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Lending, Investing and Trading After the Market Break: Opportunities to Seize and Risks to Manage

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Recent dramatic downturns in the credit, equity and derivatives markets, together with an acute general shortage of liquidity, will present attractive opportunities for lenders, investors and traders with cash to deploy in the months ahead. At the same time, these market participants will need to recognize and manage significant new risks.

New Opportunities...

Fresh opportunities will manifest themselves in a variety of ways.

Valuations. With valuations down and fewer cash-flush players, investors will have the chance to acquire securities and other assets at depressed prices. Lenders will be able to provide financing at higher rates and on stronger terms.

Reemergence of Down-Cycle Sectors. Once liquidity begins to improve, investment sectors that traditionally rebound in down cycles should start to gain traction. These sectors include trading in distressed loans and swap termination claims, the provision of rescue financing and lending to debtors in bankruptcy.

Improved Negotiating Leverage. We will see a reversal of boom-era leverage dynamics between the providers and the users of capital. Years of easy financing led to equity investments and syndicated loans being structured on terms that were favorable (sometimes astonishingly so) to issuers and borrowers. The pendulum is now moving in the other direction. Those with funds will be able to dictate better economic terms and stronger protective provisions, which will spur an investor-favorable shift in the contours of transaction documents.

...and New Risks

But with these new opportunities come very real risks.

Counterparties. As the shakeout in the financial sector illustrates, counterparty risk may emerge in unexpected and sometimes devastating ways. Investors and lenders now need to re-focus on counterparty due diligence, including an assessment of the consequences of a counterparty default, in much the same way they have traditionally conducted due diligence on issuers and borrowers.

Regulation. Widespread financial institution failures will lead to more vigilant enforcement of current rules and the evolution of an expanded regulatory regime, perhaps featuring new regulators and/or a realignment of responsibilities among existing authorities. These developments will affect trading, hedging and exit strategies. Adapting to a changing regulatory landscape will challenge all market participants.

Lenders, investors and traders responding to the new market reality should make sure their attorneys are able to provide effective assistance in areas such as due diligence, negotiation and documentation of transaction terms, and amelioration of risk. We outline below some of the investment areas we expect to become increasingly active over the next 12 months, and highlight some of the key hazards that investors will need to address. We structure our

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Memorandum

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"Lenders, investors and traders should be able to obtain attractive pricing and set favorable documentation terms. At the same time, market participants will need to focus carefully on evolving risk and regulatory issues."

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discussion by reference to the following market and regulatory areas: Credit; Derivatives; Asset-Backed Securities; Equity; and Tax.

CREDIT

Loan Portfolio Sales

As financial institutions continue to evaluate and remediate their loan portfolios, we expect an increasing number of portfolio asset sales, including portfolios of non-performing commercial and industrial bank loans. Whether assets are sold at auction or in negotiated bilateral transactions, the intelligent use of purchase and sale documentation will help to allocate risk appropriately between sellers and purchasers, and to clarify the mass settlement processes associated with portfolio dispositions.

An auction seller can accelerate and rationalize the bidding process by providing prospective purchasers with a comprehensive package of draft transaction documents. The seller's proffered documents generally should include (i) a detailed description of the portfolio of assets being sold, (ii) the procedure for calculating the purchase price, (iii) closing conditions and timeframes, (iv) representations, warranties and indemnities by the parties and (v) a dispute resolution mechanism. While auction sellers generally indicate that their purchase and sale documentation is non-negotiable, an experienced purchaser will nonetheless conduct targeted due diligence on portfolio assets, and may insist that the seller discuss related documentation points. From a purchaser's perspective, fully understanding the auction documents' terms, conditions and risk-allocation features is a vital first step toward formulating an economically sound bid.

Agreements governing bilateral transactions are, of course, subject to private negotiation between the parties, and are thus likely to be more evenhanded than auction-related documents. As in the auction context, however, negotiated purchase and sale agreements must effectively allocate risk and address issues arising from the transfer of a potentially diverse collection of assets.

Distressed Loan Trading

With the tremendous loss of leverage and the slowdown in the U.S. economy, an increasing incidence of corporate defaults seems inevitable. Investors with cash will be well positioned to purchase bank loans on a distressed basis from cash-starved lending institutions, CLOs and investment funds. As always, purchasers of distressed debt will face uncertainties beyond the general question of ultimate recovery by the lenders as a whole; for example, the purchaser of an individual loan position often must make its own assessment of subordination and litigation risks. These concerns can be minimized, however, through adequate due diligence and properly drafted purchase documentation.

Sponsor Buybacks of Portfolio Company Debt

We expect equity sponsors to take advantage of the credit crisis by purchasing portfolio company debt at prices significantly below par. In some instances, the sponsor will acquire the debt for investment. In other cases, the purpose will be to retire the debt in order to cure a financial covenant default or avoid an equity cure at par.

A sponsor interested in acquiring portfolio company debt must clear a number of hurdles, the most fundamental of which is confirming that the assignment section of the loan agreement permits the purchase. Other terms of the credit agreement to be reviewed include the "Permitted Investments," "No Restricted Payments" and "Transactions with Affiliates" covenants, and the provisions regarding ratable sharing of proceeds and voting rights. In addition, sponsors must consider whether the purchase will cause the portfolio company to recognize cancellation-of-indebtedness income. Since sponsors are control parties and typically have board representation, fiduciary duties and corporate

opportunity doctrines also come into play, as does the need to address the informational advantage a sponsor may have over a potential seller. A sponsor may also need to consider potential issues regarding equitable subordination. [1]

New Credit Facilities/Amendments

As in past economic downturns, investors with cash will have a chance to provide favorably priced rescue and "take-out" facilities to borrowers facing defaults under their existing credit arrangements. We expect a renewed focus on underwriting fundamentals, greater covenant protections for lenders, shorter cure periods for borrowers and limitations on the ability of borrowers to meet EBITDA-driven financial covenants by making additional equity infusions. Borrower requests for amendments or waivers to existing facilities—even those that arguably would result in an improved credit risk for lenders—should be viewed as occasions to improve weak lender covenant protections or to generate revenue through loan repricing and consent fees.

Syndicated Credit Facilities: Defaulting Lender Risk

In a credit market turned upside down, we are seeing a new emphasis on "lender credit risk" in the syndicated loan space. There are two facets to this concern. Syndicate members must grasp the consequences of a co-lender's failure to fund, and secondary market participants must understand the risks entailed in purchasing a defaulting member's loan.

From a legal perspective, the risk of a lender default is borne primarily by the borrower—each lender's funding commitment is an independent "several" obligation, such that if one lender fails to fund its pro rata portion of a requested borrowing, the other syndicate lenders have no obligation to lend the difference. On a practical level, though, one syndicate member's failure to fund may affect the borrower's financial health and thus increase the credit risk faced by the remaining lenders. Accordingly, prospective syndicate members should perform due diligence on their potential co-lenders before deciding whether to participate in a proposed loan.

As failures to fund become more prevalent, defaulting lenders' loans will become increasingly available for purchase in the secondary market. The most basic legal issue for a secondary purchaser is whether the loan is still "fungible" with the borrower's other outstanding loans. In this regard, relevant questions include whether the buyer will be required to fund the drawdown not met by the defaulting lender, and whether the borrower and administrative agent will waive rights of set-off or other remedies against the buyer or the acquired loan.[2]

Bank Loan Participations: Grantor Insolvency Risk

Owners of bank loan participations take on two kinds of credit risk: the borrower might fail to repay the underlying loan, and the grantor of the loan participation might go bankrupt. While the first possibility has always been carefully analyzed, we are now seeing greater attention to the potential consequences of grantor insolvency. In a typical bank loan participation, a lender (or "grantor") grants an undivided participation interest in an underlying loan to a "participant" investor. Only the grantor, by way of the credit agreement, has a direct legal relationship with the borrower. The participant's contractual rights stem exclusively from its participation agreement with the grantor.

Unfortunately, it follows that if the grantor files for bankruptcy, the participant's receipt of payments on the underlying loan will continue to depend upon (and flow through) the grantor. Whether the

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1 For a discussion of the issues involved when a borrower or its equity sponsor seeks to buy back loans in the secondary market, please see our memorandum dated March 11, 2008, "Purchases of Bank Loans by a Borrower or its Sponsor," available at www.rkollp.com/2008/03/memorandum_purchases_of_bank_l.php.

2 For a discussion of the issues that may arise when a when a lender fails to fund its revolving commitment in a syndicated credit facility, please see our memorandum dated October 10, 2008, "The Defaulting Lender in Today's Loan Market," available at www.rkollp.com/2008/10/the_defaulting_lender_ in_ today.php.

participant is entitled to the proceeds of the underlying loan paid by the borrower to the grantor, as opposed to merely having the right to assert a claim as a creditor in the grantor's bankruptcy, will hinge on whether the participation agreement is characterized as (i) a true purchase and sale of an undivided interest in an underlying loan or (ii) a loan by the participant to the grantor. [3]

Counterparty Risk

The failure or near failure of many financial institutions has prompted fresh attention to the issue of counterparty credit risk. As recent events demonstrate, the economic strength of the institution with which an investor transacts—whether a counterparty to a bank loan trade, an administrative agent under a loan facility, the grantor of a loan participation or a derivative counterparty—can have profound effects on the investor's own financial well-being.

We anticipate a spotlight on counterparty credit risk in the coming months. In particular, we expect to see more probing pre-transaction counterparty financial due diligence, as well as demands for additional credit enhancements such as collateral and set-off rights, cash escrows, and supporting letters of credit and guarantees by creditworthy affiliates. More broadly, we expect that investors will work to limit and diversify their overall counterparty exposure.

DIP Lending

The provision of debtor-in-possession (DIP) financing to bankrupt borrowers has traditionally been a lucrative form of lending for many financial institutions. DIP financing is generally considered safe because DIP lenders receive certain protections under the Bankruptcy Code and are usually paid back first when the borrower emerges from bankruptcy or liquidates.

However, current market illiquidity (which may have contributed to the debtor's bankruptcy in the first place), coupled with the consolidation of traditional lenders on Wall Street, leaves fewer institutions in a position to provide DIP financing. In addition, certain changes to the Bankruptcy Code pursuant to the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (e.g., expanded reclamation rights for suppliers, less time for debtors to assume or reject leases, more upfront consideration for utilities, etc.) add to a bankrupt debtor's cash requirements and thus engender a need for larger DIP facilities. In other words, just as demand is increasing for DIP financing, it is becoming ever more difficult to obtain. DIP lenders with available funds should be able to capitalize on this dynamic by negotiating higher rates and fees and more attractive terms.

DERIVATIVES

Trading Swap Termination Claims

The bankruptcy of a financial institution involved in significant over-the-counter derivatives transactions is likely to spawn active trading in swap termination claims. The insolvency of a swap counterparty triggers the right of the non-defaulting party to terminate all derivatives transactions between the parties. A robust contractual netting process, honored in bankruptcy, allows the parties to promptly determine the final amount "owed to" or "owed by" the insolvent party. Claims for amounts owed by an insolvent party will likely be considered an unsecured claim on that party's bankruptcy estate. Holders of swap termination claims often seek to monetize them well before the conclusion of an insolvent counterparty's bankruptcy. Swap termination claims, like other types of unsecured claims, constitute a tradable asset class during the course of the bankruptcy. Sellers and buyers of swap termination claims take on unique economic and legal risks that can be managed through appropriate documentation.[4]

3 To learn about the basic features of a loan participation and how a bankruptcy court would allocate proceeds of the grantor's estate among loan participants and other creditors, please see our memorandum dated March 19, 2008, "The 'Second Risk' that Keeps Loan Participants Up at Night," available at www.rkollp.com/2008/03/memorandum.php.

4 For a discussion of how (i) swap termination claims are calculated, (ii) unsecured bankruptcy claims are traded and (iii) customary claims-trading documentation should be modified when applied to swap termination claims, please see our memorandum dated October 6, 2008, "Trading Swap Termination Claims," available at www.rkollp.com/2008/10/trading_swap_termination_claim.php.

ISDA's Evolving Auction Methodology

Buyers of credit default swaps (CDSs) are acutely focused on the operational and counterparty risks embedded in the credit derivatives market. In particular, holders of credit default protection increasingly worry about their ability to realize the "recovery value" of underlying assets from their swap counterparties promptly after a credit default. We expect that investors in the North American CDS and LCDS derivatives markets will sleep more soundly due to ISDA's evolving cash settlement mechanism, which is intended to generate prompt cash (as opposed to physical) settlement of outstanding derivative transactions through a binding auction process that produces trusted recovery values.[5]

Regulation of Credit Default Swaps

After rapid unregulated growth over the past decade, the CDS market is now under scrutiny by federal and state agencies. SEC Chairman Cox has referred to the CDS market as a "massive hole" in the federal regulatory framework. Any attempt by the SEC to extend its oversight into the CDS space would likely be based on the anti-fraud and anti-manipulation provisions of the federal securities laws, which apply to "security-based swap agreements." The SEC also may seek additional authority to impose recordkeeping or reporting requirements, as suggested by Erik Peterson, Director of the Division of Trading and Markets, in his recent testimony before the House Committee on Agriculture.

On the state level, Governor David A. Paterson has announced that New York will be the first state to attempt to regulate at least the portion of the CDS in which "protection buyers" own the underlying security, suggesting that under these circumstances New York will view the swap as an "insurance contract." In keeping with this initiative, on September 22, 2008, the New York State Insurance Department issued Circular Letter No. 19, signaling an intent to reverse its 2000 opinion that CDSs are not insurance. More broadly, we understand that New York insurance regulators are currently working with industry groups, such as the ISDA, to better understand the CDS market.

ASSET-BACKED SECURITIES

In the asset-backed securities market, we expect to see opportunities in both traditional trading and control/ foreclosure situations.

Traders will face an array of due diligence issues, the specifics of which will relate to the nature of the asset class in question and the terms of relevant deal documentation. Issues that may require particular examination include the contents of the underlying asset pool; the structure of the pre- and post-default distribution waterfall; the ability of third-party servicers to prepare accurate reports regarding collections, delinquencies, diversification, etc.; and any obligations of third parties to provide substitute collateral or other credit enhancements.

In the control/foreclosure area, we believe investors will see opportunities to obtain voting control of the "senior class" of the ABS vehicle's securities and effect the liquidation of the vehicle. Liquidations of ABS vehicles may in turn present occasions to acquire asset portfolios at distressed prices.

EQUITY

Private Equity Investments

With limited debt financing available, there are fewer players and less cash competing for private equity investments and going-private transactions. Since prices will be attractive, we expect transactions to be completed, albeit with lower-than-traditional leverage; sponsors may well intend to add leverage later, when credit becomes more accessible.

In recent years, sponsors had no difficulty attracting co-investors to provide the requisite equity, which meant co-investors had few rights besides the ability to exit the investment alongside the sponsor. Now,

5 For a discussion of ISDA's complex and evolving auction methodology, please see our memorandum dated March 4, 2008, "ISDA's Evolving Auction Methodology: Cash Settlement of Loan Credit Default Swaps," available at www.rkollp.com/2008/03/memorandum_isdas_evolving_auct.php.

with a larger portion of the purchase price being funded by equity and fewer cash-flush players, co-investors should be in a position to negotiate more favorable terms, including the right to force an exit, limits on sponsor closing fees and management fees, and the ability to block related-party transactions.

Public Company Preferred Stock ("Rescue Preferred")

As cash-hungry public companies hunt for capital, we expect to see significant issuances of convertible preferred stock and/or preferred stock with warrants. In recent years, preferred stock terms became extremely issuer-friendly. The preferred dividend frequently was not cumulative; flimsy blocker provisions allowed issuers to pay unlimited dividends to the common holders if merely the current quarter's dividend on the preferred had been paid; and the preferred's liquidation preference often had limited practical value, since it was triggered only by an actual liquidation (and not by a merger or substantial asset sale).

By contrast, the current climate should afford preferred stock investors leverage to insist on more traditional protections on the above points. In addition, preferred investors may demand limits on the amount of common dividends (or dividend participation rights for the preferred) and the establishment of liquidation preference premiums. In appropriate circumstances, such as low-price equity infusions or change-of-control transactions, preferred investors also may seek more robust anti-dilution conversion (or warrant) price adjustments. Finally, preferred investors may call for the right to board representation if preferred dividends are not kept current.

Public Company Common Stock

Investors may see inviting buying opportunities in public company shares that are trading at depressed prices. The acquisition of a large equity position, however, may raise myriad regulatory issues. If an investor acquires more than five percent of an issuer's common stock, it must file with the SEC a Schedule 13D providing detailed information about the investor's ownership position and intentions toward the issuer (or, in the case of "passive" investments, a briefer Schedule 13G). At the 10 percent ownership level, Section 16 of the Exchange Act requires an investor to disclose its ongoing purchases or sales of the issuer's securities and to disgorge any "short-swing" trading profits. Also, if an investor acquires a large enough equity stake to become an "affiliate" of the issuer, the investor will be able to dispose of its issuer stock in the public market only pursuant to a resale registration statement or in accordance with Rule 144 under the Securities Act.

In addition, rapid or voluminous accumulations of equity might implicate the SEC's tender offer rules, the notice-and-waiting provisions of the Hart-Scott-Rodino Act, state anti-takeover statutes, issuer poison pills or other defenses, and legal ownership limits in certain regulated industries.

Short Selling

The SEC's emergency ban on shorting the stock of some 1,000 financial sector issuers expired earlier this month. However, investors pursuing short-selling strategies remain subject to a number of legal obligations. Some of these are new. For example, many institutional investment managers now must file a weekly Form SH, disclosing to the SEC their shorting activity for the prior week.[6] In addition, new Rule 10b-21 under the Exchange Act, effective October 17, 2008, prohibits an investor from misleading its broker about the investor's ability to deliver borrowed shares upon settlement of a short trade.

Beyond the new rules, investors must remain aware of traditional legal issues surrounding short sales, such as the definition of share "ownership" expressed in Regulation SHO, prohibitions on the use of material nonpublic information and Regulation M's ban on

6 On October 15, 2008, the SEC adopted temporary Rule 10a-3T, extending the Form SH reporting regime, with some modifications, until August 1, 2009. For a description of the SEC's ongoing Form SH reporting requirements, please see our memorandum dated October 17, 2008, "SEC Extends and Modifies Short-Sale Disclosure Regime," available at www.rkollp.com/2008/10/sec_extends_and_modifies_short.php.

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shorting during the "restricted period" preceding a public offering.

TAX

Removal of Some Restrictions on Use of Built-in Losses for Acquired Banks

Section 382 of the Internal Revenue Code restricts the use of net operating loss carryovers and built-in losses by a company that has undergone an ownership change. In new Notice 2008-83, however, the IRS has stated that, in the case of banks, it will not treat losses on loans or bad debts as having been incurred prior to the ownership change. Consequently, Section 382 will not prevent an acquired bank from claiming deductions with respect to such losses (including deductions for reasonable additions to bad debt reserves). The ongoing availability of built-in losses may encourage bank acquirers to sell troubled loans or write them down realistically, in either case to recognize the tax benefit from the resulting loss. Write-downs of this sort may in turn spur additional loan sales, which could then be effected without a further accounting loss.

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The months ahead will offer abundant opportunities. Lenders, investors and traders should be in a strong position to obtain attractive pricing and set favorable documentation terms with counterparties. At the same time, market participants will need to focus carefully on risk issues and the evolving regulatory landscape. Since novel and complex legal issues will permeate the new transactional and trading environment, it is imperative that investors proceed in partnership with skilled and well-informed counsel.

If you have questions about any of the topics discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below:

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