

# LOWENSTEIN SANDLER PC CLIENT ALERT

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## LIMITED TIME FOR HOLDERS OF LEHMAN BROTHERS CREDIT DEFAULT SWAPS TO PARTICIPATE IN ISDA SETTLEMENT PROTOCOL

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**Clients who desire to participate in the International Swaps and Derivatives Association, Inc. ("ISDA") 2008 Lehman Brothers Holdings Inc. ("Lehman") Credit Default Swap ("CDS") Settlement Protocol (the "Settlement Protocol") must do so by Wednesday, October 8, 2008 at 5:00 p.m. (New York time). The period to join the Settlement Protocol opens on Monday, October 6, 2008; accordingly, there is a relatively narrow window for clients to elect to participate.**

On Thursday, October 2, 2008, ISDA published a draft Lehman CDS Settlement Protocol and, on Friday, October 3, 2008, the Lowenstein Sandler Derivatives Practice Group, along with other dealers, end-users and market professionals, participated in an ISDA-sponsored conference call on this subject. The comment period for the draft Settlement Protocol closed at 5:00 p.m. on Friday, October 3, 2008. It is anticipated that the final Settlement Protocol will be made available to market participants on the morning of October 6, 2008 (the final Settlement Protocol is not anticipated to contain any material changes from the draft

Settlement Protocol). Pursuant to the Settlement Protocol and other ISDA published materials, there will be a relatively narrow timeframe for protection buyers and protection sellers of CDS contracts, where Lehman is the Reference Entity, to elect to participate in the Settlement Protocol. The window to join the Settlement Protocol will open on Monday, October 6, 2008 and close on Wednesday, October 8, 2008 at 5:00 p.m. (New York time) (the "Adherence Period"). To join the Settlement Protocol, market participants must execute and deliver to ISDA an "Adherence Letter" during the Adherence Period. The Lehman auction to determine the settlement value of the Lehman CDS contracts participating in the Settlement Protocol will occur, and the results will be announced, on Friday, October 10, 2008.

The members of the Lowenstein Sandler Derivatives Practice Group (contact information appears at the end of this Client Alert) are available to counsel our clients regarding the Lehman CDS Settlement Protocol and to assist in filing Adherence Letters on a timely basis.

### **ISDA Settlement Protocols Allow for the Orderly Settlement of CDS Contracts**

Many CDS contracts provide that a protection buyer must physically settle the CDS contract by delivering a debt instrument of the Reference Entity to the protection seller. In general, in exchange for the debt instrument, the protection seller will pay the protection buyer the par value of the delivered debt instrument. However, as demonstrated by prior settlements of CDS contracts, the value of CDS contracts written on a particular Reference Entity is substantially in excess of the value of the Reference Entity's outstanding debt. For example, in the Delphi bankruptcy, it is estimated that there were USD 28 billion of CDS contracts with Delphi as the Reference Entity, but Delphi had only USD 2.2 billion par value of bonds and USD 3 billion in loans outstanding. Accordingly, if each holder of a CDS contract had to physically settle its

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contract, this settlement process would cause considerable market disruption because there are simply not enough debt instruments outstanding for every CDS contract holder to concurrently physically settle such contracts.

To mitigate this market disruption, market participants, through the auspices of ISDA, have developed the CDS settlement methodology, allowing CDS contract holders, on a multilateral basis, to amend the settlement method of CDS contracts from physical settlement to cash settlement. The price at which the CDS contracts are cash settled is determined at an auction with dealers and other market participants. The first ISDA settlement protocol occurred in May 2005 for Collins & Aikman and subsequent protocols have occurred with respect to Delta, Northwest, and more recently, with Tembec, Fannie Mae and Freddie Mac. General market sentiment is that the ISDA settlement protocol methodology is an efficient mechanism for settling CDS contracts and provides a fair valuation for such contracts.

Given the nature of the CDS market it is impossible to accurately estimate the disparity between the value of CDS contracts written on Lehman as the Reference Entity and the amount of Lehman outstanding debt. However, nearly every market participant believes this disparity to be significant.

### **Participation in the ISDA Protocol is Optional, CDS Protection Buyers Can Still Undertake Physical Settlement**

The Lehman CDS contract counterparties, the protection buyer or the protection seller, need not participate in the Lehman CDS Settlement Protocol (although all major CDS dealers are expected to participate). Accordingly, after the Adherence Period closes, it is important to verify that the counterparty to each relevant Lehman CDS contract has elected to participate in the Settlement Protocol. To the extent that a counterparty to one or more specific Lehman CDS contracts has not elected to participate in the Settlement Protocol, the counterparties nonetheless may enter into a bilateral amendment to provide for cash settlement or may settle in accordance with the existing terms of the CDS contracts. Moreover, the proposed Settlement Protocol does not cover every iteration of Lehman debt. For example, Lehman subordinated debt cannot be settled pursuant to the Settlement Protocol and certain other Lehman debt may not be deemed a Deliverable Obligation pursuant to either the Settlement Protocol or the express terms of a particular CDS contract.

Additionally, if a protection buyer holds Lehman debt in its portfolio and desires to retain its Lehman debt for investment or other purposes, the protection buyer

is not obligated to deliver such debt and, instead, may participate in the Settlement Protocol to monetize its CDS contracts.

### **Narrow Window to Participate in ISDA Protocol Means Market Participants Need to Act Quickly**

As previously stated, participation in the Settlement Protocol requires the execution and delivery of an Adherence Letter by Wednesday, October 8, 2008 at 5:00 p.m. (New York time). Members of the Lowenstein Sandler Derivatives Practice Group are available to assist our clients in delivering the appropriate Adherence Letter, to counsel on the benefits and detriments of joining the Lehman CDS Settlement Protocol relative to a specific client's holdings, to draft the appropriate physical settlement documents or to otherwise provide advice regarding CDS contracts or other derivative positions.

Lowenstein Sandler's Derivatives Practice Group will continue to monitor and report on developments regarding the issues affecting investment managers, pooled investment vehicles and other matters of interest to our clients.

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