



Wrapping Up Lehman

The implications of PwC's scheme of arrangement

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At 7:56 am (London time) on 15th September 2008 administration proceedings were commenced for Lehman Brothers International (Europe) (LBIE). Tony Lomas, Steven Pearson, Dan Schwarzmann and Mike Jervis, all partners at PricewaterhouseCoopers LLP, were promptly appointed to be the joint administrators for LBIE and its affiliated entities in administration and have since served in that role. Since the commencement of LBIE's administration proceedings, virtually all of the billions of dollars in assets belonging to LBIE's prime brokerage customers have been trapped at LBIE. Now, nearly 10 months later, there appears finally to be a potential end in sight to this all too injurious freeze on customer assets.

LBIE's former businesses

Prior to 15th September 2008, one of LBIE's primary business functions was to serve as prime broker to a significant number of hedge funds, institutional investors and other clients. LBIE offered many services to its prime brokerage customers, including, among others, execution, clearing and settlement of trades, and custody, financing, foreign exchange, securities lending and valuation services. LBIE generally held customer assets as a custodian, with customers retaining a proprietary interest in the custodied assets. In many cases, legal title to the assets passed to LBIE; in those instances in which it did not, the assets became subject to a security interest in favor of LBIE. (Generally, LBIE did not hold assets itself, but rather through third party depositories, exchanges, clearing systems and sub-custodians.) LBIE thus provided its clients with the equivalent of many of the back-office functions that other, larger investors are able to handle in-house. Because many of LBIE's prime brokerage customers relied heavily on LBIE for critical financial and operational matters, they were particularly distressed when LBIE commenced its administration proceedings, more so than they may have been in the context of insolvency proceedings for any other service provider. The devastation suffered by LBIE's customers has only been exacerbated during the ensuing 10 months by their frustration at being subject to a continuing moratorium on the return of their assets.

As noted by Steven Pearson in a February 2009 statement, the joint administrators have faced numerous complex obstacles in their efforts to distribute trust property to LBIE's customers. There currently are no facile means to determine with confidence a given customer's entitlement to trust property; the joint administrators, therefore, have been reluctant to distribute assets for fear of liability for making improper distributions of trust property. Further, recipients of trust property have faced the spectre of claims being asserted against them by other LBIE customers in respect of distributions of trust property. The obstacles to distribution have arisen, in part, because not all LBIE creditors have

responded to requests for information from the joint administrators, the joint administrators cannot rely upon LBIE's books and records, and LBIE's custodians, depositories, and affiliates have not provided all of the information that has been requested from them by the joint administrators. With complete information absent, the piecemeal resolution of customer claims is necessarily tainted by clouds of uncertainty.

PwC's actions on 14th July 2009

On 14th July 2009, the joint administrators took a significant step forward in their efforts to unfreeze and return customer assets. On that day, they applied to the High Court in London for directions with respect to a potential scheme of arrangement designed, among other things, to provide procedures for use by LBIE to more rapidly deliver so-called "trust property" (i.e. segregated assets, derived assets or recovered assets held in custody at LBIE) to certain of its prime brokerage and other customers, or scheme creditors. The joint administrators also filed on 14th July an 86-page *Summary of the Principal Terms and Effect of the Scheme of Arrangement*, a detailed description of the scheme, the actual terms of which will be contained in a further scheme document to ultimately be distributed to scheme creditors. The summary details the purpose, understanding and operation of the scheme, which itself is the result of protracted negotiations between and among a working group consisting of the joint administrators and the members of a creditor's committee appointed in the administration proceedings, and their respective advisors.

The scheme is, in essence, a contractual compromise of claims between LBIE and the affected scheme creditors. Its primary objective is to facilitate, through the imposition of a bar date for submitting final claims and the development of processes for the valuation and reconciliation of these claims, the joint administrators' ability to return client assets much more promptly and efficiently than had previously been thought possible. Indeed, the joint administrators currently anticipate that if the scheme is approved by the scheme creditors on the expected timetable, they will be in a position to begin the wide-scale return of trust property to customers in the first quarter of 2010. The scheme would accomplish this, in part, by eliminating the need for a case-by-case resolution of customer claims, a process that has proven to be both slow and laborious to date.

Timing and process

An initial hearing on the court's jurisdiction with respect to the scheme is currently scheduled to take place at the end of July. If the court rules favourably, the joint administrators anticipate that a series of additional court hearings and creditors' meetings will be held in September and October, culminating in a creditors' meeting at which scheme creditors

will be asked to vote to approve the scheme. Even if the scheme is approved by the requisite number of scheme creditors (more than 50% of those in attendance at the creditors' meeting) holding the requisite amount of claims (more than 75% in value of the claims held by those scheme creditors in attendance), there will be an opt-out provision that would enable such opt-outs to become unsecured LBIE creditors, whose claims will be treated outside the scheme. LBIE has worked with its creditors' committee to develop a scheme that compromises the scheme creditors' existing claims and provides them with new scheme claims that carry with them the right to share in the LBIE trust property. Should there be a large number of opt-outs, the efficacy of the scheme clearly could be compromised.

The proposed scheme

The joint administrators anticipate that approval and implementation of the scheme will "significantly expedite" the return of customer assets to scheme creditors and avoid an unpredictable, tedious, and costly trust property claims resolution process. Significantly, however, the joint administrators caution that the scheme is not intended to provide for the treatment of all claims against LBIE. Rather, the scheme is intended to streamline and standardize the claims resolution process with respect to trust property claims held by LBIE customers. The goal of the scheme, therefore, is to provide certainty with respect to a certain pool of assets (i.e. trust property) and finality with respect to customers' entitlements to these assets, thereby avoiding potential pitfalls relating to, among other things, shortfalls in assets to which numerous customers have claims, valuation questions, and the legal and practical effects of the termination of various types of financial contracts.

Scheme creditors

Under the proposed scheme, only scheme creditors will be entitled to seek the return of trust property. Accordingly, the definition of "scheme creditor" is a critical facet of the scheme. The proposed scheme provides that a scheme creditor is a creditor with a proprietary claim to segregated securities held in trust by LBIE at the time LBIE commenced its administration proceedings that could have been satisfied on that date by the delivery of such segregated assets. The joint administrators' expectation is that the scheme will apply to more than 1,000 scheme creditors and ultimately lead to the return of approximately \$13 billion in trust property.

Once a claimant is confirmed as a scheme creditor, then all of the scheme creditor's claims will be resolved through the scheme. Its existing claims against LBIE will be exchanged for new scheme claims, including the right to have contractual positions, allocations and distributions determined through the scheme. All other claims of such scheme

creditors (i.e. all claims other than the new scheme claims, such as claims for damages, indemnification, or breach of contract) will be released, so that scheme creditors' only means of receiving trust property will be through the vehicle of the scheme itself. Each scheme creditor, therefore, will no longer have the ability to challenge the scheme or to proceed against LBIE outside of the dispute resolution mechanisms set forth in the scheme. Claimants possessing only unsecured claims against LBIE, but not proprietary claims to segregated assets, will not become scheme creditors. Nor will creditors whose relationship with LBIE does not arise out of a custody or prime brokerage arrangement. Further, any cash held by LBIE has been or will be distributed outside of the context of the scheme; the scheme thus does not affect claims to funds held by LBIE on 15th September 2008.

Scheme objectives and provisions

The scheme's specific objectives include (i) setting a bar date after which most trust property claims could no longer be asserted against LBIE (currently proposed to be 31st December 2009 or, if approval of the scheme is delayed beyond 31st October 2009, the last business day of the second full calendar month after the scheme is approved); (ii) establishing a mechanism to determine and value creditors' claims (a pro forma claim form allowing for uniformity of claims will be prepared and assets will be valued at either (a) sale price, (b) mid-market price, or (c) fair market value, as determined in good faith by the scheme Supervisors); (iii) establishing a means to determine contractual positions of claimants to trust property; (iv) developing a methodology to determine the necessary level of reserves that must be retained to satisfy as yet unresolved claims; (v) predicting costs for the management and distribution of assets held in trust by LBIE; (vi) effecting distributions to scheme creditors (as trust property becomes available for distribution, it will be allocated to scheme creditors in proportion to their asset claims); (vii) sorting through relevant information to determine how to effect the scheme; (viii) compromising all potential

non-excluded claims; (ix) establishing a dispute resolution procedure with referrals to a valuation expert, an independent adjudicator, or the court; and (x) determining the value and crystallizing any unsecured claims of scheme creditors.

The joint administrators intend that the scheme will be completed, with all trust property claims resolved, within five years of its effective date. The scheme will be managed and administered by the scheme Supervisors, initially Steven Pearson, Tony Lomas and Anthony John Kett, each of whom is a qualified insolvency practitioner, who will be empowered with all the authority of the joint administrators and will be charged with making the determinations and calculations required to be made by LBIE under the scheme. A scheme committee, consisting of between three and five scheme creditors will receive periodic reports from the scheme supervisors regarding the scheme's progress and, presumably, serve as the liaison between the scheme supervisors and the scheme creditors.

As previously noted, the bar date for the submission of claims is currently anticipated to be 31st December 2009, or two full months after the anticipated 31st October 2009 approval (or effective) date, i.e. the date the Court order sanctioning the scheme is delivered to the Registrar of Companies in England and Wales) of the scheme. Should the effective date occur after 31st October 2009, the claims bar date will be the last business day of the second full calendar month following the effective date of the scheme. If the effective date does not occur before 30th June 2010, the scheme will be discarded; however, that would not preclude the proposal of a new scheme by the joint administrators. The scheme will cease to operate five years after the effective date, unless the scheme supervisors select an earlier date or, in consultation with the scheme committee, determine a later date to close the scheme.

The joint administrators intend, from time-to-time, to identify assets that constitute trust property that will

be distributed to scheme creditors. The allocation of such assets will be made on a stock line by stock line basis, as determined by LBIE in its sole discretion. All scheme creditors submitting a claim to a particular asset held by LBIE will then share in the allocation of that asset on a proportionate basis. Claims will be paid out in US dollars and, subject to certain prescribed limitations, the costs of the conduct and operation of the scheme and management of the trust property will be deducted from each scheme creditor's allocated distribution amount.

Included in the summary of the scheme is a useful set of charts to assist LBIE customers in understanding, among other things, which customers will be scheme creditors, what constitutes a scheme creditor's asset claim, the proposed methodologies for the determination and valuation of claims, the proposed means of determining the allocation of assets to scheme creditors and the timing of the allocation determination, and the procedures for the ultimate distribution of assets.

The joint administrators have advised that further information with respect to the scheme will be made available at the LBIE section of PwC's website, as well as in advertisements to be placed in the Wall Street Journal and the Financial Times. While it is clear from the summary and its appendices that the joint administrators and the LBIE creditors' committee have expended significant time and resources to developing a viable means of ensuring the smooth unwinding and return of the LBIE trust property assets, only time will tell whether LBIE's creditors will approve the scheme or whether there remain more years of protracted claims resolution negotiation or litigation with the joint administrators regarding the customer assets that to date remain frozen at LBIE. **THF**

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NOTES

1. In the UK and other common law countries, "administration" is the term used for allowing insolvent companies to carry on their business without going into liquidation while efforts are made to rehabilitate the company. Should it ultimately be determined that rehabilitation is feasible, the administrators are charged with seeking to achieve the best result for all creditors. By commencing administration proceedings, LBIE sought to avoid a haphazard fire sale and, instead, to effectuate an orderly return of assets to its customers.
2. The joint administrators have written to more than 1,700 customers with potential claims for the return of trust property in an effort to gather the information necessary to determine the universe of trust property claims against LBIE. As of 29th May 2009, they had received only approximately 950 responses to their requests.
3. A scheme of arrangement is the administration proceeding's analogue to a plan of reorganization in a Chapter 11 case under the US Bankruptcy Code.
4. As Steven Pearson, one of the Joint Administrators, told the Financial Times on 15th July 2009, "[T]his is probably the most complex scheme out there." Lehman's European clients

set for claims filing, *Financial Times*, 15th July 2009. Pearson also noted that the joint administrators prepared at least 30 drafts before submitting the scheme summary to the High Court.

5. Importantly, persons or entities that are not designated as scheme creditors but that wish to assert a claim to trust property must do so in accordance with the scheme.
6. The failure to file a claim form by the claims bar date will not automatically extinguish a scheme creditor's right to receive distributions under the scheme. Rather, it would provide the scheme supervisors the opportunity to make a determination regarding the scheme creditor's claim based solely on relevant information in LBIE's possession (as opposed to information contained in a scheme creditor's claim form). The bar date is simply a final date for the submission of claims; it does not bar the joint administrators from considering potential claims not timely submitted or received.
7. The complete summary of the scheme is available at http://www.pwc.co.uk/pdf/lehman_mini_es_140709v2.pdf. The official (and abbreviated) summary may be found at http://www.pwc.co.uk/pdf/lehman_summary_document_140709v2.pdf.