

Applicants
D. N. Swanson
First Statement
"DNS1"
9 June 2010

IN THE HIGH COURT OF JUSTICE

No. 7942 of 2008

CHANCERY DIVISION

COMPANIES COURT

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (in administration)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

FIRST WITNESS STATEMENT

OF

DAVID NELS SWANSON

I, DAVID NELS SWANSON, of Lehman Brothers International (Europe) (in administration) ("LBIE"), Level 23, 25 Canada Square, London, E14 5LQ state as follows.

A. INTRODUCTION

1 Since August 1999, I have been a member of LBIE's legal department. Following LBIE's entry into Administration, I was retained by Anthony Victor Lomas, Steven Anthony Pearson, Michael John Andrew Jervis, Dan Yoram Schwarzmann and Derek Anthony Howell who are the joint administrators of LBIE (the "Administrators"), to assist them in the conduct of LBIE's administration. I am duly authorised to make this witness statement on behalf of LBIE and the Administrators.

2 I make this statement in support of the Administrators' application (the "Application") for orders and directions seeking clarification on the construction of certain provisions in the ISDA Master Agreements (as defined below). Terms defined in the ISDA Master Agreements have the same meanings in this Witness Statement.

3 There is now shown to me a paginated bundle of copy documents, marked “DNS1”, to which I refer in this witness statement. Where no cross reference to the paginated bundle is provided and where there is no other indication of the source of my information or belief, the contents of this witness statement are derived from facts and matters which are within my own knowledge and belief. These facts and matters have been learned in my capacity as a member of LBIE’s legal department prior to its administration or as a result of the work undertaken by me in assisting the Administrators, or they have been provided to me either by the Administrators, members of LBIE’s Capital Markets Contracts Legal Documentation department or LBIE’s Street Counterparties Team, or by the Administrators’ legal advisers, Linklaters LLP (“Linklaters”).

4 Nothing in this Witness Statement is intended to waive privilege in respect of any matter referred to, and privilege is not being waived.

B. ISDA MASTER AGREEMENT

5 Prior to LBIE entering administration on 15 September 2008, it entered into a high volume of derivatives transactions with a wide range of counterparties. In most cases, these transactions were documented under an ISDA Master Agreement, Multicurrency-Cross Border version (a “**1992 ISDA Master Agreement**”), published in 1992 by the International Swaps and Derivatives Association, Inc. (“**ISDA**”), or an ISDA 2002 Master Agreement, published in 2002 by ISDA (a “**2002 ISDA Master Agreement**” and, together with the 1992 ISDA Master Agreement, each an “**ISDA Master Agreement**”). A copy of each of the 1992 ISDA Master Agreement and the 2002 ISDA Master Agreement is provided at pages 1 to 60 of DNS1.

6 The ISDA Master Agreements are the most widely used agreements for documenting derivatives transactions in the derivatives market. According to the Bank For International Settlements, as of December 2009 the total notional amount outstanding of over-the-counter derivatives transactions globally was USD 614,674 billion, carrying a gross market value of USD 21,583 billion. It is likely that the vast majority of these were governed by an ISDA Master Agreement. Consequently, the construction of provisions within the ISDA Master Agreements is of key importance to all market participants.

7 In general terms, the ISDA Master Agreements allow parties to enter into any number of derivatives transactions on certain standard terms. These standard terms can be applied, disappplied, amended or supplemented by the parties if they specify

the application, amendment or supplement in the schedule to the ISDA Master Agreement. For example, the parties are required to specify the governing law of the ISDA Master Agreement that will apply to transactions between them under that agreement. The governing law is typically either English law or New York law.

- 8 Each ISDA Master Agreement contains provisions allowing one or both parties, upon the occurrence of certain events, to terminate (close out) the transactions entered into under it.
- 9 Other than where First Method is applicable under a 1992 ISDA Master Agreement (which provides that, if the Non-Defaulting Party is out of the money, no amount is payable by it under the 1992 ISDA Master Agreement following a close-out), the effect of the close-out provisions in the ISDA Master Agreements is to entitle one party to a payment following a close-out where, on a net basis, the transactions are in the money in favour of that party, whether or not that party is the Defaulting Party. Provision for the application of First Method is not included in the 2002 ISDA Master Agreement.
- 10 The use of First Method under a 1992 ISDA Master Agreement is uncommon and applied to very few of LBIE's ISDA Master Agreements that were outstanding when it entered administration.
- 11 Section 2(a)(iii) of each ISDA Master Agreement provides that, amongst other things, where an Event of Default occurs with respect to one party (the Defaulting Party) to the ISDA Master Agreement, the other party (the Non-Defaulting Party) is not required to make further payments or deliveries to the Defaulting Party, effectively protecting the Non-Defaulting Party from having to increase its exposure to the (prospective) Defaulting Party while a Potential Event of Default exists with respect to that party or, if it does not elect to terminate the ISDA Master Agreement and close out the outstanding transactions, following the occurrence of an Event of Default with respect to the Defaulting Party.
- 12 Once a close-out of the transactions entered into under an ISDA Master Agreement occurs, any amounts not paid, or deliveries not made, as a result of the operation of Section 2(a)(iii) are taken into account in determining which party, on a net basis, is in the money and which party is out of the money under the relevant ISDA Master Agreement, for the purpose of determining what amount is payable by one party to the other in respect of the close-out.

- 13 At the time that LBIE entered administration, approximately 2,000 of its ISDA Master Agreements had outstanding transactions under them. All the transactions under at least 1,693 of these have been closed out. Such close-outs took place even where the party effecting the close-out was out of the money and would be required to make a close-out payment to LBIE.
- 14 Concern that a Non-Defaulting Party may opt not to close out the transactions under a Master Agreement for a long period, or indefinitely, in reliance on Section 2(a)(iii) has been expressed by HM Treasury in paragraphs 7.7 to 7.14 of its Consultation Paper, *Establishing Resolution Arrangements for Investment Banks* (December 2009), a copy of which is at **pages 61 to 215 of DNS1**. The possibility of a counterparty taking such a position has been identified by HM Treasury as an issue of such concern that, if a market solution is not found, legislation is likely to be required to prevent such a position being taken by a Non-Defaulting Party in future insolvencies (see paragraph 7.14 of the Consultation Paper at **page 176 of DNS1**).
- 15 In the United Kingdom, Rule 13.7.9 of the Financial Services Authority's Prudential Sourcebook for Banks, Building Societies and Investment Firms ("BIPRU") provides that:
- "a firm must not recognise as risk-reducing any contract containing a provision which permits a non-defaulting counterparty to make limited payments only, or no payments at all, to the estate of the defaulter, even if the defaulter is a net creditor ("walkaway" clause)".*
- If Section 2(a)(iii) is to be construed as a walkaway clause it will have severe regulatory implications for many market participants.
- 16 The effect of Section 2(a)(iii) operating as a walkaway clause would be to require banks, building societies and investment firms that are subject to BIPRU and that have been calculating their regulatory capital on a net basis (which is generally the case) to set aside more regulatory capital against transactions entered into by them pursuant to an ISDA Master Agreement. This would be costly and, therefore, it is unlikely that any such party would have understood Section 2(a)(iii) (or any other provision within an ISDA Master Agreement) to fall foul of BIPRU 13.7.9. Similar provisions appear in the rules of the other European regulators.
- 17 Whilst the focus of the Application must be the English law construction of Section 2(a)(iii), in *In re Lehman Brothers Holdings, Inc.*, Case No. 08-13555 et seq. (JMP) (jointly administered), a bench ruling on September 15, 2009 which concerned a

New York law-governed ISDA Master Agreement, the Bankruptcy Court for the Southern District of New York ruled that, amongst other things, the rights of a Non-Defaulting Party to withhold periodic scheduled payments due to a Defaulting Party in reliance on Section 2(a)(iii) indefinitely is improper under US bankruptcy law when triggered by a Bankruptcy Event of Default (a copy of the judgment is at **pages 216 to 385 of DNS1**). Section 2(a)(iii) is applicable regardless of whether English or New York law is specified to govern an ISDA Master Agreement and has its origins in the conditions precedent to the original New York law-governed ISDA Code of Standard Wording, Assumptions and Provisions for Swaps published in 1985.

- 18** As I explain in further detail below, I understand that FR Acquisitions Corporation (Europe) Limited, JFB Firth Rixon, Inc., BEIG Midco Limited (formerly Liberator Midco Limited) and KP Germany Zweite GmbH (formerly Dido Erste Vermögensverwaltungs-GmbH) have relied on Section 2(a)(iii) to avoid obligations that otherwise would have accrued and will otherwise accrue to LBIE's favour under their respective outstanding derivative transactions. The purpose of this Application is to determine whether Section 2(a)(iii) should be construed and has the effect of allowing Non-Defaulting Parties (such as the parties listed above) to withhold payments or deliveries indefinitely, and if so, what steps the Administrators might take to overcome its obviously damaging consequences for LBIE.

C. FACTUAL BACKGROUND

- 19** There is now shown to me (i) a long-form confirmation entitled "Amended Forward Starting 3 Year Contingent GBP Swap Transaction" and dated 28 April 2008, which was executed by FR Acquisitions Corporation (Europe) Limited and LBIE (the "**FRAC Confirmation**"), a copy of which is at **pages 386 to 390 of DNS1**, (ii) a Novation Confirmation dated 29 August 2008 (the "**JFB Confirmation**"), evidencing the novation to JFB Firth Rixon, Inc. of the rights and obligations of FR Acquisitions Corporation (Europe) Limited under a transaction originally entered into between FR Acquisitions Corporation (Europe) Limited and LBIE, a copy of which is at **pages 391 to 396 of DNS1**, (iii) a long-form swap confirmation entitled "2nd Revised Transaction" and dated 30 January 2007, which was executed by Liberator Midco Limited (now BEIG Midco Limited) and LBIE (the "**LM Confirmation**"), a copy of which is at **pages 397 to 400 of DNS1**, (iv) a long-form swap confirmation entitled "Transaction" and dated 4 December 2007, which was executed by Dido Erste Vermögensverwaltungs-GmbH (now KP Germany Zweite GmbH) and LBIE

(the "First Dido Confirmation"), a copy of which is at pages 401 to 403 of DNS1, and (v) a long-form swap confirmation entitled "1st Revised Transaction" and dated 21 January 2008, which was executed by Dido Erste Vermögensverwaltungs-GmbH (now KP Germany Zweite GmbH) and LBIE (the "Second Dido Confirmation"), a copy of which is at pages 404 to 407 of DNS1.

The FRAC Transaction

- 20 The FRAC Confirmation evidences an interest rate derivative transaction (the "FRAC Transaction") entered into under a 1992 ISDA Master Agreement incorporated by reference, and as amended, therein.
- 21 The terms of the FRAC Transaction, as set out in the FRAC Confirmation, provide that:
- (i) FR Acquisitions Corporation (Europe) Limited will pay to LBIE a Fixed Amount each quarter in GBP equal to the Notional Amount multiplied by 5.555 per cent. and multiplied by a Day Count Fraction of Actual/365 (Fixed); and
 - (ii) LBIE will pay to FR Acquisitions Corporation (Europe) Limited a Floating Amount each quarter in GBP equal to the Notional Amount multiplied by a floating rate, determined on a quarterly basis by LBIE in accordance with the Confirmation, and multiplied by a Day Count Fraction of Actual/365 (Fixed).
- 22 Prior to LBIE entering administration, LBIE made net payments to FR Acquisitions Corporation (Europe) Limited of the following amounts as they fell due:
- (i) GBP 139,445.03 on, or around, 20 March 2008; and
 - (ii) GBP 103,563.02 on, or around, 20 June 2008.
- 23 Since LBIE entered administration, LBIE failed to make net payments to FR Acquisitions Corporation (Europe) Limited of the following amounts as they fell due:
- (i) GBP 98,474.66 on, or around, 22 September 2008; and
 - (ii) GBP 107,766.44 on, or around, 22 December 2008.
- 24 Since LBIE entered administration, FR Acquisitions Corporation (Europe) Limited has withheld net payments to LBIE of the following amounts (determined as described in Paragraph 21, above):
- (i) GBP 600,087.67 on, or around, 20 March 2009;

- (ii) GBP 930,616.10 on, or around, 22 June 2009;
- (iii) GBP 1,024,669.35 on, or around, 21 September 2009;
- (iv) GBP 1,179,952.50 on, or around, 21 December 2009; and
- (v) GBP 1,172,847.02 on, or around, 22 March 2010.

25 FR Acquisitions Corporation (Europe) Limited has not closed out the FRAC Transaction and is relying on Section 2(a)(iii) to withhold payment of the amounts set out in Paragraph 23. FR Acquisitions Corporation (Europe) Limited's intention to continue to rely on Section 2(a)(iii) has been confirmed by the legal advisers Macfarlanes LLP in a letter to Linklaters dated 23 April 2010, a copy of which is at page 408 of DNS1.

The JFB Transaction

26 On 31 July 2008, the rights and obligations of FR Acquisitions Corporation (Europe) Limited under an interest rate transaction entered into with LBIE were novated to JFB Firth Rixon, Inc. pursuant to the JFB Confirmation. Exhibit A of the JFB Confirmation sets out the terms of the interest rate derivative transaction (the "**JFB Transaction**") applicable to both JFB Firth Rixon, Inc. and LBIE following the novation. The JFB Transaction is governed by a 1992 ISDA Master Agreement incorporated by reference therein.

27 The terms of the JFB Transaction, as set out in the JFB Confirmation, provide that:

- (i) JFB Firth Rixon, Inc. will pay to LBIE a Fixed Amount each quarter in USD equal to the Notional Amount multiplied by 4.3655 per cent. and multiplied by a Day Count Fraction of Actual/360; and
- (ii) LBIE will pay to JFB Firth Rixon, Inc. a Floating Amount each quarter in USD equal to the Notional Amount multiplied by a floating rate, determined on a quarterly basis by LBIE in accordance with the Confirmation, and multiplied by a Day Count Fraction of Actual/360.

28 Prior to both LBIE entering administration and the JFB Transaction being novated to JFB Firth Rixon, Inc., FR Acquisitions Corporation (Europe) Limited and LBIE made net payments of the following amounts as they fell due:

- (i) USD 921,343.40 on, or around, 20 March 2008 from LBIE to FR Acquisitions Corporation (Europe) Limited; and

- (ii) USD 3,029,235.44 on, or around, 20 June 2008 from FR Acquisitions Corporation (Europe) Limited to LBIE.
- 29** Since LBIE entered administration, JFB Firth Rixon, Inc. has withheld payment to LBIE of the following amounts (determined as described in Paragraph 27, above):
- (i) USD 2,652,758.33 on, or around, 22 September 2008;
 - (ii) USD 1,908,819.79 on, or around, 22 December 2008;
 - (iii) USD 4,513,238.89 on, or around, 20 March 2009;
 - (iv) USD 5,224,050.00 on, or around, 22 June 2009;
 - (v) USD 6,172,548.96 on, or around, 21 September 2009;
 - (vi) USD 6,693,183.97 on, or around, 21 December 2009; and
 - (vii) USD 6,756,441.61 on, or around, 22 March 2010.
- 30** JFB Firth Rixon, Inc. has not closed out the JFB Transaction and is relying on Section 2(a)(iii) to withhold payment of the amounts set out in Paragraph 29. JFB Firth Rixon, Inc.'s intention to continue to rely on Section 2(a)(iii) has been confirmed by the legal advisers Macfarlanes LLP in a letter to Linklaters dated 23 April 2010, a copy of which is at **page 408 of DNS1**.

The LM Transaction

- 31** The LM Confirmation evidences an interest rate derivative transaction (the "**LM Transaction**") entered into under a 1992 ISDA Master Agreement incorporated by reference, and as amended, therein.
- 32** The terms of the LM Transaction, as set out in the LM Confirmation, provide that:
- (i) Liberator Midco Limited will pay to LBIE a Fixed Amount on 20 November 2006, 8 December 2006 and semi-annually thereafter on the last calendar day of each of June and December (adjusted to account for business days) in GBP equal to the Notional Amount multiplied by 5.1705 per cent. and multiplied by a Day Count Fraction of Actual/365 (Fixed); and
 - (ii) LBIE will pay to Liberator Midco Limited a Floating Amount in GBP equal to the Notional Amount multiplied by a floating rate, determined for the period between the Effective Date and 20 November 2006, the period between 20 November 2006 and 8 December 2006 and thereafter for successive six-

month periods by LBIE in accordance with the Confirmation, and multiplied by a Day Count Fraction of Actual/365 (Fixed).

33 Prior to LBIE entering administration, both Liberator Midco Limited and LBIE made net payments of the following amounts as they fell due:

- (i) GBP 2,944.73 on, or around, 20 November 2006 from Liberator Midco Limited to LBIE;
- (ii) GBP 7,036.35 on, or around, 8 December 2006 from Liberator Midco Limited to LBIE;
- (iii) GBP 2,946.05 on, or around, 29 December 2006 from LBIE to Liberator Midco Limited;
- (iv) GBP 390,575.64 on, or around, 29 June 2007 from LBIE to Liberator Midco Limited;
- (v) GBP 1,476,025.71 on, or around, 31 December 2007 from LBIE to Liberator Midco Limited; and
- (vi) GBP 1,175,261.77 on, or around, 30 June 2008 from LBIE to Liberator Midco Limited.

34 Since LBIE entered administration, LBIE failed to make a net payment to Liberator Midco Limited of the following amount as it fell due:

GBP 1,533,151.73 on, or around, 31 December 2008.

35 Since LBIE entered administration, Liberator Midco Limited has withheld net payments to LBIE of the following amounts (determined as described in Paragraph 33, above):

- (i) GBP 3,379,700.61 on, or around, 30 June 2009; and
- (ii) GBP 5,857,332.39 on, or around, 31 December 2009.

36 Liberator Midco Limited has not closed out the LM Transaction and I believe that it is relying on Section 2(a)(iii) to withhold payment of the amounts set out in Paragraph 35. The Administrators have written to Liberator Midco Limited twice seeking payment of the amounts owed to LBIE but they have received no response (copies of the Administrators' letters to Liberator Midco Limited are at pages 409 to 412 of DNS1).

The First Dido Transaction

- 37 The First Dido Confirmation evidences an interest rate derivative transaction (the "First Dido Transaction") entered into under a 1992 ISDA Master Agreement incorporated by reference, and as amended, therein. In accordance with the terms set out in the First Dido Confirmation, this 1992 ISDA Master Agreement was superseded by a 1992 ISDA Master Agreement dated 12 February 2008 between KP Germany Zweite GmbH (formerly Dido Erste Vermögensverwaltungs-GmbH) and LBIE (the "KP ISDA Master Agreement"), a copy of which is at pages 413 to 441 of DNS1.
- 38 The terms of the First Dido Transaction, as set out in the First Dido Confirmation, provide that:
- (i) Dido Erste Vermögensverwaltungs-GmbH will pay to LBIE a Fixed Amount on 31 December 2007 and semi-annually thereafter on the last calendar day of each of June and December (adjusted to account for business days) in EUR equal to the Notional Amount multiplied by 4.695 per cent. and multiplied by a Day Count Fraction of Actual/360; and
 - (ii) LBIE will pay to Dido Erste Vermögensverwaltungs-GmbH a Floating Amount on 31 December 2007 and semi-annually thereafter on the last calendar day of each of June and December (adjusted to account for business days) in EUR equal to the Notional Amount multiplied by a floating rate, determined for successive six-month periods by LBIE in accordance with the Confirmation, and multiplied by a Day Count Fraction of Actual/360.
- 39 Prior to LBIE entering administration, both Dido Erste Vermögensverwaltungs-GmbH and LBIE made net payments of the following amounts as they fell due:
- (i) EUR 209,703.47 on, or around, 31 December 2007 from Dido Erste Vermögensverwaltungs-GmbH to LBIE; and
 - (ii) EUR 44,471.19 on, or around, 30 June 2008 from LBIE to Dido Erste Vermögensverwaltungs-GmbH.
- 40 Since LBIE entered administration, LBIE failed to make a net payment to Dido Erste Vermögensverwaltungs-GmbH of the following amount as it fell due:
- EUR 262,368.67 on, or around, 31 December 2008.

41 Since LBIE entered administration, Dido Erste Vermögensverwaltungs-GmbH has withheld net payments to LBIE of the following amounts (determined as described in Paragraph 38, above):

- (i) EUR 1,004,494.69 on, or around, 30 June 2009; and
- (ii) EUR 2,070,002.56 on, or around, 31 December 2009.

The Second Dido Transaction

42 The Second Dido Confirmation evidences an interest rate derivative transaction (the "**Second Dido Transaction**") entered into under a 1992 ISDA Master Agreement incorporated by reference, and as amended, therein. In accordance with the terms set out in the Second Dido Confirmation, this 1992 ISDA Master Agreement was superseded by the KP ISDA Master Agreement.

43 The terms of the Second Dido Transaction, as set out in the Second Dido Confirmation, provide that:

- (i) Dido Erste Vermögensverwaltungs-GmbH will pay to LBIE a Fixed Amount on 31 December 2007 and semi-annually thereafter on the last calendar day of each of June and December (adjusted to account for business days) in USD equal to the Notional Amount multiplied by 5.485 per cent. and multiplied by a Day Count Fraction of Actual/360; and
- (ii) LBIE will pay to Dido Erste Vermögensverwaltungs-GmbH a Floating Amount on 31 December 2007 and semi-annually thereafter on the last calendar day of each of June and December (adjusted to account for business days) in USD equal to the Notional Amount multiplied by a floating rate, determined for successive six-month periods by LBIE in accordance with the Confirmation, and multiplied by a Day Count Fraction of Actual/360.

44 Prior to LBIE entering administration, Dido Erste Vermögensverwaltungs-GmbH made net payments of the following amounts to LBIE as they fell due:

- (i) USD 48,423.50 on 31 December; and
- (ii) USD 391,409.01 on 30 June 2008

45 Since LBIE entered administration, Dido Erste Vermögensverwaltungs-GmbH has withheld net payments to LBIE of the following amounts (determined as described in Paragraph 43, above):

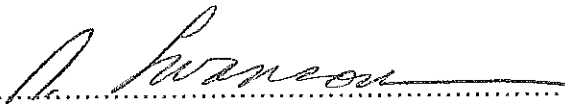
- (i) USD 1,212,265.31 on, or around, 31 December 2008; and

(ii) USD 1,863,241.81 on, or around, 30 June 2009.

46 Dido Erste Vermögensverwaltungs-GmbH has not closed out the First Dido Transaction or the Second Dido Transaction and has indicated in a letter to LBIE dated 16 October 2008 that it is relying on Section 2(a)(iii) to withhold payment of the amounts set out in Paragraphs 41 and 45 (a copy of which is at page 442 of DNS1).

STATEMENT OF TRUTH

I believe that the facts stated in this Witness Statement are true.

Signed: 

DAVID NELS SWANSON

9 June 2010

Applicants

D. N. Swanson

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