

Applicants  
S A Pearson  
First Statement  
"SAP1"  
6 October 2008

**IN THE HIGH COURT OF JUSTICE**

**Claim 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**

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**WITNESS STATEMENT OF  
STEVEN ANTHONY PEARSON -  
REDACTED VERSION OF THE STATEMENT  
BEFORE MR JUSTICE BLACKBURNE AT A  
HEARING ON 7 OCTOBER 2008**

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I, STEVEN ANTHONY PEARSON, of PricewaterhouseCoopers LLP, Plumtree Court, London EC4A 4HT, state as follows.

**INTRODUCTION**

- 1** I am a licensed insolvency practitioner and a partner in PricewaterhouseCoopers LLP ("**PwC**"), a firm of accountants at the above address. I am one of the joint administrators of Lehman Brothers International (Europe) ("**LBIE**") (in administration). We were appointed as such by order of Mr Justice Henderson on 15 September 2008.
- 2** I am also one of the joint administrators appointed in respect of each of Lehman Brothers Holdings Plc ("**LBH**"), Lehman Brothers Limited ("**LBL**"), LB UK RE Holdings Limited ("**LBUKRE**"), Storm Funding Limited, Mable Commercial Funding Limited and Lehman Brothers Europe Limited

(“**LBEL**”) (together with LBIE the “**Lehman Administration Companies**”). In addition to the Lehman Administration Companies, three further Lehman companies in the UK have entered into administration, pursuant to out of Court appointments (with partners from PwC appointed as administrators), bringing the total number of Lehman companies currently in administration to ten.

- 3 My partners, Anthony Victor Lomas, Michael John Andrew Jervis and Dan Yoram Schwarzmann are the other joint administrators of the Lehman Administration Companies (together the “**Administrators**” and each an “**Administrator**”). I am duly authorised to make this witness statement on behalf of LBIE and the other Administrators.
- 4 I make this witness statement in support of the Administrators’ application, made under paragraph 63 of Schedule B1 to the Insolvency Act 1986 (the “**Act**”), for an order directing them to take steps towards the achievement of the statutory purpose of LBIE’s administration by implementing the procedures and processes set out in the Schedule to this witness statement (the “**Application**”).
- 5 This Application is made at an early stage in LBIE’s administration (it is hoped that it will be heard just over three weeks after LBIE was placed into administration) and before the Administrators are required, or in a position, to put proposals to LBIE’s creditors for the achievement of the statutory purpose.
- 6 Our focus since our appointment has been in seeking to achieve a better result for LBIE’s creditors as a whole than would be achieved on an immediate winding up.
- 7 The Administrators make this Application in the face of significant pressure from counterparties from which, as part of its wider financial markets activities, LBIE received very substantial amounts of cash and assets (in terms of value). The counterparties allege that the cash and assets are held on trust for them, that “their property” should be returned to them immediately, and that the consequences of the counterparties being “kept out of their money” are severe.

- 8 The Administrators wish to adopt a system for dealing with these claims in an orderly and efficient manner and one which, whilst recognising the importance of dealing with the potential proprietary claims as a matter of real urgency, enables us to act in accordance with the statutory purpose for which we have been appointed.
- 9 For reasons which I explain below, the task of dealing with proprietary claims is substantial and complicated. The task is not only important from the perspective of the counterparties, which understandably want to secure the return of monies and assets to which they claim an entitlement as soon as is realistically possible (and, in many cases, sooner than that), but it is also critical to the achievement of the statutory purpose of administration that the Administrators neither:
- 9.1 return to counterparties monies and assets to which LBIE has a claim or which LBIE is entitled to retain pending discharge by the relevant counterparty of any debts owed to LBIE (and, in some cases, to other companies within the global Lehman Brothers group of companies (the “**Lehman Group**”)), for which the monies and assets stand as security; nor
- 9.2 part with monies and assets to which LBIE (or the Lehman Group) has no claim but to which there are, or might be, competing claims by two or more counterparties. In seeking to achieve a better result for LBIE’s creditors as a whole than would be achieved on an immediate winding up, it is important that the Administrators seek to minimise claims against the estate as well as maximising the realisation of its assets.
- 10 Since our appointment, we have received many claims from LBIE’s counterparties, many of whom have instructed lawyers, apparently with a view to taking legal proceedings. The majority of those counterparties which have made claims have sought the return of monies and/or assets which they believe LBIE holds on their behalf. In fact, LBIE itself holds (directly) very little of the claimed monies and assets, which are (as detailed further at Section D below) held by third party banks, exchanges, clearing systems and custodians. As explained below, in many cases, LBIE was

entitled to use the monies and assets for its own purposes, rather than hold them exclusively for the counterparties, with the result that the counterparties have no proprietary claim. Where the monies and assets have not been so used, other entities hold the monies and assets on LBIE's behalf and, as is described below, some are not, at this stage in the administration, willing or able to return them.

- 11** The Administrators, together with our legal advisers, have given a great deal of thought as to how best we can go about dealing with the multitude of claims made and that will be made. However, the first weeks of the administration have also been characterised by the “fire-fighting” that we have had to manage, inevitably, whilst we take control of LBIE's extensive operations.
- 12** This “fire-fighting” has resulted, in large part, from certain counterparties seeking to have their claims resolved in advance of others and in advance of the Administrators determining how we can most fairly and efficiently put appropriate systems in place to resolve the numerous urgent and high value claims faced by LBIE. As described in more detail below, in some cases, the Administrators have attempted to deal with claims on an ad hoc basis, diverting significant resources from the progress of the administration. However, in none of these cases have the Administrators concluded that we are able properly to return any assets or money to the relevant counterparty at this stage.
- 13** The Administrators are concerned that it will be in the interests of neither those entitled to assets held by LBIE, nor the general creditor body, for these issues to be dealt with on a piecemeal basis. It will take far longer, cost far more and, based on our experience to date, will not result in any benefit to the counterparties involved, if the process is not properly planned and implemented and if certain counterparties (those which, for instance, threaten proceedings) are dealt with before others. Accordingly, the Administrators are seeking to put in place the necessary processes and procedures to deal with the claims in a logical, efficient and fair manner, consistent with performing our primary functions of achieving the purposes of the administrations.

- 14** Section F of this witness statement and the Schedule to it set out how the Administrators intend, subject to the Court's approval, to deal, over the coming weeks and months, with claims by counterparties for the return of monies and/or assets which they believe LBIE holds on their behalf. The processes and procedures outlined in Section F and the Schedule have been reviewed by the Financial Services Authority ("**FSA**").
- 15** There is now shown to me a paginated bundle of copy documents, marked "**SAP1**", 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 either as a result of the work undertaken by me as one of the Administrators of the Lehman Administration Companies, or they have been provided to me either by my partners and colleagues at PwC involved with the administration of the Lehman Administration Companies, or by the employees of the Lehman Administration Companies who are still available to the Administrators, or by the Administrators' legal advisers, Linklaters LLP ("**Linklaters**").
- 16** Nothing in this witness statement is intended to waive privilege in respect of any matter referred to and privilege is not being waived.
- 17** Set out as Appendix A to this witness statement is a glossary of some of the terms used within it. Where <sup>"GL"</sup> appears against a term, a definition of it appears in the glossary.
- 18** This witness statement is divided into 6 sections:
- 18.1** Section A provides background information about the Lehman Group, of which the Lehman Administration Companies were part, the structure of the Lehman Group, the nature of the businesses of the Lehman Administration Companies and a more detailed description of the different aspects of the business of LBIE which are the focus of the Application.

- 18.2** Section B describes the background to the Lehman Administration Companies entering administration.
- 18.3** Section C provides an overview of the actions taken by the Administrators since their appointments and explains some of the challenges that we, our staff, the remaining Lehman staff assisting us and our advisers have faced to date.
- 18.4** Section D details the extent to which LBIE's business involved LBIE (usually through third party banks, depositaries and custodians) holding money and assets, often subject to security and other rights, on behalf of its counterparties.
- 18.5** Section E explains the specific challenges facing the Administrators in respect of claims by counterparties in relation to money and assets held by LBIE and the work being undertaken to resolve these issues.
- 18.6** Section F sets out the Administrators' proposed approach to resolving the issues which arise out of counterparties' claims to money and assets.

## **SECTION A – BACKGROUND**

### **The Lehman Group**

- 19** At the core of the business of the Lehman Group was global investment banking. Until its recent, well publicised collapse, it was one of the four biggest investment banks in the United States (“**US**”). It provided financial services to corporations, governments and municipalities, institutional clients and high net worth individuals. The business activities of the Lehman Group were organised in three segments: capital markets, investment banking and investment management. Those segments included businesses in equity and fixed income sales, trading and research, investment banking, asset management, private investment management and private equity.
- 20** The Lehman Group was headquartered in New York, with regional headquarters in London and Tokyo, and many offices in North America,

Europe, the Middle East, Latin America and the Asia-Pacific region. The ultimate parent company of the Lehman Group was Lehman Brothers Holdings Inc, a corporation incorporated in the US (“**LBHI**”). LBHI filed for bankruptcy protection on 15 September 2008 under Chapter 11 of the US Bankruptcy Code.

- 21** A structure chart showing the position of the Lehman Administration Companies within the Lehman Group is exhibited at **page 1 of SAP1**. Some of the complexity of the group of companies now being administered by the Administrators can be appreciated from that chart (which is in fact only a simplified version of the overall structure of the Lehman Group).

## **LBIE**

- 22** The principal trading company of the Lehman Group within Europe was LBIE, which is an unlimited company. LBIE is the company upon which the Application focuses. Its business involved the provision of a wide range of financial services, including trading and broking, equity and fixed income instruments and financial derivatives. It carried out its business globally.
- 23** LBIE is authorised and regulated by the FSA and was a member of the London Stock Exchange (“**LSE**”) and many other international stock and derivatives exchanges (some 50 in total).
- 24** LBIE’s headquarters were in London. Its employees were mainly long-term secondees from LBL, another company within the Lehman Group, which is also now in administration. LBIE had offices in Amsterdam, Dubai, Frankfurt, Geneva, Madrid, Milan, Paris, Qatar, Seoul, Stockholm, Tel Aviv and Zurich.
- 25** LBIE had six divisions, according to internal LBIE papers, as follows:
- 25.1 Prime Services:** these services, as described in paragraph 74 below, were provided across the whole of Europe and in the US and Asia. The majority of clients were hedge funds.
- 25.2 Banking:** this included European advisory mergers and acquisitions, debt capital markets activities (primarily underwriting<sup>GL</sup> income) and equity capital markets activities (including underwriting).

- 25.3 Equities:** this was primarily an agency (including trading as a matched principal<sup>GL</sup>) business but included some proprietary trading. It involved dealing in cash-settled equities, convertibles<sup>GL</sup> and equity derivatives<sup>GL</sup>, and an equity strategies (event-driven) trading business.
- 25.4 Fixed Income:** this conducted LBIE's activities on behalf of clients in various fixed income instruments, including CDOs<sup>GL</sup>, credit derivatives<sup>GL</sup>, real estate and securitised products.
- 25.5 Investment Management:** this included personal investment management ("PIM") activities and various private equity investments.
- 25.6 Principal Investing:** this conducted cross-asset proprietary trading in equities, fixed income and derivatives. All transactions were to the account of LBIE, that is, not undertaken on behalf of clients.
- 26** In the year ended 30 November 2007, LBIE's reported profit on ordinary activity before taxation was more than US\$1.4 billion, with operating income of almost US\$2 billion. At 30 November 2007, according to its audited accounts, LBIE had total assets of over US\$450 billion, net current assets of some US\$13 billion and shareholder funds of some US\$6 billion. At **pages 2 to 26 of SAP1** is a copy of LBIE's annual report and accounts for the year ended 30 November 2007.
- 27** Although this Application is made in relation to LBIE only, to complete the background against which the Application is made, brief descriptions of the businesses carried on pre-administration by the other Lehman Administration Companies are set out below:

## **LBUKRE**

- 28** LBUKRE was a holding company for the real estate division of the Lehman Group within Europe. Its business consisted primarily, both directly and through its subsidiaries, of investments in real estate, funds, non-performing loans and sub-performing loans.



## **LBL**

- 29** LBL provided administrative services to fellow group companies in the United Kingdom (“**UK**”) and European operations of the Lehman Group. These services included the provision of property, employees and support services (including IT, clearance and settlement, operational, accounting and legal). LBL was the major employer within the Lehman Group within Europe and had approximately 5,300 employees, of whom around 2,000 were seconded to other group companies.

## **LBH**

- 30** The principal activity of LBH was to hold fixed asset investments in a range of assets, the majority of which were held through investments in subsidiaries, although it had some proprietary investments of its own. It had two major operating subsidiaries, namely LBIE and Lehman Brothers Europe Limited.

## **Storm Funding Limited**

- 31** This was a funding company for structured loans and investments in other financial securities. It had no employees of its own. Its principal assets and liabilities were inter group receivables and payables.

## **Mable Commercial Funding Limited**

- 32** This company was a funding vehicle for mortgage assets and asset-backed debt financing. It had no employees of its own. Its principal assets were investments in subsidiaries and inter group receivables.

## **Lehman Brothers Europe Limited**

- 33** This company provided investment banking and corporate finance activities. It also arranged derivatives transactions as agent for other Lehman Group companies. It is authorised and regulated by the FSA.

## **SECTION B –THE ADMINISTRATIONS - BACKGROUND**

### **Events leading up to the administration of the Lehman Administration Companies**

- 34** The real estate crisis relating to sub-prime mortgage lending in the US has been well documented. The Lehman Group had a large exposure to that sector. As a result, it was forced to make a number of provisions and write-downs in its accounts. Those write-downs caused significant losses in the Lehman Group's second and third quarter (2008) results.
- 35** The Lehman Group operated in a market that depends heavily on investor and market confidence. During the last few months, in part as a result of those announced losses, there was an escalating loss of confidence in the Lehman Group. This culminated in a significant deterioration in LBHI's share price on the New York Stock Exchange of almost 80 per cent during the week from Friday 5 September 2008 to Friday 12 September 2008. On Tuesday 9 September, the share price fell 45 per cent following reports that negotiations with the Korean Development Bank, regarding a potential major investment in the Lehman Group, had been put on hold.
- 36** The following day, the Lehman Group announced a third quarter loss of US\$3.9 billion. At the same time, the Lehman Group announced plans to sell a majority stake in its investment management business and to spin-off the majority of its commercial real estate assets into a new, separate public company. These measures failed to restore investor confidence and the share price fell a further seven per cent on Wednesday 10 September 2008. Following the close of business that day, Moody's Investors Service<sup>GL</sup>, one of the main credit rating agencies, announced that, in the absence of a purchaser for the Lehman Group or its business by Monday 15 September 2008, it intended to downgrade the Lehman Group's credit rating (which, as at 12 September 2008, was A2<sup>GL</sup>).
- 37** Various steps were taken in an attempt to resolve the Lehman Group's increasingly precarious situation. I understand from Linklaters that discussions took place with the US Treasury and Federal Reserve and with potential investors and purchasers of the Lehman Group's business (or part

of it). Those discussions did not, however, result in a purchaser or any other solution to resolve the Lehman Group's financial difficulties.

- 38** As part of its global treasury management, the Lehman Group operated a centralised treasury function. Accordingly, LBIE did not have control over bank accounts. Instead, payments were made into and from accounts maintained at group level (that is, at LBHI level). During each trading day, LBHI transferred cash to enable the Lehman Group companies, including LBIE, to meet their cash requirements during that day. The companies within the Lehman Group were therefore reliant upon receipt of that cash from LBHI each day to enable them to meet their obligations.
- 39** Right up until the weekend of 13 and 14 September 2008, it remained the hope and expectation of the Lehman Group management that the business could be saved. It was not until Sunday 14 September 2008 that it became apparent that a rescue would not take place. During the afternoon of 14 September 2008, the directors met with the prospective administrators of the London-based business (that is, partners in PwC) for the first time. Early that evening, it was reported that Barclays Bank had withdrawn from negotiations in the US for the acquisition of the Lehman Group's business, although there was still a possibility that the US Federal Reserve would provide emergency funding. Linklaters informs me that, at 11 p.m., the directors of the Lehman Administration Companies were told by the New York headquarters that, as from 15 September 2008, LBHI would no longer be in a position to, and would not, provide any further cash to any of the Lehman Group companies and was preparing to file for Chapter 11 bankruptcy protection in the US. The Lehman Administration Companies, which were reliant upon guarantees and ongoing funding from the Lehman Group companies in the US, could therefore not continue to trade.
- 40** During the night of 14 September 2008, preparations were carried out for a number of the Lehman Group companies in the UK to apply for administration. In the early hours of the morning of Monday, 15 September 2008, the directors of each of LBIE, LBUKRE, LBL and LBH resolved to place those companies into administration. At 7.56 a.m., administration orders were made in respect of LBIE, LBUKRE, LBL and LBH by Mr Justice

Henderson. Liaison throughout had been maintained with the FSA, who also appeared at the hearing of the administration applications. Since 15 September 2008, several further Lehman Group companies in the UK (including Storm Funding Limited, Mable Commercial Funding Limited and LBEL) have entered administration, pursuant to out-of-court appointments made by their directors, with the Administrators, or other partners at PwC, now being appointed over ten entities in the UK. Further Lehman Group entities, both in the UK and overseas, are likely to go into insolvency processes in the near future.

- 41** On the same date as the making of the administration orders in the UK in respect of LBIE, LBUKRE, LBL and LBH, LBHI announced its intention to file for Chapter 11 bankruptcy protection in the US. It has been reported in the financial press that the insolvency of the Lehman Group is by some distance the largest insolvency that has ever occurred; indeed it is estimated to be more than six times the size in pure financial terms of the collapse of Worldcom (previously the largest corporate insolvency).

## **SECTION C – OVERVIEW OF THE ACTIONS TAKEN BY THE ADMINISTRATORS TO DATE**

- 42** Before being appointed as administrators, particularly in respect of large or complex companies or groups of companies, prospective administrators often have an opportunity to familiarise themselves (and their teams) with the company's business prior to their actual appointment whilst carrying out contingency planning. Such contingency planning can last for several weeks, if not longer, depending on the circumstances. However, in this case, partners in PwC were initially contacted by the directors of the Lehman Administration Companies late on Saturday 13 September 2008 and first met with the directors on the afternoon of Sunday 14 September (at which time it was still expected by Lehman Group management that a buyer for the Lehman Group would be found), little more than twelve hours before the administration orders were made in respect of the first of those companies.

- 43** In the short period since the administration orders were made, the Administrators have endeavored to investigate and to understand the extensive operations of the Lehman Administration Companies' businesses. As described above, the Lehman Administration Companies operated hand-in-hand with their US counterparts, as well as providing financial services from a variety of offices in Europe, the Middle East, and Asia to clients across the world.
- 44** We were appointed as Administrators in an environment where there have been very significant challenges to overcome. These include, for example, the ability to pay staff, the suspension of the licences of Lehman Administration Companies at many exchanges, and the lack of key resources initially to maintain processes and systems. These challenges are explained in more detail below. These first three weeks of the administrations have involved the Administrators gaining control of the businesses, putting members of their team into each of the major functions and processes and imposing some order on the situation. In brief, the main initial activities included:
- 44.1** Raising initial funding for the administrations;
  - 44.2** Stabilising and dealing with the workforce;
  - 44.3** Dealing with regulators and exchanges;
  - 44.4** Realising assets to generate liquidity and preserving value in the estates;
  - 44.5** Setting up bank arrangements for the administrations, in particular new accounts with the Bank of England, for use by the Administrators;
  - 44.6** Negotiating for the disposal of parts of the business;
  - 44.7** Dealing with the premises of the Lehman Administration Companies;
  - 44.8** Dealing with issues relating to the Lehman entities in the US and elsewhere;
  - 44.9** Seeking to recover assets from other Lehman Group entities; and

#### **44.10** Communicating with the market.

These steps are described in more detail in paragraph 52 below.

- 45** In all the circumstances, the statutory moratorium imposed by paragraph 43 of Schedule B1 to the Act has been essential to the Administrators in our attempt to bring order to what would otherwise have amounted to chaos. The majority of counterparties (although not all) have not sought to lift the statutory stay on proceedings and appear to accept that this is a case where it is essential that the Administrators have some breathing space to take stock and review the business and the claims against LBIE as a whole.
- 46** The Administrators are obliged to treat all creditors and potential creditors equally; the statutory moratorium assists in this regard, ensuring that some creditors which seek to gain an advantage over others, simply by virtue of exerting pressure on the Administrators, are not able to have their claims determined more quickly or recover assets sooner than others.
- 47** As described in more detail below, although the Administrators appreciate that counterparties are keen to have their claims determined and to recover those assets to which they are entitled as soon as possible, there are a vast number of counterparties with similar, and often competing, interests.
- 48** If the Administrators are forced to deal as a priority with each counterparty which seeks the return of what it considers to be its assets, it will result in the current “fire-fighting” continuing and, in all likelihood, escalating. Unless processes and procedures are implemented to deal with claims in an orderly fashion, the whole progress of the administration will not be conducive to the Administrators achieving the statutory purpose for which we have been appointed.
- 49** The Administrators have deployed a team from seventeen different departments to manage the Lehman Administration Companies’ businesses and affairs, covering numerous disciplines. This team includes not only restructuring and insolvency specialists, but also partners and employees from my firm’s Banking and Capital Markets, Transaction Services, Human Resources, Investment Management, Forensics, Treasury, Corporate

Finance and Tax practices and other specialists in the financial sector from around the firm. This is the largest team that my firm has deployed on an insolvency assignment.

- 50** Further, Linklaters, the law firm appointed by the Administrators, have deployed partners, associates and trainee solicitors to advise and assist the Administrators from Linklaters' Restructuring & Insolvency, Litigation, Financial Markets, Derivatives & Structured Products, Corporate, Investment Management, Employment, Real Estate, Structured Finance, Banking, Tax, Capital Markets, Technology Media & Telecommunications and Intellectual Property departments, and from offices around the world, including Amsterdam, Belgium, Berlin, Dubai, Frankfurt, London, Luxembourg, Madrid, Milan, Moscow, Munich, New York, Paris, Stockholm and Tokyo. This is the largest legal team I am aware having been used in the first few weeks of an insolvency.
- 51** The teams from both PwC and Linklaters have been working night and day in an effort to deal with the unprecedented challenges presented by the current administrations. In addition to the substantial teams from both PwC and Linklaters, a significant number of Lehman employees have been actively assisting us in managing the initial phase of the administration. It should be borne in mind, however, that, notwithstanding the large numbers of staff and advisers available to assist the Administrators, in relation to all important strategic issues, one or more of the individual Administrators has to be involved and take the ultimate decision. Even with four Administrators and a number of other PwC partners, to whom responsibilities have been delegated, that inevitably constrains on a practical level the number of matters that can physically be attended to at once.
- 52** Inevitably, the first period of the administrations has been spent gaining an understanding of LBIE's (and the other Lehman Administration Companies') business, dealing with urgent issues that have arisen and seeking to establish a process for dealing with the business and resolving issues going forward. Some of the key activities undertaken since 15 September 2008 are described below:

## **Administration funding**

**52.1** An immediate priority has been to ensure that the Administrators have sufficient funding in order to be able to run the administrations. At the time of taking on the appointments, as a result of the centralized Treasury function referred to above, the Administrators did not have access to any cash. Accordingly, the Administrators negotiated a loan facility with Carval Investors to provide funding for the first few weeks of the administrations. That facility was negotiated and documented in the first two days of the administration, in order to ensure that the employees would be paid for September. As set out below, the Administrators have also realised several hundred million pounds of cash from various sources. The loan with Carval Investors has already been repaid.

## **Regulatory and exchange Issues**

**52.2** LBIE operated in heavily regulated markets and was subject to regulation from the FSA as well as numerous other bodies both in the UK and elsewhere in the world. The Administrators and their advisors, in order to be able to administer any of the numerous aspects of the businesses of the global banking operations carried out by LBIE, have therefore had to deal intensively with the FSA (as well as the Bank of England) and foreign regulators such as the Federal Reserve in New York, BaFin<sup>GL</sup> (the German banking regulator) and CONSOB<sup>GL</sup> (the Italian financial services regulator). Numerous meetings and telephone discussions and extensive correspondence have taken place with the regulators, in order to discuss with them the issues arising in the administration and keep them informed as to progress being made.

**52.3** LBIE was also a member of, or operated through, some 50 investment exchanges, multi-lateral trading facilities and clearing systems<sup>GL</sup>, including, among others, Euroclear, CREST<sup>GL</sup>, the LSE, the London International Financial Futures and Options Exchange (“**LIFFE**”), the London Clearing House (“**LCH**”), Eurex, Euronext, European Central Counterparty, the London Metal Exchange,



Turquoise, EDX London and ICE Futures Europe. LBIE's relationship with each of these is governed by a complex set of rules and regulations.

- 52.4** LBIE's access to these exchanges and clearing systems was in many cases frozen on administration. The Administrators have therefore had to negotiate the continuation of LBIE's access to the exchanges or find alternative methods of accessing and dealing with securities and trading positions. One such method has been the appointment of third parties to act as brokers<sup>GL</sup> and advise on strategies as to how to realise securities held by LBIE as mentioned in paragraph 52.10 below.
- 52.5** CREST accounts relating to LBIE and its UK affiliates remain disabled, except as described below. Transactions which had been executed by LBIE prior to its administration but had not yet settled in CREST (typically, because the due date for settlement had not yet occurred) are in many instances the subject of "matched instructions" in the CREST system, input by LBIE and its counterparties in respect of each transaction. While the accounts remain disabled, all related unsettled settlement instructions remain frozen. Some of those settlement instructions relate to executed transactions which, pursuant to the rules of the LSE or other exchange on which they were executed, will be cancelled and be taken into account in the calculation of net sums payable to or from LBIE and its counterparties. Other transactions were executed "over the counter" ("**OTC**" or "off-exchange") and are not due to be cancelled under the default rules of an exchange. The Administrators have been working with the LSE, CREST and other relevant parties to provide the relevant data required to ensure that the position under the exchange default rules has been properly calculated. The cancellation of a transaction under exchange default rules has no impact on the settlement instructions held within the CREST system, which must additionally be cancelled through the inputting of matched delete instructions by both parties to the

settlement (that is, both LBIE and its counterparty). During this time, LBIE's CREST settlement bank has also enforced its security rights over certain assets held by LBIE in charged CREST accounts.

**52.6** In order to deal with LBIE's assets held within CREST, "mirror accounts" (that is, accounts set up by the Administrators in parallel, replicating LBIE's accounts at the time of commencement of administration) have now been established. The reason for this is to ensure that the pending settlement instructions attached to trades held in the original LBIE accounts, as described above, do not inadvertently become active and thereby effect settlement of some of the related transactions, irrespective of whether they were due for cancellation under applicable default rules or, for some other reason, ought not now to proceed to settlement. Over £6 billion of securities are held within CREST, of which a proportion is currently expected to be LBIE's proprietary positions, the remainder being client assets. Work is continuing to enable LBIE to dispose of those securities that it holds as principal, in order to realise value for the estate. The Administrators have been working with CREST and the FSA to agree a basis for disposal of securities which is consistent with the Settlement Finality Directive<sup>GL</sup>. These discussions are ongoing and no realisations from CREST-related assets are likely until agreement has been reached.

**52.7** In relation to LBIE's futures<sup>GL</sup> and options business, steps were taken during the first few days of the administration to facilitate the transfer of client positions to other clearing brokers. However, clients' margin (including both cash, some of which is client money, and securities) was not transferred pending the implementation and completion of the wider identification and verification process that is described below. LCH and Eurex (two of the largest clearing systems for UK and European futures) have now almost completed the closing out of all of LBIE's open positions.

**52.8** Copies of press releases in respect of certain of the Administrators' dealings with the exchanges and clearing systems appear at **pages 27 to 30 of SAP1**.

**52.9** All of this requires, and will continue to require, careful navigation in order to ensure the best outcome for creditors whilst also complying with myriad regulatory requirements.

#### **Other realisation of assets**

**52.10** LBIE's business involved holding a very large amount of financial assets, such as shares and other securities, for its own account. Many of these were to hedge<sup>GL</sup> LBIE's exposure under various derivatives transactions (so that movements in the value of the derivatives would be offset by movements in the opposite direction in the value of the hedges). LBIE's administration, however, meant that the counterparties to these derivatives transactions could in certain instances terminate the transactions and many thousands of them have already done so (or purported to do so). The effect of such terminations is that any subsequent variations in the value of the hedges will no longer be matched by movements in the value of the derivatives. LBIE therefore found itself with a large number of uncovered positions, which it was holding against the background of a highly volatile market. Since LBIE's membership of various exchanges had been suspended and many counterparties were unwilling to deal with it directly, LBIE was unable to liquidate most of these positions itself. Arrangements therefore had to be put in place, as a matter of urgency, to enable positions held by LBIE to be transferred through third parties. To this end, a series of brokerage agreements were negotiated, and subsequently entered into, with a number of major market counterparties on 18 and 19 September 2008 respectively. The Administrators are currently considering whether to appoint further parties to assist with this process. Since then, some US\$5 billion of "delta" (that is, risk positions) have been removed from LBIE's books through these arrangements.

**52.11** During the period since their appointment, the Administrators have also been negotiating directly with certain counterparties to liquidate a number of high value positions. These were identified as a priority as they had or have the potential to generate cash for the estate and/or to realise a higher value than would be possible if matters took their normal course.

### **Banking arrangements**

**52.12** As a result of the centralised Treasury function within the Lehman Group prior to its collapse, none of the Lehman Administration Companies had control over bank accounts in respect of own account cash balances. Accordingly, one of the first steps taken by the Administrators was to make arrangements for new bank accounts to be opened. In order to ensure that banks with whom accounts were to be opened could not exercise rights of set-off, it was not possible for the Administrators immediately to establish accounts with any of the main commercial banks. Instead, it was necessary for special arrangements to be made for accounts to be opened with the Bank of England. As a result of the wide-ranging nature of the business, it has been necessary to open a large number of accounts, in a variety of currencies. In addition, a number of additional accounts have been opened to hold cash the entitlement to which is disputed or not yet certain.

**52.13** By way of illustration of the scope of this task, the majority of the Lehman Administration Companies have required the following types of cash accounts as a minimum: (i) an own monies account; and (ii) a designated/client account. LBIE was FSA-regulated and therefore has to have both a pre-administration designated/client account and a post-administration designated/client account. Several accounts have to be set up for each of these types of account for some or all of the following currencies: Sterling, US Dollars, Euros and Swiss Francs. LBIE also has accounts in, among other currencies, Norwegian Krona, Swedish Krona, Korean Won, Chinese Renminbi and Canadian Dollars. A process is also underway to open a

number of escrow and securities accounts. This means that there are currently over sixty accounts which have been, or are in the process of being, opened with the Bank of England, and it is anticipated that many more may be required in due course.

**52.14** In addition to the accounts with the Bank of England and with overseas banks (in respect of certain counterparties), the Administrators have also taken steps to arrange a global correspondent bank and to ensure that the BACS payments required in respect of employee salaries were made. The Administrators are also investigating opening securities accounts, to enable securities to be placed under our direct control where they currently sit with exchanges and clearing houses.

#### **Disposal of businesses**

**52.15** The Administrators, together with support from the PwC corporate finance team, the Lehman investment banking team and Linklaters, have been considering what parts of the businesses of the Lehman Administration Companies are capable of being disposed of with a view to maximising realisations for the benefit of creditors. With that in mind, the Administrators have been negotiating intensively with potential purchasers for various parts of the businesses.

**52.16** On 23 September 2008, the Administrators announced that we had signed a conditional agreement with Nomura pursuant to which we agreed to dispose of the investment banking and equities business of LBIE and its branches in Europe and the Middle East. A copy of the press release announcing this sale is at **pages 31 and 32 of SAP1**. Completion of the disposal was subject to satisfaction of certain conditions.

#### **Employee issues:**

**52.17** There were approximately 5,300 individuals employed by, or in relation to, the business of the Lehman Administration Companies at the time of our appointment on 15 September 2008. The employment issues have been particularly complicated, bearing in

mind the large number of employees and secondees and the multinational domiciles of the workforce. Because of the complex nature of the business, access to key staff is vital simply to be able to understand the trading that LBIE was undertaking prior to Administration. The Administrators have been focusing on: identifying key individuals to be retained to assist with the administering of the estates and orderly wind-down of the businesses; considering the issues of new contracts and adoption of existing contracts (the latter involving a wide-scale review of a large number of contracts and consideration of issues relating to guaranteed bonuses); and dealing with the fact that Lehman Group's competitor firms have, often aggressively, been making offers of employment to key staff.

**52.18** The Administrators took immediate steps to identify those employees who are essential to the administrations, for instance, because they have expertise in managing the complex aspects of the business, or are critical in realising value from the many complex trades and positions; and in particular departments, such as the back office, where assistance will be required in handling queries and claims, or in accessing the Lehman Administration Companies' systems.

**52.19** The Administrators have also been focusing on securing a positive outcome for employees in the context of the disposal of part of the businesses of the Lehman Administration Companies (as to which, see above). The employment aspects were a fundamental part of the disposal to Nomura (involving the transfer of some 2,500 employees), as the businesses disposed of depend heavily upon the staff employed within them. The disposal has also created significant savings in the administrations. A complicating factor was that many affected staff in London and throughout Europe are expatriate employees originally employed by Lehman Brothers Inc ("**LBI**") (a US subsidiary of LBHI, which is also insolvent). Those staff have provided their services to the Lehman Administration Companies through secondment arrangements and, in some case,

under dual contract structures. In respect of those staff, more complicated arrangements to retain them or (alternatively) to terminate the secondment arrangements, have had to be considered.

### **Dealing with the premises**

**52.20** The Administrators, together with advisors from the PwC and Linklaters Real Estate teams, have sought to identify, with assistance from Lehman personnel, those premises either occupied by the Lehman Administration Companies or in respect of which the Lehman Administration Companies have ongoing liabilities.

**52.21** In particular, the Administrators have had to give urgent consideration to the issue of payment of the fourth quarter rental payments for 2008 in relation to the premises and the continued use of the premises for the next few months.

### **Insolvency proceedings in respect of LBHI and LBI**

**52.22** The US parent company of the Lehman Group filed for Chapter 11 bankruptcy protection on 15 September 2008. On 17 September 2008, a motion was filed in the US Bankruptcy Court in the Southern District of New York to obtain court approval of a sale of certain of LBHI's assets and those of its subsidiary, LBI, to Barclays Capital, Inc. The inter-relationship among LBIE, LBHI and LBI is extremely complex, not least in respect of significant apparent inter-company indebtedness and the shared IT systems upon which all Lehman Group companies are heavily dependent.

**52.23** The Administrators instructed US counsel at very short notice to review the proposed asset sale agreement and to attend the hearing of the motion on 19 September 2008 on the Administrators' behalf. Despite a number of objections by various affected parties (and concerns expressed by the Administrators in a number of respects, in particular in relation to IT and intellectual property issues, as to the terms of the sale), the sale to Barclays Capital, Inc was approved by the US Bankruptcy Court and LBI was placed into liquidation, and a

trustee appointed, under the US Securities Investor Protection Act 1970 (“SIPA”). Since the sale order, the Administrators have had to continue to deal with numerous issues arising from the inter-relationship between the UK and US businesses.

**52.24** Both the Chapter 11 proceedings in respect of LBHI and the SIPA liquidation of LBI are subject to the supervision of US Bankruptcy Judge James M. Peck. LBHI has appointed the restructuring advisory firm Alvarez & Marsal to assist in the administration of the estate in Chapter 11.

### **Recovery of assets from other Lehman Group companies**

**52.25** The Administrators have been reviewing the arrangements in place pre-administration between the Lehman Administration Companies and the overseas companies within the Lehman Group, with a view to identifying whether any assets can be recovered from any of those entities or in respect of the arrangements LBIE had with them. There has already been correspondence between the Administrators (or Linklaters on our behalf) and both LBHI and LBI, in particular in respect of the apparent transfers (amounting to some US\$8.2 billion) prior to the commencement of the administrations.

**52.26** Further, a German member of the Lehman Group, Lehman Brothers Bankhaus A.G. (“Bankhaus”), operated a client account for LBIE, in which US\$1 billion of cash was deposited. On 15 September 2008, Bankhaus was placed into a temporary moratorium by BaFin pursuant to Section 46a of the German Banking Act. The Administrators have written to Bankhaus on 24 September 2008 demanding repayment of the client money and have written to BaFin on 1 October 2008 requesting that BaFin does not authorise any disposition over or disposal of the client money until the legal issues are resolved. The Administrators are considering the appropriate steps to investigate and pursue the issue with Bankhaus.

**52.27** For obvious reasons, given the nature and complexity of the Lehman Group, the dealings with the overseas affiliates have already taken,



and will in the future demand, a significant amount of the Administrators' attention.

### **Communications with the market, counterparties and the media**

**52.28** Inevitably, a collapse of this size and nature has attracted close scrutiny from the media and has required extensive communication with regulators, counterparties and the market more generally. The Administrators, our staff, Lehman employees and Linklaters have also had correspondence and notices from a vast number of creditors and counterparties in respect of their claims and other concerns (including more than four thousand enquiries, emails and telephone messages). The Administrators are mindful of the desire of creditors and counterparties to be kept informed as to progress of the administrations, but, at the same time of course, the need to treat parties fairly and equally.

**52.29** The sheer volume of queries has required the Administrators to set up a dedicated website (a copy of the front page of which is at **page 37 of SAP1**). On that website, counterparties and others interested in or concerned with the administrations are provided with contact details, with separate email addresses (depending on the nature of their dealings with the Lehman Administration Companies and the nature of the query) to which to address their queries or claims. To date, the dedicated email accounts have received almost 4,000 email queries; these will take a significant period of time to deal with (and are, of course, being reviewed, categorized and prioritised). Copies of the various press releases made by the Administrators also appear on the website (copies of a selection of which appear at **pages 38 to 56 of SAP1**). Further, the Administrators have prepared a webcast, which has been loaded onto the dedicated website, to explain the main issues that we have been dealing with (a transcript of which is exhibited at **pages 57 to 60 of SAP1**). The Administrators have also developed and implemented a bespoke, web based, query management and data collection system to assist

in the handling of the extensive volume of material that has been, and is expected to continue to be, received.

## **SECTION D – CLIENT MONEY AND ASSETS**

- 53** At the same time as dealing with the other pressing issues outlined in Section C above, one of the main priorities for the Administrators, with which we have been dealing since our appointment - and which is central to this Application - has been the issue of how to identify, recover and distribute client money and assets (that is, money and assets that do not form part of LBIE's estate). As explained in further detail below, as a result of the business conducted prior to administration, LBIE is or may be in possession or control of significant sums of such money and assets.
- 54** Neither LBIE nor the other Lehman Administration Companies were deposit-taking institutions. Accordingly, "client money" (within the meaning of the FSA Rules) was deposited with third party or affiliated banks. Initial investigations indicate that LBIE had an approved list of 24 banks with which "client money" could be deposited.
- 55** Where LBIE was holding "client assets", it did so through depositaries, exchanges, clearing systems, custodians, sub-custodians and nominee companies. The method used depended on the types of assets being held, the markets and clearing systems through which they were customarily traded and settled, the currencies involved and other relevant factors, including requirements imposed by the FSA Rules. Our investigations indicate that some 100 institutions were involved in providing these services to LBIE.
- 56** Whilst the Administrators are mindful of their responsibilities in relation to third party money and assets and the need to ensure that any such money and assets are distributed to those to whom there is an entitlement as soon as practicable, this must be counterbalanced by the need to ensure that, in doing so, the Administrators are neither releasing assets which could form part of LBIE's estate and which could therefore be used to benefit the creditors as a whole, nor releasing assets to which other parties may claim an entitlement, exposing LBIE to further claims. As explained in greater

detail below, not all cash and assets provided by clients will constitute “client money” (within the meaning of the FSA Rules) or “client assets”, such that the counterparty would have either a proprietary right in respect of such assets or a beneficial interest in such assets (or in a share of a pool of which such assets form a part). In a significant number of cases, LBIE was entitled to use the cash and assets for its own purposes and a counterparty may only have a claim as a general unsecured creditor for the value of the cash or assets. Even where a counterparty may appear to have an entitlement to a beneficial interest in an asset or pool of assets, that client may have liabilities to LBIE or one of its affiliates, which can be deducted before the assets are returned. Often, LBIE will have security rights over the assets, as security for such liabilities.

- 57** Claims by counterparties to cash or assets held through LBIE may arise across a number of the areas of business conducted by LBIE. These are primarily within the Prime Services division, where there are in the region of 1,300 prime brokerage accounts, and the PIM group, where there are over 4,000 PIM client accounts, although I understand that a significant proportion of these may be dormant. Some counterparties have accounts with LBI that were “introduced” from LBIE, and the nature of this arrangement is being reviewed. Approximately 3,800 have an account with LBIE.
- 58** It is important to note that, in the Prime Services area in particular, LBIE was providing a range of services to counterparties under complicated contractual documents - those services included financing and stocklending by LBIE to counterparties, as well as exchange-traded and OTC derivatives positions - that could result in the counterparty incurring substantial liabilities to LBIE. The analysis as to whether particular cash or assets received from, or for the account of, the counterparty is (or is not) client money or assets depends on the contractual arrangements entered into and the types of services provided.
- 59** Generally, the umbrella agreement entered into with prime brokerage clients (the “**Prime Brokerage Agreement**”) provides that cash received by

LBIE is not “client money” and the client is a general creditor of LBIE for the amount of any cash balances.

- 60** Some of the Prime Brokerage Agreements provide for title to assets received by LBIE to be transferred outright to it, with LBIE having a contractual obligation to account to the client for equivalent assets. More commonly, the Prime Brokerage Agreements give LBIE a charge over the client’s portfolio of assets, and also give LBIE the right to use the assets for its own purposes (commonly referred to as “rehypothecation”) with an obligation to account to the client for equivalent assets. Generally LBIE exercised its right of use. In such cases, the client appears to have a claim as a general creditor of LBIE for the value of the assets that have been rehypothecated, and not a proprietary claim; this unsecured, non-proprietary claim may be subject to LBIE having a right of set-off and/or security rights.
- 61** The issue of client assets was addressed in the webcast referred to at paragraph 52.29 above. The Administrators informed the market that one area on which we are spending extensive time is the area of assets over which clients might have claims. As noted in that webcast, the entire market is aware of the very substantial sums (many billions of dollars of assets) that were invested through LBIE. Whether or not these investments (or parts of these investments) form part of LBIE’s estate will, therefore, have a significant impact on the funds ultimately available for distribution to LBIE’s creditors. We also stated that we did not expect to be in a position to transfer client assets or monies in the short-term and that we did not yet know at what point we would be able to do so.
- 62** Having identified this as an important issue from a very early stage, we gave an update to the market on how we proposed to deal with this issue, on 21 September 2008, in a press release entitled “*Lehman Brothers International (Europe) – client money and assets*” (a copy of which is at **pages 61 and 62 of SAP1**). The approach described in this press release and the wording thereof had been discussed and agreed with the FSA prior to its release.
- 63** The press release reiterated that the Administrators regard the issue of client money and assets as “*a very important and urgent matter*”. The press

release also highlighted the obligations incumbent on the Administrators in resolving this issue. It explained that, prior to returning client money and assets: “[...] the Administrators are obliged to ensure that all Client Assets are accessible by the Administrators and that they qualify to be treated as client monies or assets. Subject to these preconditions such Client Assets should, in due course, be available for return. In addition, in respect of each client for which Client Assets are held, the Administrators must ensure that there are no liabilities owed by the client which might give rise to an entitlement to withhold all or part of a return of the Client Assets in question. Those steps will ensure no creditors are given preference and is consistent with the Administrators’ duties to preserve and realise the company’s assets for its creditors.”

- 64** The press release also outlined, in summary form, the structure of an outline process that had been discussed with the FSA for identifying assets that do not form part of the Lehman Administration Companies’ estates. That process included 6 key steps:

*“1. For those clients who have the benefit of client money protection, under the FSA rules, ascertain client money balances held with various institutions in aggregate and reconcile those balances to LBIE client records.*

*2. Ensure funds in (1) above are accessible by the Administrators for return.*

*3. Identify Client Assets in aggregate, and the manner in which the different types of assets are held. For example, assets may be registered in nominee names, held via an accountholder in a clearing system and/or third party custodians may be used.*

*4. Check documentation with each client for whom Client Assets appear to be held, including prime brokerage agreements (and any side agreements thereto), netting<sup>GL</sup> agreements, and other relevant documents, to confirm that money received from or on behalf of a particular client is "client money" within the meaning of the FSA rules and to verify related security rights and set off rights in respect of Client Assets.*

*5. Reconcile the Client Assets by client to the client's claimed position, and identify whether the client has any relevant liabilities. If any such liabilities are identified, then to determine the extent to which such liabilities owed by the client may reduce the amounts properly returnable to the client. It is also necessary to analyse whether LBIE has exercised any "right of use" over Client Assets, and whether assets so used have ceased to be available.*

*6. In determining the amount potentially returnable, to take account of any unsettled transactions between the client and LBIE, and provide for any potential liabilities of the client resulting from such unsettled transactions."*

- 65** The press release indicated that the process outlined above would take a considerable period of time to complete. It stated that: *"Our current view is that this process could take several months to conclude. Once certain aspects of the process are completed, the Administrators may consider partial returns subject to conditions. We are working closely with the FSA in the conduct of this vital process. We will update clients about progress on an ongoing basis."*
- 66** Following the publication of the above press release, the Administrators have been working to refine and implement the process discussed with the FSA. This work is still ongoing. Further information as to the specific difficulties facing the Administrators is provided in section E below. Section F describes the processes and procedures which, subject to the Court's approval, we wish to implement so as to facilitate the resolution of the claims faced by LBIE in an orderly manner, consistent with the achievement of the statutory purpose.
- 67** Broadly speaking, LBIE's counterparties have shown an understanding of the difficulties faced by the Administrators. However, this is not always the case and some counterparties have threatened or sought to commence proceedings against LBIE and/or the Administrators. Much of the correspondence referred to at paragraph 52.28 above is from clients of LBIE's prime brokerage business (predominantly hedge funds) asserting proprietary rights over money and assets purportedly held by LBIE (and/or its depositaries and custodians) and demanding the immediate return of

such money and assets; failing which it is often asserted that an application will be made to the Court. This apparent need for urgency has arisen, in some cases, from a need to satisfy redemption<sup>GL</sup> requests made on a particular fund. In light of the significant practical and legal issues outlined below, the Administrators are not yet in a position to respond substantively to the many requests they have received for delivery up of assets.

- 68** One of LBIE's hedge fund clients (RAB Capital Plc and RAB Market Cycles (Master) Fund Limited) made an application to the Court for the delivery up of assets and their proceeds on 22 September 2008 and applied on the same day to list the application on an urgent basis. The application to list the hearing of the application on an urgent basis was refused by Mr Justice Morgan (a copy of the approved transcript of his judgment is attached at **pages 63 to 65 of SAP1**). To date, these are the only proceedings commenced in the administration by a counterparty seeking the return of assets. However, other counterparties have threatened similar applications.
- 69** The Administrators are of course conscious of the adverse impact on many clients of the collapse of LBIE and other Lehman Group entities. The Administrators have been told by some hedge funds and other counterparties that their inability to withdraw securities and monies from LBIE since the inception of the administration has caused them very substantial (and potentially terminal) difficulties. During the past two weeks the Administrators have dedicated considerable resource to the making of detailed enquiries concerning the possible release of assets to counterparties of LBIE which claim to find themselves in jeopardy as a result of the collapse of LBIE. However, in each case, the Administrators have ultimately found that factors such as the complexity of the relationships between the counterparty and various Lehman Group entities and the lack of verified and reconciled data means that it is not possible at this early stage to identify securities or monies which may safely be returned to counterparties without the risk of causing loss to the estate.

## **SECTION E – CHALLENGES FACING THE ADMINISTRATORS IN RESPECT OF CLIENT MONEY AND ASSETS AND THE WORK BEING UNDERTAKEN TO RESOLVE THIS ISSUE**

- 70** As explained above, it is critical to strike a balance between the desirability of transferring cash and assets not forming part of LBIE's estate to those entitled to those assets as soon as possible and the need to protect the interests of others who may have a claim in respect of those assets and the general body of creditors as a whole.
- 71** The consideration of these competing imperatives requires the Administrators to establish, in relation to the claims of each counterparty:
- 71.1** The precise number and types of assets claimed by them;
  - 71.2** The contractual framework against, and legal basis upon which, assets were received by LBIE, and whether they have been disposed of by LBIE in exercise of its right of use;
  - 71.3** Whether the assets are held separately from other assets or are held as part of a pool of assets;
  - 71.4** Whether there are competing claims to the assets;
  - 71.5** The current whereabouts of the assets and the basis upon which they are held by third party (or affiliated) banks, custodians, exchanges, agents, clearing systems or other depositaries;
  - 71.6** The prospects of recovering the assets from the institution with which they are held;
  - 71.7** Whether or not any sums are due from the counterparty to LBIE and/or companies within the Lehman Group which could be set-off or are secured against the assets; and
  - 71.8** The cost efficiency and expediency of the relevant process.
- 72** Releasing assets to a counterparty before the above steps have been taken could lead to significant prejudice, both to LBIE's general body of creditors (if assets which properly form part of LBIE's estate are transferred to



others) or to other parties with an interest in the assets released into the possession and control of one counterparty.

**73** The difficulties facing the Administrators are numerous and grave. The practical difficulties are described below.

**74** Before doing so, to put what follows into context, I set out below a description of the Prime Services business stream. (Many of the claims to date have been from clients of the Prime Services business and I understand that similar issues are likely to arise in respect of other business streams in due course, for example, Equities and Fixed Income). The Prime Services business involves providing a broad range of services to large institutional investors (usually hedge funds). The hedge funds will want to trade actively in securities and derivatives on many markets globally, taking both long and short positions, and will also require stock borrowing and financing facilities and foreign exchange services. They do not have substantial back office functions themselves, and require a third party to arrange for custody of the hedge fund's portfolio and to provide the fund with consolidated valuations of the portfolio on a regular basis. They therefore look to one or more major financial institutions (their "prime broker") to provide them with trade execution, clearing and settlement, custodial and reporting services, to enter into OTC derivatives with the fund, and to lend cash and securities to them. Such financing to the fund is usually secured against the assets of the hedge fund that are held via the prime broker.

### **Practical challenges**

**75** The practical challenges facing the Administrators can usefully be grouped under the following general headings:

#### **Size and complexity of LBIE's business**

**76** The business conducted by LBIE was complex and broad-ranging, with many clients dealing with, and receiving services from, a range of different business areas, involving different systems. Significant parts of the technology infrastructure are based in, and run out of, the US and India. It is possible for "client money" and "client assets" (that is, money and assets

that do not form part of LBIE's estate) to exist in any of these different business areas.

- 77** Many of LBIE's clients were hedge funds which were involved with active long<sup>GL</sup> and short<sup>GL</sup> trading in financial instruments and through derivatives. LBIE provided financing and securities lending to facilitate its clients' trades and a variety of related services such as trade execution, settlement and reporting. Members of my team have been advised by LBIE staff that position data is held on eight different systems for hedge fund clients.
- 78** In order to conduct its various businesses, LBIE needed access to exchanges, clearing systems and depositaries in many jurisdictions, directly or through other financial institutions. It needed to hold cash, including client money, in many different currencies and through many different banks, and to arrange for a wide range of financial instruments in many different markets to be held through more than 100 financial institutions in the relevant markets. LBIE also had trading relationships with thousands of market participants for stock lending<sup>GL</sup> and borrowing, repo<sup>GL</sup> transactions and hedging purposes.
- 79** Across all areas of the business, there are large numbers of accounts with counterparties. For example, there were approximately 1,300 accounts in Prime Services, with each client having entered into a suite of complex legal documentation with LBIE (and, in some cases, LBI as well), the details of which will need to be individually investigated. LBIE staff have indicated that LBIE also had approximately 5,000 ISDA<sup>GL</sup> Master Agreements in place with counterparties under which OTC derivative transactions were effected, and approximately 1,000 Global Master Repurchase Agreements in place for repo transactions, in addition to a substantial number of other "master" agreements for derivatives, repo and stocklending transactions (each a "**Master Agreement**"). There were hundreds of thousands of open trades under the ISDA Master Agreements as at the date of administration.
- 80** The size of LBIE's business is reflected in the volume of correspondence received by the Administrators and their legal teams since the date of administration. As discussed at paragraph 52.29 above, PwC has set up a dedicated email inbox and telephone lines to handle queries from clients in

respect of the administrations, with a large number of communications and queries having been received through that process.

### **Contractual documentation**

- 81** In order to obtain a clear understanding of the basis upon which money and assets are held, the Administrators need to have a complete picture of the applicable contractual framework in place for each client. Many client relationships are governed by a number of contractual documents, which may in turn have been varied numerous times during the life of the relationship. There is no single, central repository for contracts. Different types of contract are stored on different electronic databases, and some documents relating to client accounts are kept in hard copy files (a large number of which are archived off site). In relation to certain areas of the business, there are numerous different funds managed by single fund managers, with each fund being a separate client, which can lead to challenges with record keeping and errors in filing.
- 82** In order to ensure that we have as complete an understanding of the contractual position as possible, it may prove necessary, when dealing with certain claims, to interview relevant employees and/or carry out reviews of the email accounts of relevant employees. This task, if necessary, could take a considerable period of time and may nevertheless not result in a complete and accurate picture of the contractual position for each client.
- 83** The Administrators will also need to ascertain whether any of the contracts governing the relationship between the parties have been terminated (in particular, because termination crystallises certain liabilities between the parties). The Administrators have received approximately 2,500 default notices in respect of Master Agreements and prime brokerage documents from counterparties so far (with most of them having been sent in by fax, letter and email, as well as to different parts of the organisation) and more are expected. Each of these termination notices will have to be reviewed for compliance with the requirements contained in the relevant Master Agreement before a substantive analysis can be undertaken of the effect of those notices. This will be a very time consuming exercise.

**84** The effect of a counterparty serving a default notice (assuming the notice is valid) is to close-out the transactions so that, for example, where LBIE has provided to a counterparty, under a repurchase agreement, assets that have been “rehypothecated”<sup>GL</sup>, the counterparty no longer has an obligation to redeliver equivalent assets and instead will set off the value of the assets against the value of the cash it had delivered to LBIE under the transaction. Since, under a repo transaction, cash would only be provided against assets with a significantly greater value, the counterparty may well owe a net cash balance to LBIE. However, the valuation of the assets for this purpose will be a matter of considerable complexity, and potentially the subject of dispute with the counterparty, and so LBIE may not recover any balance owing to it for many months. In addition, LBIE will not be in a position to recover for its Prime Services clients the assets that have been rehypothecated. Generally the process of dealing with the close-out of transactions under such Master Agreements will be a process requiring substantial resources from various areas of the organisation, the Administrators’ team and their advisors.

#### **Access to up-to-date records and reconciliation of records of positions**

**85** Before any assets can be released by the Administrators (whether directly to clients or into a trust fund for future distribution), it is necessary to have an accurate and up-to-date record of each of the positions in each client account, and to reconcile these records with the information provided by clients and by the financial institutions holding assets. In addition, as LBIE often has (for example, under certain of the standard-form Prime Brokerage Agreements) a security interest over “client assets” to satisfy any liabilities of those clients to LBIE (or sometimes to other entities within the Lehman Group), including liabilities arising from other contractual documentation, it is important to have a clear and agreed position of any amounts that may be owing by the client to LBIE (or another Lehman Group company).

**86** Collecting the information required to understand whether any given client owes any monies to LBIE (or one of the other Lehman Group companies) is challenging for a number of reasons. As explained above, the business conducted by LBIE is complex, with many clients dealing with, and

receiving services from, a range of different business areas, involving different systems. Obtaining an overall view of a client's positions across different business areas is therefore not straightforward. It will require significant co-ordination across all these business areas in order to resolve client positions.

- 87** One of the key difficulties faced by the Administrators in relation to the records arises from the fact that the electronic systems and books and records held by LBIE have not been updated (at least not in any reliable or consistent way) since 11 September 2008. In order to ensure that the accounts are correctly updated, a manual reconciliation process will need to be undertaken. In addition to checking that any transactions executed and/or settled prior to administration have been correctly reflected in the relevant accounts, the Administrators will also need to take account of failed trades<sup>GL</sup>. Because LBIE's systems booked trades on a "contractual settlement" basis rather than on an "actual settled" basis, postings in the systems need to be reversed to reflect the position at administration and to take account of any corporate actions or other automatic events (for example, the paying of dividends or redemption of bonds) that have occurred since the records were last updated.
- 88** The task of updating records has been made more difficult by the fact that accounts with exchanges and clearing houses have been frozen, positions have been closed-out under market default rules, and depositaries and custodians have in some cases been unwilling to provide information about the assets they currently hold (as well as the assets themselves). In some cases, assets are held with LBI, such as US Treasury Bills held for LBIE through LBI's account with the Depository Trust Company of New York. Even though progress has been made in arranging for transactions to be settled or unwound, and in starting to receive information again, the task of reconciling LBIE's records with those of third parties holding assets on behalf of LBIE and/or its clients is a huge task that will take a considerable period of time. Since data as at the date of administration is required, this requires those third parties to run non-standard processes. In respect of

non-cash assets, there are approximately 100 institutions worldwide involved.

- 89** In the days leading up to the administrations, there were large numbers of transfer and payment instructions that were not processed and, in the case of outstanding transaction orders or transactions that were in the course of being settled, the transactions have in many cases not been executed, or have failed to settle (including in some instances where, by virtue of implementing their default rules, positions have been closed-out by certain exchanges or clearing systems), and records have not been adjusted to reflect this. This has led to substantial reconciliation difficulties. We believe there have been over 140,000 failed trades.

### **Valuation issues**

- 90** In order to value the derivatives positions held by a client, it is necessary for the positions to be “marked-to-market”<sup>GL</sup> (a process which involves calculating a present value for the contract by reference to market rates). This process of marking-to-market has not taken place since 12 September 2008. As such, the position with respect to any given client may have changed, possibly considerably in light of the recent market volatility, since the date of the last accurate reports produced by LBIE.
- 91** Where a counterparty has closed-out the relevant Master Agreement, the counterparty will, in due course, provide valuations (as required by the terms of the Master Agreement) for the purpose of calculating the net amount payable to or from the counterparty on close-out of the transactions. The Administrators will therefore need to obtain accurate mark-to-market data for the period from 12 September 2008 onwards and to review the termination notices and calculations received from counterparties in order to be able to form a view on the termination valuations calculated by the counterparties. In my experience, calculations of net amounts upon close-outs by counterparties in circumstances such as these are often inaccurate and the documentation provided in support of such calculations (which counterparties are obliged to provide) is frequently inadequate. The process that is required to resolve these types of issues is inevitably time consuming, requiring a manual review of each close-out

calculation and the reference valuation data, and can result in matters having to be resolved through dispute resolution procedures.

- 92** As noted above, it is necessary to assess the client's position not just in relation to LBIE but also, potentially, across the entire Lehman Group (since some of the relevant contracts grant security rights and/or rights of set-off in relation to sums owed to Lehman Group companies other than LBIE), including companies which are not under the control of the Administrators (some of which are, as described above, in insolvency proceedings abroad). There are also various cross-guarantee and indemnity arrangements applicable among members of the Lehman Group to cover situations where a client is owed an amount by one Lehman Group company but owes an amount to a different Lehman Group company.

#### **Difficulties in relation to LBIE's right of use**

- 93** Where a client has not agreed that cash and assets should be transferred outright to LBIE, or has expressly excluded a right of use, it is necessary to see whether the relevant cash and assets are identifiable as being held for the client and are under the control of LBIE or its agent. Generally, the assets were booked to an account that was designated as a client account but which was recorded as being subject to a lien in favour of LBIE. However, since LBIE generally had a right of use in respect of assets of Prime Services counterparties, LBIE's systems calculated on a daily basis for each counterparty the extent of the assets that could be rehypothecated. As and when a decision was made to use any assets, they were then transferred to LBIE's proprietary account, and would then be lent, repurchased or sold from that account by LBIE, as a principal trade. Reconciling LBIE's records and the legal documentation to ascertain (a) whether a right of use exists and has in fact been exercised, and (b) whether LBIE has any rights of security in respect of the "client assets" it has not so used, will be a complex task.

#### **Access to LBIE employees**

- 94** As mentioned above, in order to gain a full understanding of the contractual position relating to a particular client, it may prove necessary to interview

relevant employees in respect of the position for each client. There are also only a limited number of employees within LBIE who understand how to operate the different document management systems that may need to be accessed by the Administrators.

- 95** All relevant employees, as a result of the uncertainty surrounding the collapse, have received many calls and emails from clients. They also have many competing demands on their time, arising in particular from the unprecedented need for information in dealing with issues relating to the administration (including demands for and claims in respect of client assets and money). As is often the case in an insolvency, employees have been distracted and are exploring other job opportunities. This has inevitably resulted in difficulties in deploying resources effectively to the tasks in hand.

#### **SECTION F: ADMINISTRATORS' PROPOSAL FOR RESOLVING ISSUES IN RESPECT OF CLIENT MONEY AND ASSETS**

- 96** The Administrators recognise that they have duties in relation to property that may be subject to trust or other proprietary claims but they must also be rigorous in the systems that they design and implement to protect the interests of the general body of unsecured creditors, if the assets subject to trust claims are in truth assets of LBIE, as well as the rights of the trust claimants.
- 97** The Administrators are creating and implementing a plan to address these issues. The objectives of the Administrators' plan can be summarised as follows:
- 97.1** To identify and take appropriate steps to gain control of all property of or held in the name of or otherwise to the order of LBIE, whether money, securities or other contractual rights, that may be subject to trust or proprietary claims (the "**Trust Property**");
  - 97.2** To identify the entire population of counterparties that purport to have claims, rights or other interests in the Trust Property (the "**Trust Claims**");
  - 97.3** To seek to reconcile all of the data and information available to LBIE and the Administrators from the pre-administration records in relation



to the Trust Property with the information supplied by counterparties, custodians and any other appropriate sources;

- 97.4** Whether by agreement, directions from the Court or otherwise, to reach a clear determination of the various legal issues (a number of which have been characterised in Section E of this statement) that impact upon the validity of the Trust Claims and the rights of LBIE over the Trust Property;
- 97.5** Subject to directions from the Court, to agree a procedure for making interim distributions of Trust Property to counterparties with valid Trust Claims;
- 97.6** To determine the basis upon which the costs and expenses of the Administrators in dealing with and determining all issues in relation to the Trust Property can be discharged from the proceeds of the Trust Property and to apply for directions on such matters, as necessary;
- 97.7** To determine the most expedient method of communicating with counterparties in relation to the procedure being adopted by the Administrators, the progress made towards the achievement of the defined objectives and the directions that may be given from time to time by the Court.
- 98** The Administrators have deployed designated resource comprising partners and staff from PwC and Linklaters (the “**Trust Property Team**”) to take responsibility for the further development and implementation of a plan designed to achieve the objectives set out in paragraph 97 above.
- 99** The key steps of this approach to address the issues in relation to Trust Property, which is continuously evolving, include the following:

  - 99.1** The Administrators have defined a procedure that will be followed by the Trust Property Team, insulated from the responsibilities and distractions of the day to day events of the administration, to deal with all of the issues in relation to Trust Property. There are 1,300 clients of the Prime Services division of LBIE alone and several hundred clients of other divisions of LBIE that may have Trust

Claims. In the first three weeks of the administration proceedings, the resources of the Administrators and their legal advisers, Linklaters, have been disproportionately consumed in dealing with the claims and enquiries of a discrete number of trust claimants who have been seeking information in relation to the Trust Property or the return of Trust Property. The Administrators consider that it is essential that the Trust Claims be dealt with in an orderly manner and that the resources of the Administrators are managed to ensure that the demands of counterparties with Trust Claims do not unreasonably interfere with the responsibilities of the Administrators to deal with the affairs of and realise the general assets of LBIE for the benefit of the general body of unsecured creditors, whilst minimising the losses of and liabilities to those creditors. Indeed, given that some Trust Property may be the subject of competing Trust Claims, it is not possible to deal with each in isolation. The creation and implementation of the Trust Property Team will ensure that the Administrators are able to deal with the issues regarding Trust Property in a logical and coherent fashion, avoiding the piecemeal resolution of multiple disputes, whilst ensuring that such a system is not unfairly prejudicial to the interests of any particular counterparty.

**99.2** The Trust Property Team will undertake *inter alia* the following functions:

**99.2.1** Design and install a new IT system onto which it will upload all of the data available from the internal systems of LBIE, including details of client deposits and securities that may be Trust Property;

**99.2.2** Implement a process to reverse or amend the LBIE records for failed or broken trades (of which there have been approximately 142,000) as a consequence of the administration, to enable the Trust Property to be more fully identified;

- 99.2.3 Identify the impact of termination notices that have been served post-administration, validate these events and other activities of third parties and either review the clients' valuation of the impact of the termination or undertake a valuation of the impact of termination rights of LBIE under various contracts;
- 99.2.4 Agree a protocol in relation to the implementation of Corporate Actions<sup>GL</sup> that may need to be undertaken in relation to Trust Property, for example, the exercise of voting rights, receipt of dividends, rights issues and other pre-emptive offers that will have an impact on the ultimate value of the Trust Property.
- 99.3 The Trust Property is located with approximately 100 third party custodians, agents, counterparties, exchanges and clearing houses ("**Depots**"). The Trust Property Team are in the process of contacting all of these Depots to obtain confirmation of the securities that are being held and to agree a procedure whereby the Administrators can have online access (which in most cases has been withdrawn by the Depots) in relation to data regarding the securities and to seek to obtain formal written confirmation of the position, by security and by Depot. The Administrators are also seeking to establish that they have complete or adequate control over the securities for the ultimate benefit of the counterparties with Trust Claims or LBIE and that any liens asserted by the Depots are assessed and valued. Once the data is available, the Trust Property Team will seek to reconcile the books of LBIE to those of the Depots, by security and by Depot, with a view to identifying and resolving discrepancies. Given the sheer number of securities, this is likely to require significant time fully to reconcile. This data is fundamental to this exercise as these assets form the basis of any Trust Property. In addition, the interests of LBIE in its "house accounts" needs to be incorporated into our work.

- 99.4** The Administrators are in the process of writing to all of the counterparties who may have Trust Claims to obtain from them full details of the rights and claims they believe they have in relation to all forms of Trust Property. This is a complex request and will require extensive work by the counterparties to provide a detailed response to the Administrators. In some instances, it may take some weeks before counterparties are able to respond. One of the principal tasks to be assigned by the Trust Property Team will be to seek to reconcile all of the data that is obtained in relation to Trust Property as a consequence of the exercise outlined above with the information obtained from counterparties. Based on the Administrators' prior experience on other similar cases, working upon the assumption that each claim could take up to 50 - 100 hours fully to resolve, this reconciliation process has the ability to consume 70,000 - 140,000 man hours.
- 99.5** There is a real prospect that these processes identify a discrepancy between (a) the stock at Depots and LBIE's records, and (b) the claims of counterparties and LBIE's records, with the result that there is insufficient Trust Property to enable counterparties with valid Trust Claims to be fully compensated. That will not be known until the claims of all counterparties are agreed. The approach of the Administrators is designed to ensure that all parties are dealt with equitably and avoid any risk that counterparties engaging with the Administrators in the early phase of the administration do not gain an unfair advantage over those who are slower to engage.
- 99.6** Whilst the data reconciliation process is being undertaken, we have instructed Linklaters to devise a programme to determine by reference *inter alia* to the various contracts utilised by LBIE in its dealings with all counterparties, the various categories of legal issues that will need to be determined before a proposal for the distribution of the Trust Property can be prepared. A number of these legal issues are complex and Linklaters has already advised the Administrators that it has identified certain points that may

require directions from the Court before they can be resolved. Although it is of course desirable for this process to take place in parallel to the data collection exercises noted above, it may be more appropriate (in some cases) to wait until it is clear that all the legal issues identified need resolution in practice (that is, that there are in fact cases that cannot be resolved purely on the data and in respect of which the legal issue has more than a *de minimis* impact on the outcome).

**99.7** One of the key challenges for the Administrators is to determine the basis upon which the resolution of the claims of different counterparties should be prioritised. The Administrators have been concerned that they have been required to allocate a significant amount of their time and resources to the claims of certain counterparties in circumstances where, ultimately, various issues, either legal, contractual, accounting or factual (some of which will be common to a broader range of counterparties) are such that it is not possible to achieve resolution swiftly. We are striving to identify a set of principles that can be applied taking into account, for example, the following factors:

- 99.7.1** The quality and timing of data being available to the Administrators;
- 99.7.2** The speed of response of counterparties in dealing with the Administrators' questions, coupled with the quality and accuracy of the data supplied, and the complexity of the data and the legal issues relevant to the determination of a particular claim;
- 99.7.3** The number of claims that may be made to a particular class or category of Trust Property;
- 99.7.4** The risk of a shortfall of Trust Property;
- 99.7.5** The cost efficiency and expediency of the relevant process; and
- 99.7.6** Market stability and confidence.

**99.8** A discrete sub-committee has been set up by the Trust Property Team to monitor the construction and implementation of this scheme and the efficiency and fairness of the methodology. This sub-committee will also review the principles applicable to prioritising the determination of the claims of the particular counterparties by identifying, where appropriate, high profile problems or hardship issues, to ensure that the overriding objective of treating all counterparties fairly is not prejudicial to the interests of a minority or that there is not otherwise a problem that requires specific and accelerated attention. This sub-committee will meet periodically (initially daily) to review the prioritisation and refine the process as events develop.

## **CONCLUSION**

**100** In all the circumstances, the Administrators respectfully invite the Court to direct them to implement the approach set out in the Schedule.

## **STATEMENT OF TRUTH**

I believe that the facts stated in this witness statement are true.

Signed: [STEVEN ANTHONY PEARSON]

**STEVEN ANTHONY PEARSON**

6 OCTOBER 2008

## Schedule

### General approach

- 1 The Administrators will:
  - 1.1 identify and take appropriate steps to gain control of all property of or held in the name of or otherwise to the order of Lehman Brothers International (Europe) (“**LBIE**”) (in administration), whether money, securities or other contractual rights, that may be subject to trust or proprietary claims (the “**Trust Property**”);
  - 1.2 identify the entire population of counterparties that purport to have claims, rights or other interests in the Trust Property (the “**Trust Claims**”);
  - 1.3 seek to reconcile all of the data and information available to LBIE and the Administrators from the pre-administration records in relation to the Trust Property with the information supplied by counterparties, custodians and any other appropriate sources;
  - 1.4 whether by agreement, directions from the Court or otherwise, reach a clear determination of the various legal issues that impact upon the validity of the Trust Claims and the rights of LBIE over the Trust Property;
  - 1.5 subject to directions from the Court, agree a procedure for making interim distributions of Trust Property to counterparties with valid Trust Claims;
  - 1.6 determine the basis upon which the costs and expenses of the Administrators in dealing with and determining all issues in relation to the Trust Property can be discharged from the proceeds of the Trust Property and apply for directions on such matters, as necessary; and
  - 1.7 determine the most expedient method of communicating with counterparties in relation to the procedure being adopted by the Administrators, the progress made towards the achievement of the

defined objectives and the directions that may be given from time to time by the Court.

## **Method**

- 2** The Administrators will:
  - 2.1** deploy dedicated resource comprising partners and employees from PricewaterhouseCoopers LLP and Linklaters LLP (the “**Trust Property Team**”), to take responsibility for the further development and implementation of a plan designed to achieve the objectives set out in paragraph 1 above; and
  - 2.2** set up a discrete sub-committee to monitor the construction and implementation of this scheme and the efficiency and fairness of the methodology. This sub-committee will also review the principles applicable to prioritising the determination of the claims of the particular counterparties by identifying, where appropriate, high profile problems or hardship issues, to ensure that the overriding objective of treating all counterparties fairly is not prejudicial to the interests of a minority or that there is not otherwise a problem that requires specific and accelerated attention. This sub-committee will meet periodically (initially daily) to review the prioritisation and refine the process as events develop.

## **Key steps**

- 3** The Trust Property Team will undertake *inter alia* the following functions:
  - 3.1** design and install a new IT system onto which it will upload all of the data available from the internal systems of LBIE relating to client deposits and securities that may be Trust Property;
  - 3.2** implement a process to reverse or amend the LBIE records for failed or broken trades as a consequence of the Administration, to enable the Trust Property to be more fully identified;
  - 3.3** identify the impact of termination notices that have been served post-administration, validate these events and other activities of third



parties and either review the clients' valuation of the impact of the termination or undertake a valuation of the impact of termination on the rights of LBIE under various contracts; and

- 3.4 agree a protocol in relation to the implementation of corporate actions that may need to be undertaken in relation to Trust Property, for example, the exercise of voting rights, receipt of dividends, rights issues and other pre-emptive offers, that will have an impact on the ultimate value of the Trust Property.
- 4 The Trust Property Team will contact all of the third party custodians, agents, counterparties, exchanges and clearing houses ("**Depots**") where Trust Property may be located to obtain confirmation of the securities that are being held and to agree a procedure whereby the Administrators can have online access in relation to data regarding the securities and seek to obtain formal written confirmation of the position by security and by Depot. The Administrators will also seek to establish that they have complete or adequate control over the securities for the ultimate benefit of the counterparties with Trust Claims or LBIE and that any liens asserted by the Depots are assessed and valued. Once the data is available, the Trust Property Team will reconcile the books of LBIE to those of the Depots, by security and by Depot, with a view to identifying and resolving discrepancies. Where appropriate, this process will take account of the interests of LBIE in its "house accounts".
- 5 The Administrators will write to all of the counterparties who may have Trust Claims to obtain from them full details of the rights and claims they believe they have in relation to all forms of Trust Property. The Trust Property Team will seek to reconcile all of the data that is obtained in relation to Trust Property as a consequence of the exercise outlined in paragraph 4 with the information obtained from counterparties.
- 6 Whilst the data reconciliation process is being undertaken, the Administrators have instructed Linklaters to devise a programme to determine by reference *inter alia* to the various contracts utilised by LBIE in its dealings with all counterparties, the various categories of legal issues

that will need to be determined before a proposal for the distribution of the Trust Property can be prepared. The Administrators will consider whether it is possible for this process to take place in parallel to the data collection exercises noted in paragraphs 4 and 5 above, or whether it is more appropriate (in some cases) to wait until it is clear that all the legal issues identified need resolution in practice.

## **Prioritisation**

- 7** The Administrators will, having taken due account of any views of the FSA, identify a set of principles that can be applied when considering prioritising claims, taking into account, where appropriate and consistent with their duties as administrators, the following factors, amongst others:
  - 7.1** the quality and timing of data being available to the Administrators;
  - 7.2** the speed of response of counterparties in dealing with the Administrators' questions, coupled with the quality and accuracy of the data supplied, the complexity of the data and the legal issues relevant to the determination of a particular claim;
  - 7.3** the number of claims that may be made to a particular class or category of Trust Property;
  - 7.4** the risk of a shortfall of Trust Property;
  - 7.5** the cost efficiency and expediency of the relevant process; and
  - 7.6** market stability and confidence.

## Appendix A

### Glossary of Terms

**A2:** see “Moody’s Investors Services”.

**BaFin (Bundesanstalt für Finanzdienstleistungsaufsicht):** the Federal Financial Supervisory Authority is the public authority responsible for regulating the German securities market. It supervises banks and financial services providers, insurance undertakings and securities trading.

**Broker:** an agent who handles investors orders to buy and sell. For this service, a commission is charged which, depending upon the broker and the amount of the transaction, may or may not be negotiated. Alternatively a broker may act as matched principal, buying from one client to sell to another client, in which case the broker will sell at a price higher than he bought rather than charging an agency commission.

**CASS:** the Client Assets Sourcebook which forms part of the FSA Handbook and contains the FSA Rules relating to holding client assets and client money.

**Clearing systems:** systems that are used to facilitate clearance and settlement of transactions between investors through electronic book-entry changes in the accounts of such investors.

**Collateralised Debt Obligations (CDOs):** securities backed by debt instruments, such that the cash flows payable on the securities are dependent on the cash flows on the debt instruments which are held by the issuer of the securities.

**CONSOB (The Commissione Nazionale per le Società e la Borsa):** the public authority responsible for regulating the Italian securities market. It is the financial regulatory authority in Italy and is the Italian equivalent of the FSA.

**Convertible:** a security which, at the option of the holder, can be converted into other securities (and, in particular, shares) of the issuer. For legal and/or fiscal reasons, convertibles may be denominated in either the same or a different currency from that of the shares.

**Corporate Actions:** A corporate action is an event initiated by a public company that affects the securities (equity or debt) issued by the company. These events are generally approved by the company's board of directors although shareholders are permitted to vote on certain events. Examples of corporate actions in relation to equities are rights issues; tender offers; exercise of voting rights; and dividends. Examples of corporate actions in relation to debt are the payment and receipt of coupons.

**Credit Derivatives:** a credit derivative is a transaction which transfers the credit risk associated with a particular instrument from one party to another. There are a number of different forms, but one of the most common is the "credit default swap". Under this, one party will (in return for a fee) agree to make a payment to the other if a default occurs in relation to debt instruments issued or loans made by a stated "reference entity". The amount of the payment usually depends on the difference between the nominal value of one of the reference entity's debt securities and its market value immediately after the default.

**CREST:** the central securities depository for the UK, in which investors can hold securities in dematerialised form. It is also the electronic settlement system which facilitates paperless delivery of UK and other securities pursuant to executed securities transactions. It is operated by Euroclear UK & Ireland Limited.

**Derivatives:** the term "derivative product" or "derivative instrument" is a generic one. A derivative product is a product whose price depends on the value of another asset, for example, currency or securities, known as the "underlying asset". The holder of a derivative product does not acquire any rights in the underlying asset itself. Options, swaps, futures, forwards and contracts for differences are all types of derivatives.

**Equity Financing:** raising money for company activities by selling common or preferred shares to individual or institutional investors. In return for the money paid, shareholders receive ownership interests in the company. Also known as share capital. Alternatively, "equity financing" can refer to the raising of finance to facilitate the acquisition of equity securities by the

entity raising the finance, with the securities being charged in favour of the finance provider.

**Equity Securities:** shares and other instruments linked to equity such as warrants over an issuer's own shares. Also includes convertible bonds which are convertible into the issuer's shares or shares of another group entity.

**Failed trades:** trades which do not 'settle' (that is, securities are not delivered or payment obligations are not met) on their scheduled settlement date. The failure may be caused by a number of reasons.

**Futures:** rights under a contract for the sale of a security, commodity or property of any other description under which delivery is to be made at a future date and at a price agreed on when the contract is made.

**Futures Brokerage:** the handling of orders placed by investors to buy and sell futures.

**Hedge:** a financial strategy that offsets the risk of adverse price movement in one security (or other investment) by buying or selling another. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

**Hypothecate:** to pledge, mortgage or otherwise place a charge or lien on an asset. All these terms represent a security interest but are interpreted differently by different legal systems.

**ISDA:** the International Swaps and Derivatives Association.

**Long:** a professional dealer is said to be long on securities when he owns securities for investment purposes, or in anticipation of a future price rise or for general trading purposes, or because of temporary inability to sell them.

**Marked-to-market:** the act of assigning a value to a position held in a financial instrument based on the current market price for the instrument or similar instruments. For derivative instruments, marking-to-market involves financial models which use the current market value of the underlying assets to obtain a 'market' price for the derivative contract at that date.

**Matched principal:** see 'broker'.

**Moody's Investors Service:** a company which performs financial research and analysis on commercial and government entities. With Standard & Poor's and Fitch, it is one of the three main credit rating agencies. The company ranks the credit-worthiness of borrowers using a standardised ratings scale. The scale used in relation to issuer ratings runs from the top Aaa rating through Aa, A, Baa, Ba, B, Caa, Ca to the lowest rating, C. 1, 2 and 3 act as numerical modifiers within each of these letter ratings, with 1 and 3 indicating the higher-end and lower-end of the letter rating, respectively.

**Netting:** calculating a net amount payable by one party to a transaction by converting all obligations into cash sums and setting these off against each other to achieve one net payment payable by the appropriate party. Netting is a means of reducing the credit risk that is involved in a series of transactions by preventing the liquidator of an insolvent counterparty from "cherry picking", that is, enforcing transactions which are profitable to the insolvent counterparty while disclaiming (terminating) the rest, forcing the insolvent counterparty to prove in the liquidation for any loss it suffers as a result of the disclaimer. A number of mechanisms can be used to achieve a net position but the most important is "close-out netting" which involves documenting all the transactions between two counterparties under a single "master" agreement which provides that, in the event of insolvency, all the transactions are terminated and replaced by an obligation to pay a single net sum.

**Prime brokerage:** a bundled package of services offered by investment banks to professional investors seeking the ability to borrow, to invest on a leveraged basis and achieve an absolute return. The services provided under prime brokerage include securities lending, trade executions, and cash management, among other things. The Prime Broker provides a centralized securities clearing facility for the hedge fund. The Prime Broker benefits by earning fees on financing the client's long and short cash and security positions, and by charging fees for clearing and/or other services.

It also hypothecates the portfolios of the hedge funds it services in order to provide collateral for its own borrowing of cash and securities.

**Redemption:** the purchase and cancellation of outstanding securities through a cash payment to the holder. Securities called for redemption but not surrendered cease to earn interest after the redemption date.

**Rehypothecate:** where securities (“original securities”) are held by a party (Party A) for a client (Party B) and a right of rehypothecation exists, Party A will be able to use those original securities, for example by on-selling the securities, lending the securities under a stock loan or transferring the securities as collateral to another counterparty. Where Party A exercise a right of rehypothecation it will have an obligation to re-deliver to Party B ‘equivalent securities’, that is, securities of the same type or class as the original securities.

**Repurchase agreement or “Repo”:** the sale of securities coupled with an agreement to repurchase those securities at a future date at a price equal to the original purchase price plus a rate reflecting interest rates. Repos are used as a way of obtaining short term funding. They are usually documented under master agreements such as the TBMA/ISMA Global Master Repurchase Agreement.

**Settlement Finality Directive:** an EU directive, implemented in England, Scotland & Wales by the Financial Markets & Insolvency (Settlement Finality) Regulations 1999, which seeks to reduce the systemic risk associated with participation in payment and securities settlement systems.

**Short:** for example, “go-short” or “sell short”. To sell a security not owned by the seller in anticipation of a price decline, the seller settling the sale through a borrowing of the security with bonds purchased at the lower price before completion in order to fulfil his obligation. Generally the seller will hope to buy the subject matter back at a lower price in order to make a profit and will make a loss if the price of the stock increases.

**Stock loan:** an outright transfer of stock is made from the lender to the borrower in return for an outright transfer of collateral, usually in the form of securities rather than cash. The securities which have been “borrowed” are

marked to market (that is, valued) each day and adjustments to the amount of collateral held are made to take account of price fluctuations. At the end of the term, securities equivalent to the borrowed securities are returned to the lender and the borrower gets back equivalent collateral. The borrower pays a fee to the lender based on the value of the borrowed securities. The legal structure is therefore the same as for repos, although the documentation used is slightly different. Stocklending is an essential part of the domestic and international securities market. For participants in the market the ability to borrow stock facilitates timely settlement and reduces the risk of settlement failures. It also helps to enhance liquidity by enabling market makers to run long and short positions. Furthermore, it enables institutions to improve their investment performance by lending stock and helps market players to reduce their costs by minimising the need to hold long positions.

**Synthetics:** a generic term for a financial instrument or derivative contract which simulates the return on an actual holding of the instrument which is referenced by the synthetic contract. For example, a party could buy shares (actual holding) or could enter into a total return swap (synthetic holding) under which that party receives the price increase of the shares but also has to pay the price decrease of the shares thereby mirroring a holding of such shares. A synthetic usually provides leverage as the purchase price of the underlying does not have to be outlaid by the party entering into the synthetic.

**UNCITRAL:** The United Nations Commission on International Trade Law.

**Underwriting:** an arrangement under which banks agree to subscribe, or procure subscribers, for an agreed amount of securities of a new issue on a given date and at a given price, thereby assuring the issuer of the full amount of the issue regardless of the response from investors generally.



Applicant  
S A Pearson  
First Statement  
"SAP1"  
6 October 2008

**No. 7942 of 2008**

**IN THE HIGH COURT OF JUSTICE**

**CHANCERY DIVISION**

**COMPANIES COURT**

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

**AND IN THE MATTER OF THE INSOLVENCY ACT  
1986**

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**WITNESS STATEMENT OF  
STEVEN ANTHONY PEARSON**

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