

KSFIOM SCHEME OF ARRANGEMENT ("SoA") **SUMMARY OF QUALITATIVE ISSUES**

This document has been produced at the request and for the use of depositors of KSFIOM and members of DAG, and incorporates advice obtained from DAG lawyers and observations from several lawyer depositors and other depositors. It does not analyse the position on amount and timing of possible recoveries, as that has been done elsewhere. It is not legal advice and is not a substitute for legal advice. Readers are referred to the final paragraph.

This summary adopts the definitions set out in the SoA.

A Summary

The Explanatory Statement circulated by the IoM authorities with the revised draft SoA contains the less-than-ringing endorsement that its purpose "is to create a financial outcome for Scheme Creditors no worse than would be achieved if the Company was to be placed into liquidation, but which is intended to enable Scheme Creditors to receive larger distributions more quickly than would be the case in a liquidation." In addition, depositors will get back what they would have got under the DCS within a year.

In brief, the following are the reasons why the SoA is disadvantageous from a legal perspective. This document does not deal with the quantitative analysis of likely recoveries in different scenarios (although we note that we consider the graphs contained in the Explanatory Statement to be misleading – we are consulting our lawyers regarding this):

- The SoA has not been negotiated or discussed at all with the "beneficiaries" (i.e. the depositors). The time limits imposed by the authorities are so tight that a full forensic analysis by advisers is not possible. Financial and other information has not been forthcoming from the IoM authorities, despite numerous requests for it. This information is required for depositors to make a fully-informed decision about the options open to them based on a proper financial comparison of the two alternatives (SOA or liquidation + DCS) and of any other claims they may have. The SoA from a legal standpoint is therefore full of pitfalls, gaps and details that cumulatively work to the disadvantage of depositors and which are, taken as a whole, significant. Many – but not all - of these are described below.
- While the SoA has been adjusted to ensure that there is a real timing advantage for depositors with £35,000 or less, and a smaller timing advantage for depositors who have a deposit in the range of £35,000 - £50,000, doubtless so as to attract the support of that group for the SoA, it does not present any advantage to larger depositors over a liquidation. Moreover, the defects in the SoA described in this document apply equally to all depositors.
- The IoM Treasury is promoting the SoA as a means of avoiding the damage to the reputation of the Isle of Man that would otherwise occur if a liquidation were to take place, and to avoid activating its DCS, and perhaps also to avoid closer scrutiny of the events leading up to KSFIOM's provisional liquidation.
- The SoA contains numerous examples of situations where the IoM Treasury obtains a better position for itself than it would under a conventional liquidation, in terms of information rights and consents given under the SoA. The IoM Treasury is getting much more from the creditors than the little it is giving them in return. It is behaving as if it is taking more risk than it actually is, given the likely recovery levels and outcomes that have been estimated following the recent report of the administrators of KSFUK, Ernst & Young.
- Under the SoA, depositors would be giving up potentially significant rights by releasing all the parties involved in the SoA's preparation from any liability arising in

connection with it whatsoever. This means that depositors cannot sue any of the parties involved in the administration of the SoA.

- The structure established by the SoA will be costly to administer – in particular as a consequence of the dual roles of Office Holder and Scheme Supervisor that the SoA establishes. In a normal liquidation, the bankruptcy trustee or liquidator undertakes this combined role in a single person. The division is bound to lead to debate and confusion, and consequently increased costs, which reduce depositors' recoveries. Those recoveries, by the IoM's own projections, are ultimately no better under the SoA than under their assumed liquidation, and their projections do not take into account any costs.
- The preparation of the SoA has taken over six months and millions of pounds in fees. It provides that most, if not all, of these fees are supposed to come out ahead of depositors' recoveries.

So, both structurally and as a document itself, the SoA represents a system that is overly bureaucratic, unnecessarily complex and simply too difficult to understand; the explanatory notes accompanying it are extremely difficult to follow and are themselves about as long as the SoA (in the case of sub-clause 18.5, almost four pages of explanation are required). The level of complexity of the document lends itself to differences of interpretation and understanding, which in turn will almost inevitably lead to disputes and delays in making the payments that the SoA contemplates.

A scheme of arrangement is a court-approved contract, setting out the terms on which the creditors of the bank all agree to relinquish their claims on that bank. In return for this, the creditors are entitled to expect benefits that they would not otherwise obtain if the company proceeded to liquidation. The SoA does not achieve this demonstrably enough to make it worthwhile.

Our view is that the slim merits of the SoA are far outweighed by its disadvantages – a view that is borne out by the advice of DAG lawyers and by the weak "recommendation" of the Provisional Liquidators, who have (it seems reluctantly) agreed to sponsor the SoA. At paragraph 10 of the Explanatory Statement circulated by the IoM authorities, the Provisional Liquidators say that the SoA "*should* be in the best interests of the *general body* of creditors of the Company". That is not a compelling statement. The Explanatory Statement itself makes it abundantly clear in the language it uses that any advantage over a liquidation is not at all clear-cut.

A liquidation is a well-established process for dealing with the assets and liabilities of an insolvent company, and the parties involved will all know from past experience and general knowledge of the applicable legislation what the procedures and formalities are. It will almost inevitably be quicker, simpler, cheaper and conducted more openly than the proposed SoA. For all these reasons, the proposed SoA is not considered to be acceptable.

B Detailed Analysis

"Creditors' Committee"

This is established and run according to clause 33. There are five members, selected by the Scheme Supervisor. Three are defined by the SoA: (i) IOM Treasury; (ii) a Protected Depositor and (iii) a non-Protected Depositor.

The other two members are left undefined. Voting on the Creditors' Committee is by a simple majority and a meeting can be held without the need for a depositor's representative being present because the quorum is

only three (cl 33.10). This means that the Creditors' Committee can railroad depositors. There is no requirement that a depositors' representative needs to be present in order for a meeting of the Creditors' Committee to be quorate or that a depositors' representative needs vote in favour of a proposal before it is passed.

"Initial Report" and Report"

These reports are required before each Distribution is made and are prepared by the Scheme Supervisor (who is also the Office Holder, i.e. our Provisional Liquidator) and are confidential to the IoM Treasury. They set out the detailed financial position of KSFIOM. There is absolutely no reason why this information should not be made available to the Creditors' Committee and therefore to all depositors.

"Post-Insolvency Costs"

These are KSFIOM's, the Office Holder's and Scheme Supervisor's costs, which are paid in priority to any Distribution. That is a normal position in a liquidation. They are however unlimited by reference to the scope of work carried out, and how they are incurred. They also run from 8 October 2008 and will therefore include costs of discussing the SoA with the IoM Treasury and providing information to the IoM Treasury and their advisers.

These costs are not qualified as "reasonable" costs and they do not need to be incurred "in connection with their roles under the Scheme". We have no idea how much these fees are at present. Nor is it reasonable for depositors to pay the fees incurred in assisting the IoMG and their advisers in drawing up this SoA, which appears may be the case.

"Preferential Liabilities"

These rank ahead of all other claims (other than Post-Insolvency Costs), which is normal. However, we have no idea what they are at the moment beyond the £0.5M indicated in the summary (draft unaudited) balance sheet as at 8 October 2008. In particular, some may be owed to the IOMG as tax, and there has been no discussion of this.

"Scheme"

Note that the Scheme Supervisor can amend the SoA at any time - after consulting the Creditors' Committee and the IOM Treasury (who of course are already on the Creditors' Committee, so they get two consultations, one behind closed doors) - "if they consider it expedient to do so and if it is in the best interests of each class of Scheme Creditors to which the relevant modification would apply provided such modifications do not adversely alter the effect or economic substance of the Scheme" (clause 36). This does not protect the interests of depositors.

PART 2 –THE SCHEME

Cl. 8 – Moratorium

Depositors give up rights to sue anywhere in the world, but only the courts of the IoM and England recognise the moratorium (or stay of proceedings) that this clause contains. It is not symmetrical and should be.

Furthermore, it is not clear what the status of claims for

"in-flight" funds would be if this clause remained as drafted.

Cl. 9 – Winding Up

If KSFIOM were to be wound up this would give depositors certain information. Not winding it up therefore continues the regime of secrecy and perceived dissimulation that has characterised proceedings to date.

PART 3 – APPLICATION OF THE ASSETS

Cl. 10

This describes the role of the Office Holder (as opposed to the Scheme Supervisor). There is no apparent basis for having two functionaries performing the role (combined) that a liquidator would normally have. Nobody has explained why this is necessary or advisable. Accordingly, it leaves the professionals who perform these roles (who are, to begin with anyway, the same people – PwC) in a position where they are constantly referring back to the SoA (and seeking legal advice on it) to determine in which capacity they are acting and dealing with possible conflicts of interest that may arise (for example, whether they can divulge information they have made available in the secret meetings that they have with IoM Treasury). That in turn leads to fees and costs for PwC, as well as a difficulty for depositors in ascertaining with whom, and on what basis and terms, they should be dealing. It seems obfuscatory at best, sinister at worst.

At present it has not been established that the claim under the Parent Guarantee would survive the implementation of the SoA.

Cl. 11

Post-Insolvency Costs appear twice as deductions from realised Assets – in clauses 11.1.1 and in 11.3.1. If that is a drafting error, then why this should be, after the amount of time and consideration that has gone into this SoA, is inexplicable. If it is not a drafting error then it is plainly wrong.

PART 4 - DISTRIBUTION

Cl. 12

Depositors should note that clause 12.5.2(G) means that anyone who has taken over someone's rights to a deposit in KSFIOM since 8 October 2008 is excluded from payments under the SoA. This does not apply to the IoM Treasury itself.

Cl. 15

Note that the IoM Treasury has a veto over both the amount and the making of any payment. The Creditors' Committee is merely consulted on this. Of course, the IoM Treasury is a member of the Creditors' Committee.

Why is it only the "intention" that Distributions be made as quickly as possible? Why not make it a binding obligation?

Cl. 16

This deals with the secret reports that are to be provided to the IOM Treasury before the IoM Treasury approves any payment being made. If they aren't provided in time, then the IoM Treasury need not make a payment under the SoA anyway.

Cl. 25

The date for conversion of non-Sterling deposits is 9

Cl. 27

April 2009 – not the date of approval by the court of the SoA; if a winding-up order were made, it would be the date of the winding-up order.

This is a complicated provision that defers depositors' claims for interest over 5% on their deposit after their "DCS entitlement" until other claims have been paid. No explanation for this mechanism has been offered.

**PART 5 – THE OFFICE HOLDER
AND THE SCHEME
SUPERVISOR**

Cl. 30 & 31

The creation of these two roles lies at the heart of many of the problems with the SoA. Even the Explanatory Statement itself oscillates between referring to the Office Holder and Scheme Supervisor as the Provisional Liquidators, since that is who they are and what they are doing. The difference is that under the SoA, the two roles can be held by different persons and that different duties are owed by them to different parties.

As mentioned above, there is no basis for this division of responsibilities, with different obligations owed to different people in different ways. All it does is create confusion in the minds of all concerned. And to a sceptic, that confusion only serves one party involved in this.

By way of example, the Office Holder is a trustee of KSFIOM's assets for the creditors. The Scheme Supervisor owes duties to KSFIOM only (cl. 31.7). But these aren't owed in a fiduciary manner except as specified in clause 32.1 (cl. 31.7). Nor is he liable in any personal way "in connection with the preparation... or implementation of the Scheme." Why not? Why are the proposers of the SoA so nervous about this that this clause goes over substantially the same ground as clause 35 (as to which, see below)?

The Office Holder reports to creditors once every 6 months, telling them of "material developments" since the last update. The Creditors' Committee is updated every three months while the Treasury is a creditor (cl. 33.11.1). Contrast this with the monthly updates that the IoM Treasury gets under cl. 32.2. When the Treasury is no longer a creditor there is no regime applicable (cl. 33.11.2)

**PART 6 – CREDITORS'
COMMITTEE**

Cl. 34

This deals with remuneration. Creditors are to pay PwC's fees at their normal time rates, and no discounts or fixed limits are referred to. Why not?

PART 7 - RELEASES

Cl. 35.1 & 35.2

Depositors are asked to waive their rights against the Office Holder, the Scheme Supervisor and the IoM Treasury "to the fullest extent allowed by law" "in connection with the preparation, negotiation and implementation of the Scheme or any matter ancillary to the Scheme". This provision is to survive the termination of the SoA (regardless of the reason why

that happens) – cl. 38.

This is ABSOLUTELY UNACCEPTABLE. Without taking away from that statement, there has been no negotiation whatsoever with us regarding the SoA, so why is that even referred to in clause 35.1?

Cl. 35.2

This provision is relatively obscure in that it appears to make KSFIOM liable for breaches of the waiver by a depositor so that if a “rogue depositor” were to breach the waiver, that will reduce the amount available for distribution.

PART 8 - MISCELLANEOUS

Cl. 38.2

If the IoM Treasury fails to make a payment due from it for 30 Business Days (i.e. six weeks) “or such longer period as the Scheme Supervisor and the IoM Treasury agree in writing” then the SoA is capable of termination by the Scheme Supervisor – it does not terminate automatically. Firstly, 30 Business Days is far too long. Secondly, its possible indefinite extension by someone who owes a duty to KSFIOM (and not depositors) is clearly easily capable of exploitation by unscrupulous parties and does not protect depositors.

There is no sanction on the IoM Treasury if it fails to comply with its obligations.

Cl. 39.3

Notices by the administrators of the SoA are deemed given after 48 hours of posting, regardless of where in the world a depositor may be, which is clearly unworkable for many depositors. Most documents these days allow for electronic service of notices (i.e. by e-mail). Why hasn’t that been done here?

Cl. 40

This is a sticking plaster over the raft of conflicts and double appearances by the IoM Treasury by virtue of being both in the Creditors’ Committee and a separate party with separate – and better – rights than the other creditors.

Cl. 41

KSFIOM will continue to be managed from the IoM – but by whom? Depositors are left with no idea. Will the current directors remain? Depositors would be justified in viewing this with scepticism.

This summary is not exhaustive. Depositors are encouraged to read the SoA itself but, as it is recognised that it is a very complex document, this summary has been prepared to assist depositors in understanding DAG’s opposition to the SoA. It is understood that depositors have different (i) priorities as to quantum and timing of their recovery, and (ii) constraints within the legislative and contractual framework surrounding the provisional liquidation of KSFIOM, which will lead them to form their own conclusions on the best way of proceeding. DAG remains committed to seeking 100% recovery for all depositors.