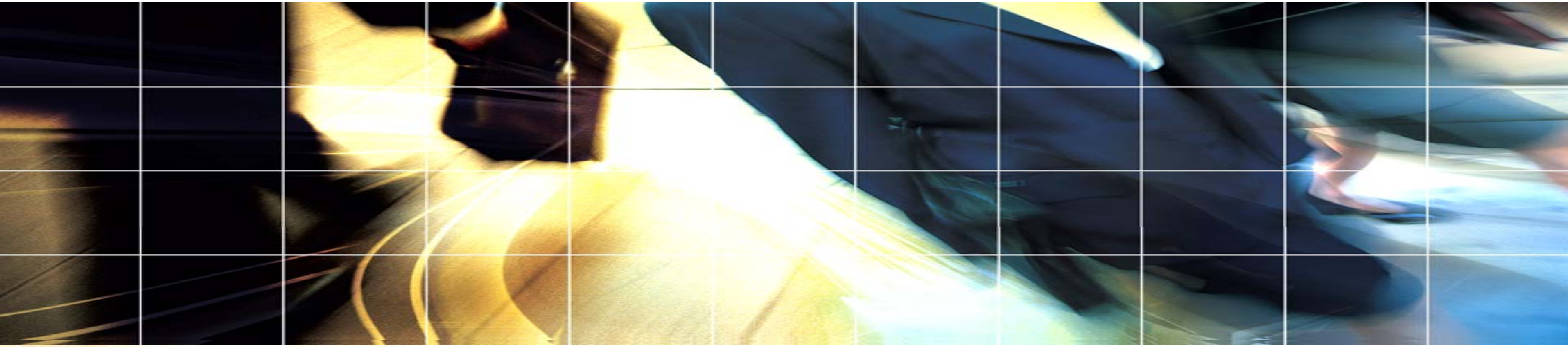
RECENT TRENDS IN CDO AND DERIVATIVE LITIGATION



NYSBA Derivatives and Structured Products Law Committee

New York, March 18, 2008

JONES DAY | One Firm Worldwide

CDOs and the "Sub-Prime" problem?

- Global CDO Market Issuance
  - 2004: $157 billion
  - 2005: $271 billion
  - 2007: $412 billion
- The Sub-Prime Trigger
  - $500-600 billion globally expected to be written off against the value of sub-prime mortgages
- But, not just a "sub prime" issue
- Broader credit crisis: ratings downgrades & forced liquidations
- Few financial institutions unscathed
- Litigation: imminent
- The worst is yet to come?

CDO Litigation Theories

- **<u>What triggers litigation</u>**:
  - Unexpected and large potential losses
  - Tripping of over-collateralization or similar tests
  - Disagreement over priority of payments
  - Liquidation of portfolio assets
  - Collateral calls
  - Poor documentation: ambiguity = opportunity
  - Unwillingness to compromise, or inability to do so – due to encumbered balance sheet
  - In our view: all bets are off and virtually every action (or even inaction sometimes) carries litigation risk

CDO Litigation Theories

- **<u>Who brings the claims</u>**:
  - CDO investors
    - Senior Note holders vs. Income Note holders
    - Institutional vs. individual investors
  - Hedge funds/ fund investors
  - Liquidators and trustees of insolvent CDOs
  - Swap counterparties
  - Mono-line insurers
  - Warehouse agents

CDO Litigation Theories

- **<u>Who gets sued</u>**:
  - Placement agents\underwriter
  - Portfolio managers
  - Financial advisors
  - Administrative agents
  - CDO directors and officers
  - Rating agencies
  - Mono-line insurers
  - Accountants
  - Other professionals? Law firms?

CDO Litigation Theories

- **<u>What are the claims</u>**:
  - Sales Practices
    - Misrepresentations and omissions
    - Collateral contracts/promissory estoppel
    - Suitability
  - Federal securities fraud claims
  - Mismanagement; Breach of fiduciary duty
  - Breach of contract
    - Contract interpretation
    - Third party beneficiary standing
  - Accessorial liability; civil conspiracy
  - Class actions ??

Mis-selling: Disclosure and Disclaimers

New York law summary:

- "where a party specifically disclaims reliance upon a particular representation, that party cannot, in a subsequent action for common law fraud, claim it was fraudulently induced to enter into a contract by the very representation it has disclaimed reliance upon."

- Disclaimer must be specific such that it "tracks the substance of the alleged misrepresentation."

- General disclaimers alone - unlikely to suffice.

- In addition to the disclaimer terms, courts will examine "the entire context of the transaction, including factors such as its complexity and magnitude, the sophistication of the parties, and the content of any agreements between them."

Mis-selling: Disclosure and Disclaimers

- *Danann Realty Corp. v. Harris (NY Ct. App.)*
  - A party, having expressly disclaimed reliance on representations not included in the contract, cannot claim fraud in the inducement of the contract on the strength of oral representations.
  - Plaintiffs' purported reliance on oral representations was negated by a specific disclaimer that expressly disclaimed reliance on "any statement or representation not embodied in the [final contract]."
  - The rule in *Danann* has been followed closely by state and federal court in New York over the past four decades.
  - **But**: Growing body of US case law that provides exceptions to the rule in Danann.

Mis-selling: Disclosure and Disclaimers

- Disclaimers must be specific in order to be effective.
- Exception to *Danaan* is invoked successfully by individual investors but also, on occasion, by institutional investors.
- *Caiola v. Citibank (2d. Cir.)*
  - "A disclaimer is generally enforceable only 'if it tracks the substance of the alleged misrepresentation . . . .'"
- *Mfrs. Hanover Trust Co. v. Yanakas (2d. Cir.)*
  - A valid disclaimer "must contain explicit disclaimers of the particular representations that form the basis" of the claim.

Mismanagement: Duty of reasonable care and skill

- Relevant to managed CDOs
- Issues predominantly affect collateral/portfolio manager, the SPV and investors
- *HSH Nordbank v. UBS* (complaints about changes in the composition of the portfolio)
- General complaints relate to:
  - Alleged failure to purchase investments which match eligibility criteria, portfolio diversity and/or quality tests
  - Undervaluation of assets when selling collateral
  - Overvaluation of assets when acquired from warehouse
- Who sets the standard of care? "Industry practice?"

Mismanagement: Duty of Good Faith

- Is there a duty of good faith?
  - Covenant of good faith and fair dealing is implied in all contracts under New York Law.
  - This does not create new contractual rights, *see, e.g. Village on Canon v. Bankers Trust Co.* (S.D.N.Y.), or substantive rights that are inconsistent with those established by the contract, *see, e.g. Tagare v. NYNEX Network Sys. Co.* (S.D.N.Y.).
  - The manner in which you obtain quotes can implicate the covenant of good faith and fair dealing. *High Risk Opportunities HUB Fund Ltd. v. Credit Lyonnais*, No. 600229/00 (Sup. Ct. N.Y. County July 7, 2005) (unpublished opinion).

Is The Written Contract The Entire Contract?

- Implied Terms: circumstances
  - Parties' intentions- "necessary to give business efficacy/officious bystander" ?
  - debate re whether separate test or both elements required
  - some authors consider that necessity is the practical test for showing the intention of the parties
  - implied term must not contradict the express wording of the contract
  - Courts are generally reluctant to imply terms into negotiated contracts

Is The Written Contract The Entire Contract?

- By statute – e.g., re sale/supply of goods and services
- Custom/usage – rare (legal/certain/reasonable/ universally acknowledged/not contrary to express terms)
  - *"You should not have purchased collateral outside of the eligibility criteria – collateral should have been fit for purpose"*
  - *"You ought to have provided me with timely/accurate customer reporting information"*
  - *"You ought to have managed the investments conservatively"*
  - *"You ought not to have substituted inappropriate investments"*

How Much is the Loss and Damage?

- Valuation difficulties
  - Often difficult to assess loss
  - Different methodologies for valuing CDO’s and CDO assets
- Market quotation and loss
  - ISDA Master Agreement
  - Which formula chosen by the parties?
  - Does the chosen formula produce a commercially reasonable result?
  - How do you bullet-proof” a CDS valuation
  - *High Yield Fund; AEP v. BMO*

How Much is the Loss and Damage?

- Penalty clauses
  - May be relevant where amounts payable following a breach of contract
  - Liquidated damages/penalty
  - Is the stipulated sum a genuine estimate of loss flowing from the breach?
- Exclusions/limitation of liability clauses
  - Reasonableness requirement if excluding for misrepresentation or negligence
- Mitigation
  - Claimant cannot recover damages for a breach where loss could have been avoided by taking reasonable steps

CDO Class Actions?

- Presumption of reliance based on “fraud on the market theory” not available to CDO investor class.
- Is there another basis for a presumption of reliance?
  - *Affiliated Ute Citizens of Utah v. United States* (U.S. Sup. Ct.)
    - Presume reliance in “omissions” cases.
  - *Cromer Finance v. Berger* (S.D.N.Y.)
    - Hedge fund = no public trading = no fraud on the market theory.
    - Numerosity requirement barely met (≤100 class members).
    - But class certified because fraud concerned NAV and the Court presumed that every investor relied on NAV.
- *But see Primavera v. Askin* (S.D.N.Y) (denying certification to purported class of hedge fund investors).

Choice of Law/Forum

- The language in the 1992/2002 Master Agreement is not broad enough to cover all disputes relating to the Master Agreement under New York law.
- Include broad choice of law provision stating that controversies "arising out of or relating to" the Master Agreement are governed by New York law.
- Include provision defining set-off rights as part of documentation.
- Exclusive vs. non-exclusive
- London vs. New York
- "Jurisdictional Arbitrage"

Issues in International CDO and Derivatives Litigation

- Layers of complications in addition to documentation and sales and marketing issues
- Registration Claims
- Franchise/Reputation Risk
- Jurisdictional issues
- Discovery/Access to Evidence
- Novel Damages Theories
- The potential for “Criminal” Liability
- Strict Liability (disclaimers are ineffective)

Tips/Final Thoughts

- Audit of real world practices:
  - Detailed assessment of current exposure
  - Examination of documents and sales practices
  - Understanding of regulatory risk in off-shore transactions
- Restructuring:
  - A trap for the unwary but an opportunity for others
  - Obtain a release for prior actions as part of the modification
  - Improve on existing forum selection provisions
  - Insert jury trial waivers
  - Provide for indemnification
- Plan for dealing with liquidation, collateral call and other events
  - Develop/review procedures for liquidation
  - Have on-call experts to vet valuation and process
  - Conduct the liquidation/calls with anticipation of litigation

Tips/Final Thoughts

- Can drafting errors or mismatches between contractual documentation be exploited?
- Can you take advantage of specific rules governing particular types of contracts, e.g., contracts of insurance/contracts of guarantee?
- Indemnity available under transaction documents
  - Administrative agents; portfolio managers
  - Priority of payments for swap counterparty
- Sharing legal documents between group companies
- Choice of Forum
  - Exclusive –v- non-exclusive
  - Consistency of forum choice in transaction documents
  - Possibility of legal action in a different forum
  - Anti-suit injunctions
  - Tactical considerations

Exhibit 1

- **A REVIEW OF U.S. CDO LITIGATION:**
  - *Bank of New York Trust Co. v. Franklin Advisers, Inc., et al*. (S.D.N.Y.)
  - *SNS Bank, N.V. v. Citibank, N.A. et al*. (N.Y. Sup. Ct.)(1st Dep't)
  - *Banco Espirito Santo de Investimento, S.A. v. Citibank, N.A.* (S.D.N.Y.)(2d Cir.)
  - *Daniel Boone School Dist. V. Lehman Bros. Inc*. (W.D. Pa.)
  - *Debussy, L.L.C. et al. v. Deutsche Bank, A.G. et al*. (S.D.N.Y.) (2d Cir.)
  - *Deutsche Bank Trust Co. Americas v. Lacrosse Financial Products, LLC, et al*. (N.Y. Sup. Ct.)
  - *Wells Fargo Bank, N.A. v. Calyon, Magnetar Constellation Master Fund, Ltd., et al*. (S.D.N.Y.)
  - *HSH Nordbank AG v. UBS AG and UBS Securities LLC* (N.Y. Sup. Ct.)

Exhibit 1

- **A REVIEW OF U.S. CDO LITIGATION:**
  - *Bank of New York Trust Co. v. Franklin Advisers, Inc., et al.* (Interpleader Complaint, filed in S.D.N.Y. Feb. 28, 2007)
    - BONY was Trustee under an Indenture pursuant to which two Franklin companies issued various classes of notes and securities.
    - Another Franklin company agreed to act as Manager of the collateral provided as security for the debt obligations issued under the Indenture.
    - Certain of the collateral was liquidated pursuant to a Notice of Redemption and the Trustee was charged with making payments from the liquidated proceeds in accordance with the Indenture.
    - BONY, an interpleader plaintiff, alleged that as Trustee it has received competing claims from the Majority Preferred Shareholders and the Collateral Manager and thus was exposed to multiple liability with respect to its disposition of certain funds absent Court resolution.
    - BONY sought to extricate itself by depositing the funds into the Court registry through the interpleader complaint.

Exhibit 1

- **A REVIEW OF U.S. CDO LITIGATION:**
  - *SNS Bank, N.V. v. Citibank, N.A., et al*. (N.Y. Sup. Ct.) (1st Dep't)
    - Dutch Bank purchased $15MM in income notes in CDO.
    - Bank executed a subscription agreement.
    - The CDO was launched in 1996.
    - In 2000-01, there were significant portfolio losses.
    - In 2001, the Administrative Agent replaced the Portfolio Manager with an affiliate.
    - Portfolio losses continued to mount.
    - Bank's claims included: breach of contract, breach of fiduciary duty, unjust enrichment.
    - Defendants: Fund, Fund Directors and Officers, Administrative Agent, Portfolio Manager, and Employees of Administrative Agent.

Exhibit 1

- **A REVIEW OF U.S. CDO LITIGATION:**
  - *SNS Bank, N.V. v. Citibank, N.A., et al*. (cont'd)
    - Motion to dismiss granted; affirmed on appeal.
    - Principal holdings:
      - Income Note holders have no third-party beneficiary standing to assert breaches of Administration Agreement and Portfolio Management Agreement.
      - None of the defendants owed a fiduciary duty to Income Note holders, notwithstanding stray references to "fiduciary" role in marketing and other materials.
      - Defendants were not unjustly enriched where they received fees pursuant to the express formula set forth in the transaction documents and Offering Memorandum.
      - Limitation of liability provisions in Administration and Portfolio Management Agreement were enforceable.

Exhibit 1

- **A REVIEW OF U.S. CDO LITIGATION:**
  - *SNS Bank, N.V. v. Citibank, N.A., et al.* (cont'd)

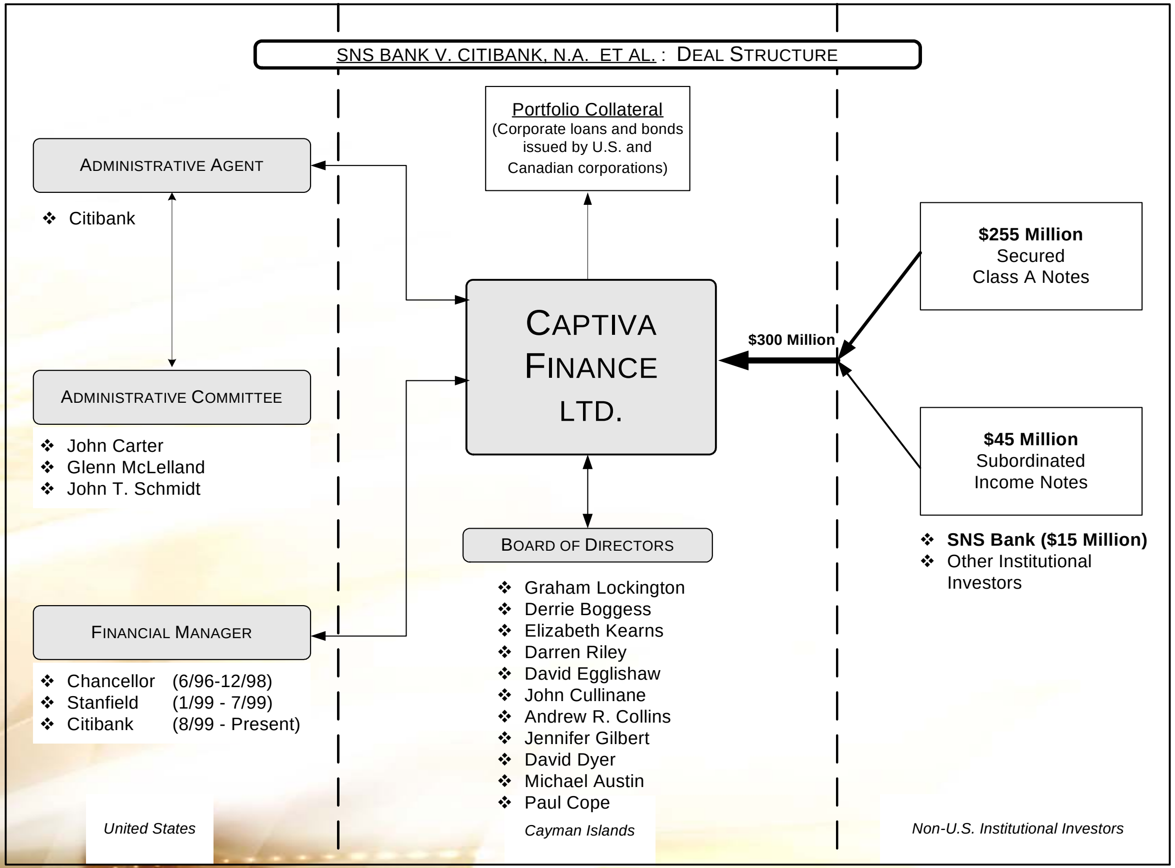


Exhibit 1

- **A REVIEW OF U.S. CDO LITIGATION:**
  - *SNS Bank, N.V. v. Citibank, N.A., et al.* (cont'd)
    - A historical perspective on default rates
    - Market forces cause of defaults. Would court today be receptive to argument?

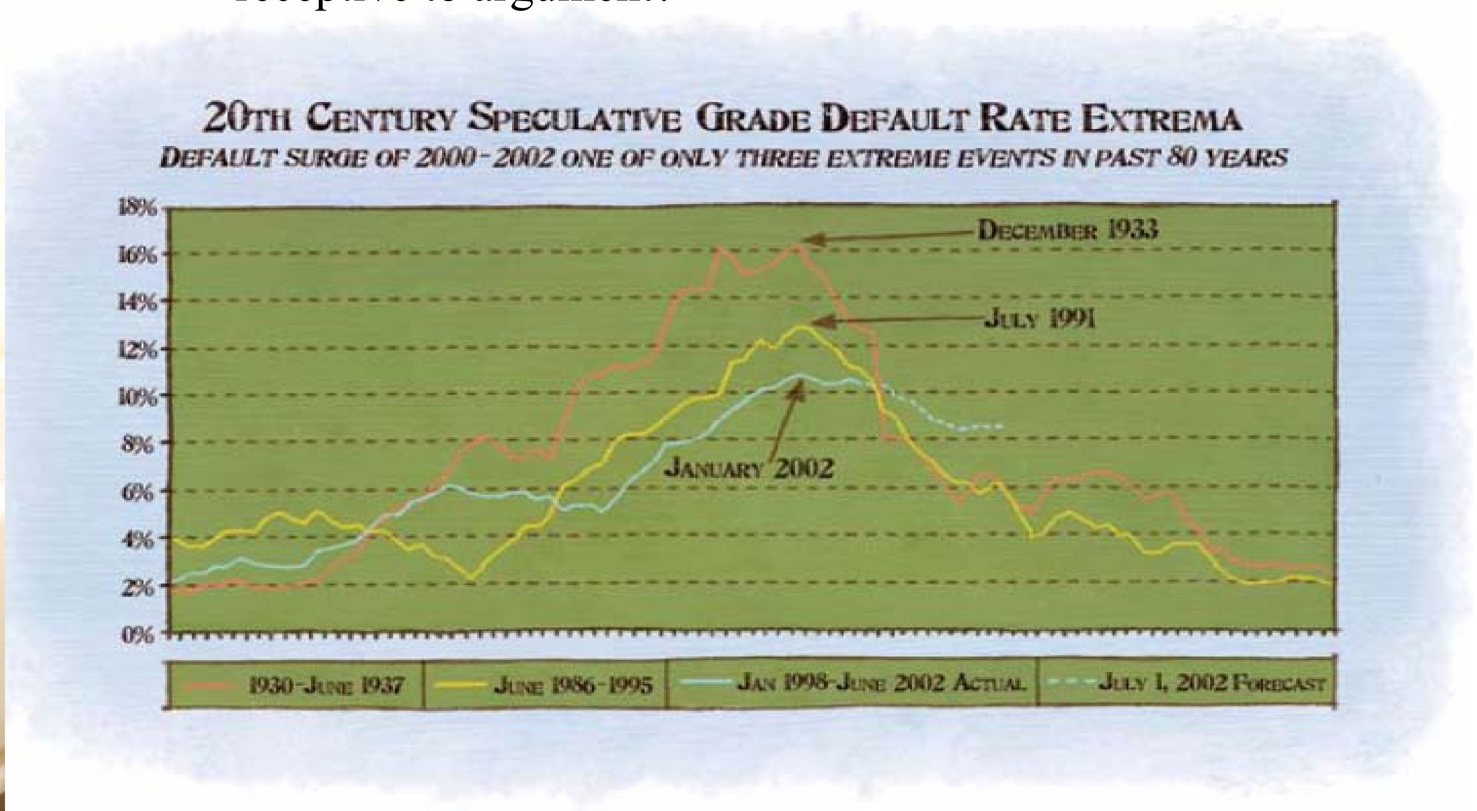


Exhibit 1

- **A REVIEW OF U.S. CDO LITIGATION:**
  - *SNS Bank, N.V. v. Citibank, N.A., et al.* (cont'd)
    - The priority of distribution provision, simplified

[redacted]

Exhibit 1

- **A REVIEW OF U.S. CDO LITIGATION:**
  - *Banco Espirito Santo de Investimento, S.A. v. Citibank, N.A.* (S.D.N.Y.) (2d Cir.)
    - Portuguese Bank purchased $25MM in Income Notes issued by two CDOs.
    - Bank executed a subscription agreement for only one of the two purchases.
    - There were extensive face-to-face meetings prior to each investment at which certain oral representations are alleged to have been made.
    - Bank claimed that defendant promised "active" oversight and management and "protection of principal."
    - When the portfolio performance deteriorated, there were further written and oral communications.
    - Bank claimed that defendant stated "the portfolio was distressed from the very start" and loans were issued "under lax underwriting standards."
    - Bank alleged breach of oral promises, fraud on the inducement, breach of fiduciary duty and unjust enrichment.
    - Defendant: placement agent = administrative agent = portfolio manager for one of the two CDOs.

Exhibit 1

- **A REVIEW OF U.S. CDO LITIGATION:**
  - *Banco Espirito Santo de Investimento, S.A. v. Citibank, N.A.* (S.D.N.Y.) (2d Cir.)
    - Motion to dismiss granted; affirmed on appeal by the Second Circuit.
    - Principal holdings:
      - Disclaimers of reliance in marketing materials and Offering Memorandum effectively disclaimed Bank's reliance on any extraneous representations, including "oral promises."
      - "Every promise **is** a representation."
      - Ban lacked third-party beneficiary standing to enforce Administration and Financial Management Agreements.
      - The limitation of liability provisions in those Agreements applied.
      - The fraud claim was dismissed because the Bank failed to allege that the defendant knew of the distressed portfolio at the relevant time.
      - The Court *sua sponte* foreclosed any opportunity to amend.

Exhibit 1

- **A REVIEW OF U.S. CDO LITIGATION:**
  - *Daniel Boone School Dist. V. Lehman Bros. Inc.* (W.D. Pa.)
    - Pennsylvania school district suffered investment losses in certain unauthorized CMO investments made by its investment advisor.
    - Investment advisor had purchased CMOs from Lehman. PA statute prohibited school districts from purchasing such derivative investments.
    - School district alleged that Lehman had raised questions about the impropriety of derivatives investments for the school district.
    - School district alleged various claims of direct and accessorial liability.
    - On motion to dismiss, court dismissed all claims of direct liability and accessorial liability, but let stand a claim for civil conspiracy under PA Law.
    - Although Lehman was not primarily liable, it "***might be liable as a co-conspirator with [investment advisor]*** because it sold derivatives to him knowing that his purchase of those derivatives was unlawful."

Exhibit 1

- **A REVIEW OF U.S. CDO LITIGATION:**
  - *Debussy, L.L.C. et al. v. Deutsche Bank, A.G. et al*. (S.D.N.Y.) (2d Cir.)
    - Synthetic CDO investment made in 1998.
    - Plaintiff purchased 100% of the subordinated floating Certificates.
    - Two Scudder mutual funds purchased 100% of senior Notes.
    - A Scudder entity was the original portfolio manager.
    - In April 2002, Deutsche Bank acquired Scudder.
    - Deutsche Asset Management replaced Scudder as Portfolio Manager.
    - Plaintiff approved replacement.
    - Two months later, the Notes were redeemed: 50% recovery of principal.
    - Certificate holder received no return of principal.
    - Plaintiff claims breach of fiduciary duty and breach of contract.
    - District Court: Cased dismissed; failure to bring as derivative claim.
    - Affirmed on appeal.

Exhibit 1

- **A REVIEW OF U.S. CDO LITIGATION:**
  - *Deutsche Bank Trust Co. Americas v. Lacrosse Financial Products, LLC, et al*. (N.Y. Sup. Ct.)
    - Deutsche Bank, as trustee of the Sagittarius CDO, filed an interpleader action in December 2007 to determine whether the CDO's investors (led in this case by UBS) or the CDO's credit insurer (a unit of MBIA that entered into a credit default swap) have the right to the remaining payments under the CDO.
    - The interpleader complaint names as defendants "Does 1 though 100, the owners of the beneficial interests" - that is the investors who bought the interests in the CDOs.
    - The MBIA unit claims it has senior rights as a result of provisions in the credit default swap agreement, a position that unnamed investors have, according to the complaint, characterized as "neither reasonable nor correct." The interpleader action seeks to sort out the competing interests.

Exhibit 1

- **A REVIEW OF U.S. CDO LITIGATION:**
  - *HSH Nordbank AG v. UBS AG and UBS Securities LLC* (N.Y. Sup. Ct.)
    - On February 25, 2008, German state-owned bank HSH Nordbank AG sued UBS and UBS Securities LLC.
    - The lawsuit relates to one of HSH's constituent bank's $500 million investment in 2002 in CDO securities created and managed by UBS.
    - HSH also provided UBS with CDS protection.
    - HSH claims that UBS selected inferior collateral and used the CDO as a dumping ground for troubled mortgage-backed securities as a way to profit from the CDS.
    - HSH accuses UBS of breach of contract, fraud, negligent misrepresentation, and breach of fiduciary duty.
    - HSH is demanding at least $275 million in restitution plus punitive damages.

Exhibit 1

- **A REVIEW OF U.S. CDO LITIGATION:**
  - *HSH Nordbank AG v. UBS AG and UBS Securities LLC* (N.Y. Sup. Ct.) (cont'd)
    - Forum: New York state court lawsuit between two foreign-domiciled companies. UBS has counter-sued in the UK.
    - Theory: not a mere misrepresentation or mis-selling claim. Rather, suit looks behind the documents at UBS's conduct and claims that UBS fraudulently manipulated the transaction structure to its own profit and to the investors' detriment.
    - Novelty: Apparently the first reported filing of a CDS dispute concerning "sub-prime" assets.

Exhibit 2

- **DERIVATIVES: CLOSE-OUT CALCULATIONS**
  - *High Risk Opp. HUB Fund Ltd. v. Credit Lyonnais*, Slip op. (N.Y. Sup. Ct. July 07, 2005)
  - *AEP Energy Services, Inc. et al. v. Bank of Montreal (S.D. OH)*

Exhibit 2

- **DERIVATIVES: CLOSE-OUT CALCULATIONS**
  - *High Risk Opp. HUB Fund Ltd. v. Credit Lyonnais*, Slip op. (N.Y. Sup. Ct. July 07, 2005)
    - Issue: whether Credit Lyonnais properly valued contracts through the Market Quotation procedure.
    - What does "Market Quotation" mean?

"Market Quotation" *means, with respect to one or more Terminated Transactions and a party making the determination, an amount determined on the basis of quotations from Reference Market-makers. Each quotation will be for an amount, if any, that would be paid to such party… or by such party… in consideration of an agreement between such party… and the quoting Reference Market-maker to enter into a transaction (the "Replacement Transaction") that would have the effect of preserving for such party the economic equivalent of any payment or delivery… by the parties under Section 2(a)(i) in respect of such Terminated Transaction or group of Terminated Transactions that would, but for the occurrence of the relevant Early Termination Date, have been required after that date.*

Exhibit 2

- **DERIVATIVES: CLOSE-OUT CALCULATIONS**
  - *High Risk Opp. HUB Fund Ltd. (cont'd)*
    - Parties entered into several non-deliverable forward contracts (NDFs).
    - NDFs were currency contracts based on the exchange rate between the US dollar and the Russian ruble where High Risk was entitled to payment at Termination if the value of the ruble declined and Credit Lyonnais if the value of the ruble increased.
    - ISDA Master Agreement with "Event of Default" and "Early Termination Date" provided for calculation of "Settlement Amount" using "Market Quotation."
    - Series of events placed High Risk in voluntary liquidation.
    - Credit Lyonnais declared Early Termination of eight outstanding NDFs on grounds that High Risk's insolvency constituted an Event of Default.

Exhibit 2

- **DERIVATIVES: CLOSE-OUT CALCULATIONS**
  - *High Risk Opportunities HUB Fund Ltd. (cont'd)*
    - Credit Lyonnais contacted 13 market-makers to obtain valuations.
    - Credit Lyonnais instructing the market-makers in writing to consider the existence of Exchange Risk as a factor in valuing the NDFs.
    - Credit Lyonnais followed up with phone calls to several of the market makers.
    - Credit Lyonnais eventually received 4 quotations upon which it relied.
    - High Risk sued Credit Lyonnais claiming it caused High Risk's insolvency by failing to post margin payments and that it improperly calculated the Settlement Amounts owed.

Exhibit 2

- **DERIVATIVES: CLOSE-OUT CALCULATIONS**
  - *High Risk Opportunities HUB Fund Ltd. (cont'd)*
    - High Risk claimed that the market quotations were not obtained in good faith.
    - Held:
      - Section 14 is unambiguous and must be enforced according to the plain meaning of its terms.
      - Market Quotation procedure did not mention Exchange Risk, which was instead described in the individual Confirmations, executed after the Master Agreement.
      - Credit Lyonnais failed to act in good faith because it interfered with the market-makers' independence in valuing the NDFs.
      - Under the Master Agreement, Loss valuation procedure applies where, as here, adequate Market Quotations were not obtained.

Exhibit 2

- **DERIVATIVES: CLOSE-OUT CALCULATIONS**
  - *High Risk Opportunities HUB Fund Ltd. (cont'd)*
    - ***What does "Loss" mean?***

"Loss" *means, with respect to this Agreement or one or more Terminated Transactions… the Termination Currency Equivalent of an amount that party reasonably determines in good faith to be its total losses and costs (or gain, in which case expressed as a negative number) in connection with this Agreement or that Terminated Transaction or group of Terminated Transactions, as the case may be,* ***including any loss of bargain, cost of funding or, at the election of such party but without duplication, loss or cost incurred as a result of its terminating, liquidating, obtaining or reestablishing any hedge or related trading position (or any gain resulting from them)****.… A party may (but need not) determine its Loss by reference to quotations of relevant rates or prices from one or more leading dealers in the relevant markets."*

Exhibit 2

- **DERIVATIVES: CLOSE-OUT CALCULATIONS**
  - *AEP Energy Services, Inc. et al. v. Bank of Montreal (S.D. OH)*
    - Natural Gas Commodity Derivatives Transactions: swaps, options, daily gas
    - Large NYMEX-lookalike swap portfolio: over 50,000 NYMEX contract equivalents; net exposure = 7000 contracts
    - 1992 ISDA Master Agreement with "Additional Termination Event"
    - On Feb. 10, 2003, Moody's lowered AEP's credit rating = Additional Termination Event; MTM $50MM in favor of AEP
    - On Mar. 13, 2003, MTM $49MM in favor of AEP
    - On Mar. 14, BMO delivers termination notice, seeks market quotes
    - On Mar 24, BMO delivers Settlement Amount calculation, seeking a payment from AEP of $34MM = swing of over $83MM.
    - Lawsuit in Ohio followed.

Exhibit 2

- **DERIVATIVES: CLOSE-OUT CALCULATIONS**
  - *AEP Energy Services, Inc. et al. (cont'd)*
    - What does "economic equivalence" mean? A simplified hypothetical.

	Contracts	Interim Value Dec. 1, 2002	MTM Value Mar. 1, 2003	Early Termination Mar. 1, 2003	Settlement Date Mar. 26, 2003
MM or Settle Price		\$3.50	\$5.00	\$5.00	\$5.00
Fixed Price		\$4.00	\$4.00	\$4.00	\$4.00
Portfolio I					
Value of Short Position	-50	\$250,000.00	(\$500,000.00)	(\$495,000.00)	(\$500,000.00)
Portfolio II					
Value of Short Position	-100	\$500,000.00	(\$1,000,000.00)	(\$990,000.00)	(\$1,000,000.00)
Vaue of Long Position	50	(\$250,000.00)	\$500,000.00	\$505,000.00	\$500,000.00
Value of Gross Positions		\$250,000.00	(\$500,000.00)	(\$485,000.00)	(\$500,000.00)
Value of Net Position		\$250,000.00	(\$500,000.00)	(\$495,000.00)	(\$500,000.00)
Portfolio III					
Value of Short Position	-1000	\$5,000,000.00	(\$10,000,000.00)	(\$7,500,000.00)	(\$10,000,000.00)
Value of Long Position	950	(\$4,750,000.00)	\$9,500,000.00	\$11,875,000.00	\$9,500,000.00
Value of Gross Positions		\$250,000.00	(\$500,000.00)	\$4,375,000.00	(\$500,000.00)
Value of Net Position		\$250,000.00	(\$500,000.00)	(\$495,000.00)	(\$500,000.00)

Key Assumptions:
- Fixed Price = \$4.00/mmBTU
- Bid-Offer Spread for volumes up to 100 contracts = \$.02
- Bid-Offer Spread for volumes of about 1000 contracts = \$0.50

Exhibit 3

- **DERIVATIVES: ENFORCEABILITY**
  - *Ursa Minor Limited et al. v. Aon Financial Products, Inc. et al. (S.D.N.Y.)(2d Cir.)*

Exhibit 3

- **DERIVATIVES: ENFORCEABILITY**
  - *Ursa Minor Limited et al. v. Aon Financial Products, Inc. et al.*, 2000 WL 1010278 (S.D.N.Y. July 21, 2000), *aff'd*, 7 Fed. Appx. 129 (Apr. 11, 2001).
    - Bear Stearns loaned $10MM to Ecobel -- a Philippines real estate developer
    - Loan was secured by a Surety Bond issued by GSIS, a government entity
    - Bear Stearns entered into a CDS with Aon Financial Products
    - When Ecobel defaulted, GSIS refused to pay on the Surety Bond, claiming that the assignment of the Surety Bond to Bear Stearns was either forged or made by persons without authority.
    - Bear Stearns served a Notice of Credit Event on Aon.
    - Aon refused to pay, parroting the reasons set forth by GSIS and claiming that the Surety Bond "never existed."
    - Aon preemptively sued Bear Stearns in Illinois. Suit was dismissed.
    - Bear Stearns sued in SDNY and obtained summary judgment, interest and fees.

Exhibit 3

- **DERIVATIVES: ENFORCEABILITY**
  - *Ursa Minor Limited et al.* (cont'd)

•*AFP's obligation to pay is triggered by the occurrence of a "Credit Event" and the corresponding presentation of a Credit Event Notice. The Confirmation lists only one such event, a "Failure to Pay," which is defined as "**the failure by [GSIS] to make, when due, any payments under the [Surety Bond] for whatever reason or cause**."*

•*Moreover, the determination of a "Credit Event" under the Credit Default Swap is without regard to, inter alia:*

> •*(i) any lack or alleged lack of authority or capacity of [GSIS] or [Escobel] to enter into the [Surety Bond] or [Loan Agreement];*
> •*(ii)* ***any actual or alleged unenforceability, illegality, or invalidity with respect to the [Surety Bond] or [Loan Agreement];*** *[or]*
> •*(iii) the failure of [GSIS] or [Escobel] to make any payment as a result of compliance with any applicable law,order, regulation, decree, or notice . . ."* **.**

Exhibit 3

- **DERIVATIVES: ENFORCEABILITY**
  - *Ursa Minor Limited et al.* (cont'd)

Defendants contend that they cannot be liable because [Aon's] obligations were premised on a valid bond being procured by Ecobel. Because GSIS "asserted the invalidity" of the bond, defendants state that there is at least a question of material fact as to whether a "Credit Event" occurred, and [Aon] cannot be liable as a matter of law. The Court disagrees. . . . [Aon] specifically waived all defenses concerning the enforceability of the Bond in paragraph 3 of the Confirmation. The plain language of the Credit Default Swap negates any defense [Aon] may raise with regard to the "unenforceability, illegality, or invalidity" of the Bond, or the "alleged lack of authority or capacity" of GSIS to enter into the Bond. (Ex. C to Liberatore Decl.) . . . ***The Court finds that [Aon] has an obligation to pay irrespective of the Bond's potential invalidity or unenforceability with respect to GSIS.***

Exhibit 4

- **DERIVATIVES: PAROL EVIDENCE**
  - *Eternity Global Master Fund Ltd. v. Morgan Guaranty Trust Co. (2d Cir.)*
  - *Deutsche Bank AG v. AMBAC Credit Protection Products, LLC (S.D.N.Y.)*
  - *Aon Financial Products, Inc. v. Societe Generale (2d Cir.)*

Exhibit 4

- **DERIVATIVES: PAROL EVIDENCE**
  - *Eternity Global Master Fund Limited v. Morgan Guaranty Trust Company of New York et al. (2d Cir.)*
    - Credit Default Swap dispute
    - <u>Issue</u>: whether Argentina's "voluntary" debt exchange in 2001 qualified as a "Restructuring" under the 1999 ISDA Credit Derivatives Definitions.
    - Eternity alleged breach of contract claims under the ISDA Master Agreement and claims of fraud concerning JPM's alleged representations concerning a secondary market for the CDS.
    - The district court dismissed the contract claims, holding that the debt exchange was not a "Restructuring" as a matter of law and dismissed the fraud claims for failure to plead with particularity.
    - Second Circuit affirmed dismissal of fraud claims but reversed ruling on contract claims and remanded for further proceedings concerning the interpretation of the contract.

Exhibit 4

- **DERIVATIVES: PAROL EVIDENCE**
  - *Eternity Global Master Fund (cont'd)*

[W]e assess ambiguity in the disputed CDS contracts by looking to (i) the terms of the three credit default swaps, (ii) the terms of the ISDA Master Swap Agreement, (iii) ISDA's 1999 Credit Derivatives Definitions -- which are incorporated by reference into the disputed contracts; and (iv) ***the background "customs, practices [and] usages" of the credit derivatives trade****.*

* * *

Morgan makes the intuitively appealing argument that a "mandatory transfer" cannot be an exchange offered on "voluntary terms." The district court was persuaded by this argument, citing Black's Law Dictionary. . . .

A dictionary definition, however, does not take into account what "mandatory transfer" means in the context of a particular industry. Eternity makes the less obvious but plausible argument that to credit-risk protection buyers such as itself ***a mandatory transfer includes any obligation exchange achieved by "economic coercion,"*** *. . . .*

Exhibit 4

- **DERIVATIVES: PAROL EVIDENCE**
  - *Deutsche Bank AG v. AMBAC Credit Protection Products, LLC*, 2006 WL 1867497 (July 6, 2006)
    - CDS: DB (protection buyer) and Ambac (protection seller)
    - Issue: Time to deliver "Deliverable Obligations."
      - DB's position: industry practice and other contractual provisions permit delivery well past the nominal deadline.
      - Ambac's position: documents set out a specific timeline; Ambac not required to pay for bonds tendered one month after due date.
    - Holding: Strict compliance with the contract.
    - Ambac had no obligation to pay for bonds that were not delivered in accordance with the contractual term.

Exhibit 4

- **DERIVATIVES: PAROL EVIDENCE**
  - *Deutsche Bank AG v. AMBAC Credit Protection Products, LLC (cont'd)*
    - CDS governed by 1999 ISDA Credit Derivatives Definitions.
    - In case of a Credit Event.
      - Section 3.3: either party may send an irrevocable Credit Event Notice.
      - Then, protection buyer has 30 days to provide the seller with a notice of intention to settle, physical settlement method, and describe the types of Deliverable Obligations buyer expects to deliver to seller.
      - Section 3.4: If a NIPS is not delivered within 30 days, the "thirtieth calendar day shall be the Termination Date" and the buyer loses its ability to make any claim for credit protection.

Exhibit 4

- **DERIVATIVES: PAROL EVIDENCE**
  - *Deutsche Bank AG v. AMBAC Credit Protection Products, LLC (cont'd)*
    - Section 8.5: Defines Settlement Period. The final day of the Physical Settlement Period is known as the Physical Settlement Date.
    - Section 8.1: Buyer shall deliver "on or prior to the Physical Settlement Date" and Seller shall pay Buyer "that portion of the Physical Settlement Amount that corresponds to the portion of the Portfolio that Buyer has Delivered."
    - Section 9.3(c)(ii): Permits delivery for "an additional five Business Days after the Physical Settlement Date."
    - Section 9.3(c)(ii): "If Buyer fails to Deliver any portion of the Portfolio specified in the [NIPS] on or prior to the date that is five Business Days after the Physical Settlement Date, such failure shall not constitute an Event of Default and such date shall be deemed to be the Termination Date."

Exhibit 4

- **DERIVATIVES: PAROL EVIDENCE**
  - *Deutsche Bank AG v. AMBAC Credit Protection Products, LLC (cont'd)*
    - Under Section 9.3(c)(ii), DB was required to deliver no later than Feb. 14, 2004– five days after the Delivery Date of Feb. 9.
    - DB claimed Section 9.3(c)(ii) not applicable because:
      - The Confirmation trumps the 1999 Definitions, and the Confirmation directly contradicts Section 9.3(c)(ii): document ambiguity.
      - Industry practice permits flexibility with respect to delivery of bonds and other obligations.
    - Court rejected DB's arguments.
    - How to reconcile with *Eternity Global*?

Exhibit 4

- **DERIVATIVES: PAROL EVIDENCE**
  - *Aon Financial Products, Inc. v. Societe Generale*, 476 F.3d 90 (2d Cir. 2007)
    - Issue: whether a Credit Event occurred under any of the definitions set forth in the parties' CDS.
    - Aon entered into two CDS contracts:
      - BSIL/Aon CDS
      - Aon/SG CDS
    - Definitions of Credit Event differed between the two contracts.
    - Credit Event was held to have occurred under BSIL/Aon CDS in *Ursa Minor*.
    - Aon moved for summary judgment against Soc Gen arguing that a Credit Event occurred as a matter of law on basis of *Ursa Minor*.

Exhibit 4

- **DERIVATIVES: PAROL EVIDENCE**
  - *Aon Financial Products, Inc. v. Societe Generale (cont'd)*
    - The District Court granted Aon's motion for summary judgment.
    - The 2d Circuit reversed and entered judgment in favor of SG, finding no Credit Event occurred:
      - The Aon/SG CDS was unambiguous and thus the court was required to give effect to the contract as written.
      - BSIL/Aon CDS contract did not define Credit Event to include Sovereign Event whereas the Aon/SG CDS contract did.
      - It does not follow that from the occurrence of a Credit Event as defined in one contract that there was a Credit Event as defined in the other.
      - The term "Failure to Pay" has distinctly different meanings in the two agreements.

Exhibit 5

- **DERIVATIVES: CHOICE OF LAW**
  - *Finance One Pub. Co. Ltd. v. Lehman Bros. Special Financing*, 414 F.3d 325 (2d Cir. 2005)
    - Issue: What law applies to setoff rights in connection with ISDA-documented transactions.
    - Lehman: New York law; Finance One: Thai law
    - ISDA Master Agreement with standard choice-of-law clause.
    - In Schedule, the Parties chose New York law as the "governing law."
    - Held:
      - Lehman's setoff rights under the Master Agreement would be governed by New York law in accord with Agreement.
      - But, Thai law would govern the existence or nonexistence of an ***extra-contractual*** setoff right.
    - 2d Circuit affirmed: Lehman lost the choice of law argument, but prevailed!

Exhibit 6

- **DERIVATIVES: NEW COMPLAINT IMPLICATING DUTIES OF CALCULATION AGENT**
  - *Jeld-Wen, Inc., et al. v. Citibank, N.A.* (S.D.N.Y.), Complaint filed March 9, 2008
    - Plaintiff Jeld-Weld sued Defendant Citibank
    - Products at issue are two forward sale contracts for Cendant stock based on 1992 ISDA Master Agreement.
      - Contracts established collar prices for Jeld-Wen's sale of stock.
      - Contracts provided for a Citibank-guaranteed 11 cent per share per quarter dividend.
    - Claims alleged:
      - Breach of Contract
      - Breach of Covenant of Good Faith and Fair Dealing
      - Negligent Misrepresentation

Exhibit 6

- **DERIVATIVES: NEW COMPLAINT IMPLICATING DUTIES OF CALCULATION AGENT**
  - *Jeld-Wen, Inc., et al. v. Citibank, N.A.* (S.D.N.Y.), Complaint filed March 9, 2008
    - Plaintiffs theory is that Citibank knew that Cendant was to be subject to a spin-off transaction at the time the parties entered into contracts, and following the spin-off, Citibank, in its role as Calculation Agent under the contracts, was charged with making good-faith adjustments, if necessary, to the terms of the contracts; but rather than make good faith adjustments "to account for the economic effect" of the spin-off, Citibank materially altered the terms of the deals by slashing its guaranteed dividend payments to Jeld-Wen and adjusting the collar prices to decrease the value of the contracts to Jeld-Wen.
    - Notably, Jeld-Wen alleges that other financial institutions with which it had similar agreements made economically neutral adjustments in response to the Cendant spin-off.

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- Jay concentrates his practice in securities, derivatives, and other financial products litigation. He has extensive experience in class action litigation under the federal securities laws. He typically represents issuers in securities litigation and has often represented non-U.S. issuers in such litigation. In derivatives litigation, Jay has represented both plaintiffs and defendants in claims concerning ISDA swap agreements, including credit default swaps, total return swaps, and commodity swaps. In addition, he routinely provides prelitigation advice to clients involved in disputes concerning swaps and other derivative instruments. He has successfully represented offshore CDO funds and their administrative agents in litigation brought by institutional investors.
- A number of Jay's representations have involved litigation or investigation outside the United States, and he is well versed in navigating international discovery and judgment enforcement.
- Jay also has broad commercial litigation experience under federal and state consumer protection and financial disclosure statutes and the federal antiracketeering laws.
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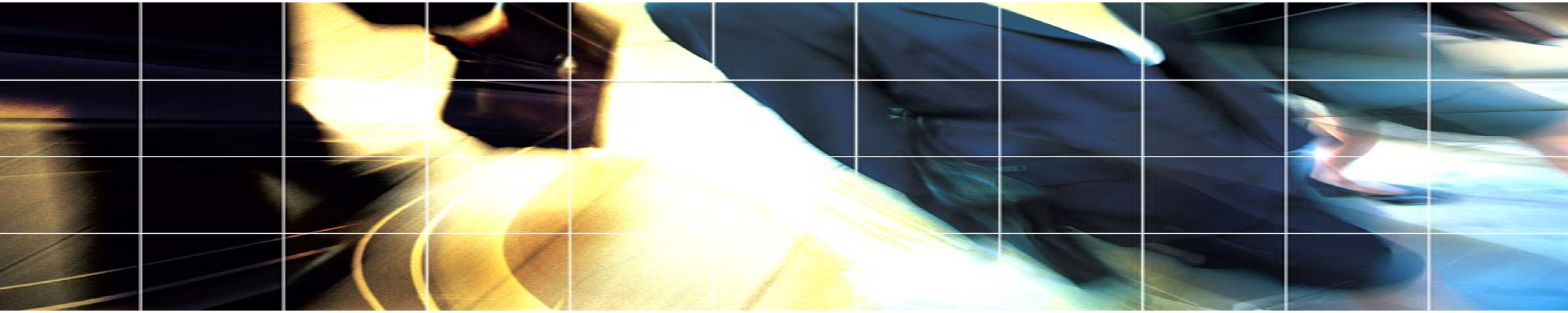

Thank you.

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