JONES DAY

APRIL 2007

BANKING & FINANCE REPORT

INHERIT THE WIND
PROVERBS 11:29

(Certain Matters Borrowers Should Consider Prior to Entering the Credit Markets)

FOREWORD

The report that follows constitutes the first general report to clients and friends by Jones Day's Banking & Finance Practice (formerly named "the Lending/Structured Finance & Derivatives Practice" but still encompassing all three areas). Accordingly, we solicit and welcome any ideas you may have about its utility to you and other topics of general interest that you would like to see covered.

A word about the genesis of this report: We value your confidence in and loyalty to us. Earning a client's confidence by assisting it to achieve sound results under challenging circumstances without unnecessary inefficiency is the essence of professional satisfaction for a transactional lawyer.

You make the judgments, but we'd like to think that some of you will get better results and avoid unpleasant surprises if some of your judgments can be made at an early stage in the transaction on a fully informed basis, particularly prior to your executing fee letters and signing term sheets, after which you lose considerable leverage.

One size most definitely does not fit all clients in our practice. We represent capital providers such as banks and debt funds, as well as capital users such as private equity funds and nonfinancial corporations, in both leveraged acquisition

transactions and unleveraged transactions. Each category has concerns that are unique to it and may, in some cases, be adverse to the other side's positions. Although we obviously cannot and do not, without consent by all parties, represent parties having conflicting interests in the same transaction, we see no conflict in, and believe that all of our clients fully support, our advising clients of general matters that are, after all, common knowledge in the market, particularly when doing so should increase transactional efficiency.

In that spirit, we are expecting that our first report will be of interest primarily to nonfinancial clients and smaller equity funds and their portfolio companies that may borrow or raise other forms (*e.g.*, by securitizations such as CLOs) of leveraged and unleveraged financing. Many of the matters we are about to mention are already known to large equity fund clients that have recently encountered some of these issues in mega-transactions. Some of these issues arise in turn out of securitization and loan trading and affect all borrowers and users of capital. Those funds are presently trying to address these issues by, among other things, reducing the risk of default by insisting on the use of incurrence covenants rather than maintenance covenants and limiting the circumstances under which rights to approve transfers are lost.

Our first report follows. We hope you will find it and future reports to be of interest and value.

REPORT

The theme of this report is, to borrow from but modify the passage from Proverbs cited above, that the borrower that does not properly trouble its counterparty's house at the outset of a transaction may very well inherit the wind. To express this thought in wholly secular terms, if you don't do sufficient basic market research before entering today's financial markets (the practices and perceived risks of which can change on a weekly basis), just as you would routinely do before entering a new line of business, you run a significant risk of surprise, disappointment, and unnecessary exposure by failing to negotiate provisions to reduce but not necessarily eliminate certain risks. Indeed, some borrowers with smaller financial needs might consider the feasibility of staying out of those markets entirely by approaching a regional lender.

The *Financial Times*, in an editorial published in its February 3–4, 2007 edition, titled "Where is all the risk?" made a number of significant observations about today's financial markets. It cited recent public remarks previously reported by that newspaper and made by Sir John Gieve, the deputy governor of the Bank of England, and Jean-Claude Trichet, president of the European Central Bank. Both expressed what they perceived as the growing risk of instability to the financial markets stemming from the increasing complexity of those markets, particularly in the derivatives area, "because the ultimate bearer of some risks is no longer clear." The editorial concluded, "For everyday financial consumers all this complexity can seem a bit, well, complex. But the moral is simple: investments you do not understand are likely to be risky. It does not take a genius to work that out." The editorial did not point out that some of the global financial players (of which more later) have made mistakes by failing to sufficiently consider market characteristics.

We observe at the outset that, in our experience, no principled commercial bank or investment bank wishes to simply abandon or dismember a borrower that experiences financial difficulty. However, because of the increasing strength of nontraditional lenders in the markets, the syndication agent is often unable to control a syndicate whose members have widely diverging interests. Indeed, some members, through judicious use of credit default swaps and total return swaps, can effectively eliminate any credit exposure to the borrower, thus freeing themselves to engage in nontraditional creditor conduct.

Some of the factors that we hope you will consider are set forth below.

FEE LETTERS

If you do not read, understand, and carefully negotiate fee letters before descending into the maelstrom of documenting a transaction, you could very possibly become obligated, among other things, to pay twice for essentially similar services, pay for services you don't need, and pay prepayment fees to the advisor who is earning the advisory fee on the transaction. In short, you could very well wind up, through your own ignorance, in a disadvantageous position. Providers do not intentionally mislead borrowers. However, they expect a reasonable degree of sophistication from borrowers and should not be expected to nursemaid them. Because many fee letters lack transparency for inexperienced persons and vary widely, we strongly suggest that you insist that all fee proposals be put in writing before negotiations begin. Further, we recommend that you contact counsel after the initial draft of the fee letter is received but before responding to it.

A BROADER VIEW: THE MIXED BLESSINGS OF STANDARDIZED DOCUMENTATION

Today, the period from inception to closing of a credit transaction has shrunk drastically—often to 48 hours or less. Technology and continued specialization have permitted credit providers to document transactions faster than ever before. The added speed of documentation, coupled with the increased capital available, has led many credit providers to standardize their lending and derivatives documentation. This phenomenon is often referred to as "commoditization." When credit transactions become commoditized, far less attention is paid to individualizing the details of documentation, and the documentation often fails to take into account your business operations and cycles. The burden is on you to be aware of and present your concerns to credit providers. If you do not, the likelihood of defaults increases exponentially. Commoditized documents, such as credit default swaps, can themselves contain serious embedded ambiguities, leading to litigation and other unpleasant consequences. Credit providers, who are quite familiar with their own

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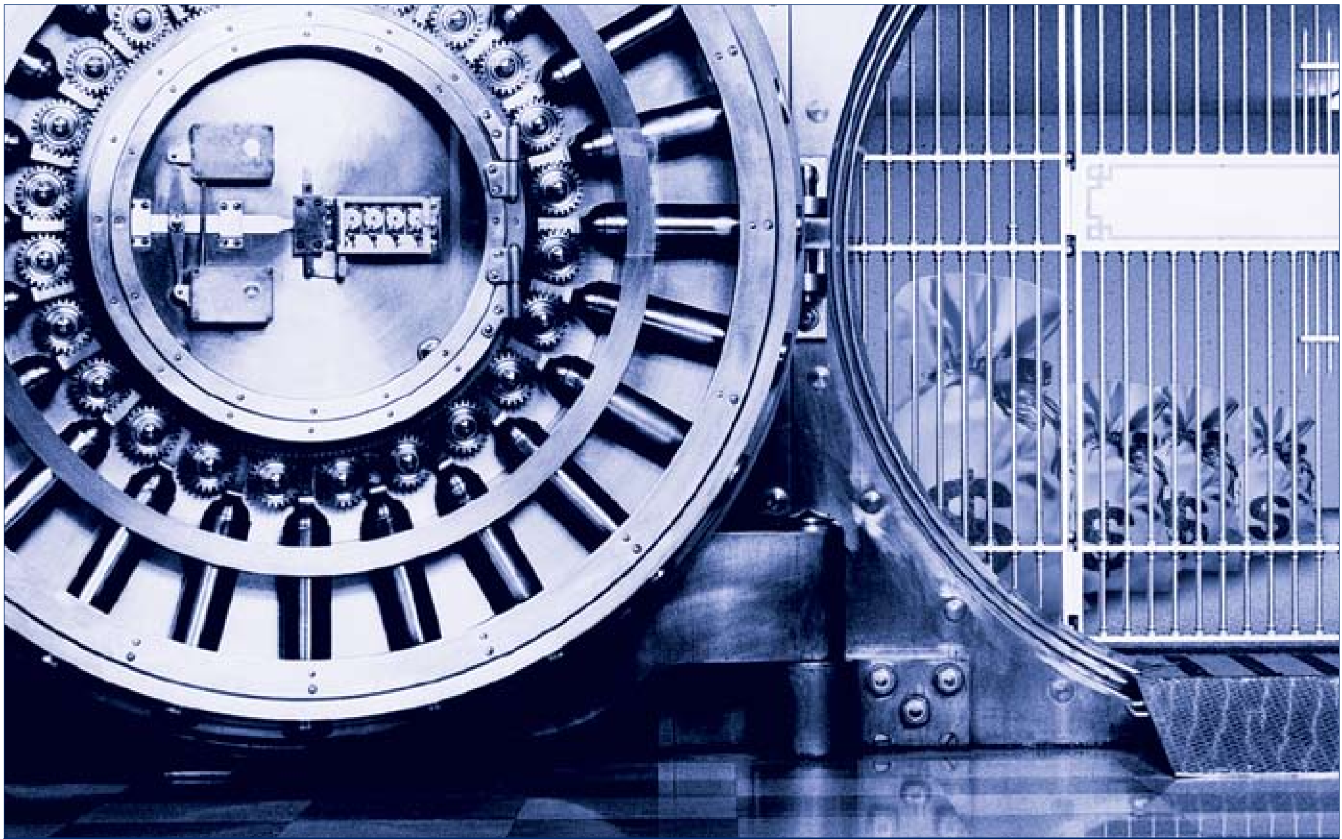
forms, often present a document that purports to be their "standard" credit agreement, which is often derived from an industry trade association form, and in the case of derivatives, from ISDA Master Agreements. They expect you to be able to respond to them.

While you know your own business, navigating through lengthy, often impenetrable forms under impossible time schedules is not your specialty. Often, in the rush to get a deal done, you will be unable to take enough time to consider the terms to which you are being asked to commit. Indeed, during consideration of the initial commitment papers, you may be tempted to assume that the credit provider's terms are fair or the best generally available, without any independent investigation.

Often, transaction terms are negotiated separately from full documentation of the credit facility. Credit providers usually wish to negotiate at the outset a summary term sheet and fee letter that set forth, in general terms, the fees, the size of the facility, commitments to pay expenses regardless of completion, and the major financial metrics (incurrence or maintenance) you must observe going forward to ensure that the credit risk remains within parameters acceptable to the credit providers. The term sheet is liberally sprinkled with phrases such as "usual" or "customary in transactions of this type." This practice, together with the time pressure, can lead to incomplete and vague documentation, which in turn can increase the need for waivers and amendments.

Very often, the summary terms are submitted to the provider's credit committee and form the basis for credit approval for



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the transaction. As a result, they may be couched in terms that favor the credit provider more than the borrower, often including potentially burdensome reporting requirements, complex collateral packages, and tight covenant levels. If you are not careful—and it is your responsibility, not the credit provider's, to be so—you may find yourself committed to terms that simply won't work for you.

You might consider, if time exists, using one available technique to help avoid some of the risks that standard-form commitment papers pose, which is to figure out whether the terms proposed are truly "market" for an entity of your size. This analysis can best be made by ensuring that there is someone on your team familiar with current market practice. Including experienced counsel to negotiate the final credit documents may help, but the best method, often used by sophisticated borrowers, may be to show the deal to several different, but similarly situated, credit providers. You may be able to negotiate lower fees and better terms if you are willing and able to take the time to present your deal to several different credit providers before committing yourself to a specific lead provider.

SECURITIZATION

Many securitization transactions involve the creation of a special-purpose entity ("SPE") and transfers of loans to it, with the SPE in turn creating securities evidencing varying interests in the transferred assets. The securities so created are often referred to as "CLOs" or "CDOs." The popularity of securitization reflects the simple facts that it improves the transferor's capital position and permits the transferor to recycle money and that related advisory fees and collateral agent fees yield a higher return on capital than that which would have been obtained from net interest income if the loans had instead been retained.

We note preliminarily that most borrowers, even the very largest ones, are still learning about the consequences of securitization and loan trading—most recently the risks of actions by certain funds intent on taking over the sponsor's equity position upon an event of default. These funds have, prior to engaging in nontraditional creditor conduct, often effectively eliminated their credit exposure to the borrower by offsetting credit default or total return swaps. Large sponsors have sought to reduce this risk by using incurrence rather than maintenance tests and limiting the events of default under which rights to approve transfers are lost to payment defaults and acts of bankruptcy. The new slogan is "covenant lite." High-yield bonds, because they are generally in public hands and often require regulated solicitations for approvals and waivers, have used the concept of incurrence rather than maintenance covenants to reduce default risk for years, and the concept is hardly new. This risk could, of course, be avoided entirely by eliminating covenants and events of default, actions that we would not recommend to a provider.

RATING AGENCIES

Most securitizations are priced and traded on the basis of rating agency ratings. This leads to extensive rating agency involvement, including, among other things, investigation of the loan loss record and servicing ability of the servicer or collateral agent (in each case, usually the transferor or an affiliate thereof), review of financial information for the principal underlying borrowers, and review of their business activities. In addition to the usual loan transfer provisions, which some major banks rely on without further elaboration, a trend toward more frequent use of so-called cooperation agreements concerning rating agency matters is rising.

A borrower should understand the extent of cooperation requested and particularly what it is agreeing to do (for example, the agreement should permit deferral of premature disclosure of sensitive, nonpublic information for a reasonable period, just as is commonly included in a demand registration provision requiring the filing of a registration statement on demand), because failure to perform any of the agreed obligations would constitute an event of default.

LOAN TRADING

Credit agreement provisions concerning transfers of direct ownership interests can be somewhat misleading. Often there is the defined term "permitted assignee," which usually includes any fund having at least $250 million in assets and any fund controlled or managed by an affiliate of a lender. Transfers to those entities are permitted without borrower consent. Transfers to other entities are permitted only with borrower consent, which, it is usually provided, is not "to be unreasonably withheld." If an event of default occurs, however, then the borrower's right to approve the transfers is terminated. Hence, at the very time when the right may be of most value to prevent a transfer to a "predator" or "vulture" fund, for example, the right is lost. It is too soon to know the extent to which limiting the events of default that cause rights to approve transfers to be lost to payment defaults and bankruptcy events will be made available to entities other than the very largest sponsors.

Some people are beginning to apprehend that because of the similarity of the methods of distribution and purchasers, many of which are not banks, a reclassification of loans as securities is not unlikely, but the protests of the affected providers or threats to move to a better regulatory jurisdiction may delay its occurrence.

ADVERSE EFFECTS OF SECURITIZATION AND LOAN TRADING—IMPAIRMENT OF ABILITY TO OBTAIN NEEDED WAIVERS AND AMENDMENTS

One of the most significant negative effects of securitization and loan trading on borrowers is the impairment of a borrower's ability to obtain needed waivers and amendments. Accordingly, a borrower not needing large sums of money might be well advised to find a lender that doesn't intend to securitize its loans or transfer significant amounts of its loans to others. Because bank and investment bank regulators would be reluctant, to put it mildly, for reasons of prudence to permit a provider to limit its right to transfer loans upon a default, obtaining a binding and enforceable obligation not to make transfers will generally not be possible.

The reason these activities can impair important borrower protections is quite simple—syndicate members, if indeed their identity can be accurately determined, frequently have different interests based in part on whether and to what extent they have hedged their credit risks. In securitizations, conflicts between the interests of the security holders and those of the collateral agent may also exist. A collateral agent's ability to replace existing collateral with nondefaulted securities may alleviate this problem. This is a serious, unsolved problem. Some providers may agree to a minimum holding period, but it will usually terminate upon the occurrence of an event of default. Inexperienced borrowers are frequently astonished that no one told them about the consequences of securitization.

If the securitization is effected under U.S. Regulation AB, then if the underlying obligations of a single obligor represent 10 percent or more of the asset pool of the SPE's assets, that obligor must provide certain financial information for inclusion in the prospectus. If such obligor's obligations represent 10 percent or more but less than 20 percent of the asset pool, then selected financial data as required by Section 301 of Regulation S-X are required. If such obligor's obligations represent 20 percent or more of the asset pool, audited financial statements meeting Regulation S-X requirements are required. In addition, if the underlying obligations constitute "securities," they must themselves be registered under Regulation AB. Some people are beginning to apprehend that because of the similarity of the methods of distribution and purchasers, many of which are not banks, a reclassification of loans as securities is not unlikely, but the protests of the affected providers or threats to move to a better regulatory jurisdiction may delay its occurrence. These threats would not, however, cause a court to duck the issue.

CONFIDENTIAL INFORMATION

U.S. Restrictions. Under U.S. law, certain derivatives including credit default swaps are, if "security-based" (*e.g.*, based on or referenced to securities), treated as being securities for purposes of the antifraud provisions Rule 10b-5. The purchase or sale of securities or the acquisition, writing, or exercise of a security-based credit default swap is a "sale or purchase" and if made while in possession of material, nonpublic information (which may be confidential information distributed to syndicate members) is a violation of Rule 10b-5. Some syndication agents and borrowers have attempted to control the problem for certain entities, such as hedge funds that engage in active trading, by allowing them to elect to receive only "public" information disseminated by the borrower to the syndicate. This has led to problems in obtaining needed waivers and amendments, the requests for which are often classified as "private," and these providers may be required to designate a specified person (such as a law firm) to receive nonpublic information in connection with amendments and waivers.

U.K. Restrictions. The U.K. also has legislation that addresses "insider dealing," both on a criminal and a civil basis. If a syndicate member has confidential information relating to an issuer of securities (including derivatives), it cannot deal in those securities, pass on the information to others or encourage them to deal in the securities, or otherwise "misuse" the information. This is, however, normally addressed by "information walls" within the institution, rather than by limiting the information provided by the issuer, so that the difficulties regarding obtaining amendments and waivers attributable to this concern do not generally arise.

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