial disclosures will have to be updated regularly to reflect any material changes in the information provided.

The Court's decision went on to state that a group of similarly situated creditors who take collective action may have fiduciary duties to other creditors in the same class. Although the Court declined to address the specific nature or particular scope of these duties, it can be expected that in an appropriate case some obligation to advance the rights of other creditors in the same class will likely be found to exist.

Finally, the Court indicated its support for the amendments to Rule 2019 proposed by the Advisory Committee on Bankruptcy Rules, which would increase the existing disclosures and could cause further issues for distressed debt traders and investors. Should the proposed amendments become effective, *ad hoc* committee members will also be required to disclose short sales, derivative instruments, and other hedges that influence their positions in Chapter 11 proceedings.

Though limited to Delaware, the *Washington Mutual* decision parallels a similar development in the United States Bankruptcy Court for the Southern District of New York and could be a seminal case in other jurisdictions' interpretation of Rule 2019.

Heads up:

- **Recourse vs. Non-Recourse Trading of Lehman Claims.** In the current market, Lehman claims are trading on both a recourse and non-recourse basis, with recourse claims commanding higher price levels. Although recourse sellers benefit by receiving price premiums, non-recourse sellers can take satisfaction in transaction finality with regard to liability risks related to disallowance of the claim in whole or in part.

- **LSTA Shift Date Rules.** The Loan Syndications and Trading Association (LSTA) published new rules regarding Shift Dates, which went into effect on January 12, 2010. The new procedure ends the practice of Shift Date Polls; instead, the LSTA will determine the Par Shift Dates and Distressed Shift Dates, and such determinations will be binding on market participants. The LSTA has also updated trade forms to reflect the new Shift Date procedures.

- **LMA New Combined Documents.** The Loan Market Association (LMA) has revised trading documentation, the effect of which will result in par trades being subject to a number of distressed debt terms. The revised trading documents have gone into effect as of January 25, 2010.

- **Lock-up Agreements.** Plan support agreements (also known as lock-up agreements) have become more common in the current economic environment. Investors must weigh a number of considerations when deciding whether or not to become a consenting lender under such agreements, including the effect it may have on pending trades, as a decision on whether or not to become a consenting lender may constrain the pool of potential buyers.

SEWARD & KISSEL LLP

If you have any questions or comments about this Newsletter, please feel free to contact any of the attorneys in our Distressed Debt Group via telephone at (212) 574-1200 or e-mail by typing in the attorney's last name followed by **@sewkis.com**.

Distressed Debt Group

Partners

Greg B. Cioffi
Kalyan ("Kal") Das*
Ron Cohen
Craig Hickernell
John Ashmead

Counsel

Renée Eubanks
Arlene R. Alves

* Admitted also in the United Kingdom, Australia and India

This edition of the newsletter may be found on the web at www.sewkis.com under Publications.

SEWARD & KISSEL LLP
One Battery Park Plaza, New York, New York 10004
Telephone: (212) 574-1200 **Fax:** (212) 480-8421
Electronic Email: sknyc@sewkis.com
www.sewkis.com