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The Coming Wave — What the Turmoil in the Credit Markets Means — and What to Expect in 2008

The following is a transcript from a panel discussion concerning the recent dramatic changes in the credit markets, how those changes have affected the U.S. and international restructuring landscapes, and the anticipated practical and legal effects of a turn in the cycle/credit crunch. The discussion took place at the New York offices of Chadbourne & Parke LLP on Wednesday, October 24, 2007. Some 100 clients, restructuring professionals and other interested parties attended the discussion.

The Honorable George E. Pataki, former governor of the State of New York and now counsel at Chadbourne & Parke LLP (and recent President Bush appointee as special representative to the United Nations General Assembly) opened the discussion with some introductory remarks.

The panelists are Anthony Murphy, Managing Director, Citi Markets & Banking and Global Head of Institutional Recovery Management for the bank; Eric Siegert Senior Managing Director, Houlihan Lokey Howard & Zukin; Marc Sole, Senior Vice President, D.E. Shaw & Company; Leon Szlezinger, Senior Managing Director, Mesirow Financial Consulting, L.L.C.; Adrian Harris and Joseph Smolinsky, partners in the bankruptcy and corporate restructuring department at Chadbourne & Parke LLP. The moderator is Howard Seife, chair of Chadbourne's bankruptcy and corporate restructuring department. The panelists' comments are their own and do not reflect the positions or views of their respective institutions, and the panelists' comments may not be used in any proceeding involving these institutions.

Governor Pataki's Introductory Remarks

Governor Pataki: Now the topic this evening is "The Coming Wave." As an aside, I met my wife body-surfing in the Hamptons in a pre-hurricane. So I'm pretty good at riding waves. But I can't tell you what the proper way to ride this one is.

The Present Crisis

The financial experts on the panel know far more about this than I do, but let me briefly talk about the public side of what is happening with the subprime mortgage crisis and the decline in the housing market. As you all know, the subprime market is huge, with some \$1.3 trillion in mortgage debt outstanding. While the creation of the subprime market was enormously positive in so many ways, including providing access to credit for people who didn't have access before and increasing liquidity in the market at lower interest rates, it also had some negative consequences, as we are seeing today.

The primary negative as I see it is was the separation of the lending and / continued page 2

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collection functions occasioned by the widespread use of structured finance vehicles like collateral loan obligations and collateral debt obligations. What may have been good for the subprime mortgage originator may not be necessarily good for the ultimate holder of the obligation and we are now seeing the consequences of that as the housing market continues to decline. Today the September numbers came out and the housing market declined another 8 percent from August and nobody knows where the floor is.

When you look at what is happening from the public's eye, there are two real issues here. The first is the liquidity crisis, which we all know about and is captured eloquently in one of my favorite quotes, "Moore's Second Economic Law," to the effect that "markets are liquid until they aren't." The comment is profound and very simple and we are seeing the consequences of

of assets across the country. The way to deal with the instability in the financial markets is to inject liquidity into the system. The problem with that, however, is what has become known as the moral hazard question.

When the loan origination and collection functions are severed as a consequence of securitizations, the chances are that you will get a lot of irresponsible lending decisions. The question then becomes whether you bail out parties by injecting liquidity into the system or do you let the system struggle through the inevitable market disequilibrium?

Obviously, the simple solution is to inject liquidity. But the easy way out increases the risk that irresponsible lending will continue because the market perceives that a bail out will always be there. And that is the moral hazard, and the more times you do that, the more likely it is that the crises will happen again.

The way to deal with price stability is, of course, is to deal with interest rates. The risk with interest rate cuts is that you have

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that now. But more importantly, what might we expect from the public sector as an antidote to the liquidity crisis?

I believe you have really two essential players — the central banks, particularly the Federal Reserve in the United States, and the politicians. And when there is a crisis, the worst and last thing in a politician's mind is to do nothing. You saw that in the political response to the Enron bankruptcy when, in the demand do something, Congress passed Sarbanes-Oxley, the wisdom of which I think a lot of people still question. But my greatest fear is that the politicians, in their zeal to show that they are trying to do something, will take action in the near term that has negative consequences.

The Central Banks' Response

The Fed, the central bank in the U.S., has two roles: maintaining stability in the financial markets and stability in the pricing

inflation and you lose that stability.

Let me make a bold projection here. This crisis is so real and so significant because it's a crisis on the debt side, not the equity side, and that is relatively unique if you look at the economic history of the last few decades. And because the crisis is mainly centered in the debt and structured finance markets, the consequences may very well spread to places that we can't presently determine. Because of that I think it is far more likely that the Fed and the other Central Banks will act to inject liquidity.

And while the Central Banks will pay lip service to the moral hazard, I believe that as between imposing long term discipline on the credit markets by letting natural market forces play out now, versus alleviating the current crisis, I think the Central Banks will run the risk of future crises by providing an expedient fix now.

The Fed has signaled with its recent half-point interest rate

cut that when it comes to price stability versus the risk of an economic slow down, they are willing to take the risk of higher inflation. I think you will see that continue.

The Political Response

As for the politicians, they are clamoring to do something. It is not exactly clear what they will do, but in my view there are two approaches that politicians might employ. The first involves longer term, preventive measures that attempt to preclude what has happened from recurring, and the second approach is geared to providing immediate relief to homeowners who are in imminent danger of losing their homes through foreclosure.

Longer term, I think we are going to see a couple of positive steps that Congress and the administration may be able to enact with bipartisan support. For example, I think you are going to see more federal oversight of those mortgage originators that are not presently subject to federal regulation. Perhaps surprisingly, more than 50 percent of the of the subprime loans now in trouble originated from lenders or entities that are not subject to federal regulation.

The second thing I think you'll see in the way of a longer-term fix is more oversight of the rating agencies, and for good measure. The agencies look at the security behind the debt and have rated the debt highly based on something called the HPA, or housing price appreciation factor. Leading up to the present cycle, the HPA used by the rating agencies was based off of the past 10 years, when home prices in the U.S. went up by over 125 percent.

But an evaluation of security using a predominantly rear view mirror approach to housing appreciation has proven to be misguided in view of the fact that in the last year, home prices have declined by over 4 percent across-the-board, nationally, on average. Surprisingly, the agencies have acknowledged that their rating analyses do not work when the HPA is negative. I think you are going to see longer-term solutions to try to make sure the rating agencies are a little bit more responsible as they go forward and rate these debt obligations in the future.

Now, in the short-term, are there going to be bailouts? It's a complicated answer, but I think the philosophy is relatively straightforward. I don't think you're going to see political action, meaning legislation or action by Congress or the administration to help the lenders. I think there is a relatively broad consensus that the lenders were sophisticated and understood or should have understood the risk they were taking.

So I don't think you'll see any significant action there. But on the part of the individuals, are we going to see all these foreclo-

tures continue? Are we going to see tens of thousands of people lose their homes? I think that is where you are probably going to see some effort to enact legislation that would allow defaulting homeowners to stay in their homes as a renter at market rates for a period of time.

To make a long story short, it is a very real crisis that is going to continue. I think you can count on the Central Banks, including the Federal Reserve, given their understanding the magnitude of this crisis, to deal with it. They'll never admit as much, of course, so as not to create the appearance that overly risky lending is without consequences.

I think you'll see some positive long-term solutions coming out of Congress and the administration in a bipartisan way. My fondest hope is that in the short-term they don't repeat Sarbanes-Oxley and get carried away and go far too far. In closing I thank you for the opportunity to talk to you and I hope you find the panel discussion informative and thought-provoking.

These Are Indeed Interesting Times

Mr. Seife: In thinking of today's program, the Chinese curse came to mind, which is, "May you live in interesting times." These certainly are interesting times in the credit market. Just today, Merrill Lynch announced that they are taking a write-down of \$7.9 billion for bad mortgage debt, which is a staggering figure.

That follows write-downs from a number of other major institutions, including Citi, Morgan Stanley and a number of others. We have oil trading for over \$90 a barrel from time to time, numerous hedge funds going into liquidation and, as Governor Pataki mentioned, home sales are down eight percent in September. Every day there are more subprime crises, and dozens of lenders have gone out of business.

What is particularly odd is that the default rates on speculative grade debts remain at record lows, 1.4 percent in August, and probably the same in September. So one of the questions that we hope this panel can answer is, should we expect more defaults in the near future? Barclay's Capital is predicting default rates to rise to five and-a-half percent by mid-2008. At the same time, J.P. Morgan is predicting default rates will stay at current levels. So these are interesting times.

Adrian, I've spoken mostly about events that have been going on in the United States. What's the status of things in the U.K. and Europe? I was in London a few weeks ago and I saw a long line of depositors outside a bank waiting to withdraw their life savings. What is going on the other side of the pond?

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The Northern Rock Affair and the Bank of England's Response

Mr. Harris: Most of the people in this room will be familiar with Northern Rock. But what I thought I might do is go through a timeline of what actually happened because there were two things that were happening at the same time. One was that Northern Rock had a problem. That was very specific because of the nature of the business model that Northern Rock had. The other one was the problem of liquidity in the financial markets and the problems experienced by the Bank of England, the government and the Treasury, and how they all worked together, or didn't work together, as the case may be.

On 25 July, Northern Rock (the U.K.'s eighth largest bank) issued an upbeat set of trading results, reporting interim profits up by 0.7 percent to £296 million and pledging to boost dividends to shareholders by 30 percent. While saying the outlook for the business was very positive, the bank also notes that sharp increases in borrowing rates in the money market are likely to make life more difficult and that changes in interest rates and credit-risk environments will influence the size of its annual profits. Northern Rock says its assets have grown 28 percent to £113 billion, its new residential lending remains low risk and that sales growth from its core mortgage business remains good.

On August 9th, global credit concerns are ignited by French bank B.N.P. Paribas's decision to suspend three of its investment funds with exposure to the troubled U.S. subprime market. Share prices fall sharply and banks curb lending to each other. The European Central Bank injects \$130 billion into the European banking system.

On the 14th of August, Governor Mervyn King of the Bank of England is alerted to the potential impact of the global credit squeeze on Northern Rock's business in a phone call with officials at the Financial Services Authority, or the FSA, and the Treasury.

On the 4th of September, the rate at which British banks lend to each other, the LIBOR (the London Interbank Offered Rate) rises to its highest level in almost nine years. The three-month loan rate hits just under 7 percent, which is above the Bank of England's emergency lending rate of 6.75 percent. Thus, banks are beginning to become very reluctant to lend to each other.

On the 12th of September, Mervyn King says that the Bank of England would be prepared to provide emergency loans to any bank, but, and this is an important point, he rules out following

the lead of the European Central Bank and the U.S. Federal Reserve to pump huge sums into the banking system to ease the liquidity drought, in deference to moral hazard concerns.

I'll quote what he said at the time: "The provision of large liquidity penalizes those financial institutions that sat out the dance, encourages herd behavior and increases the intensity of future crises." So he was very much against putting liquidity into the market and not following the ECB and the Fed.

On the 14th of September, Northern Rock says extreme conditions in the financial markets forced it to approach the Bank of England for assistance. Northern Rock's boss, Adam Applegarth, who, amazingly, is still employed (Mr. Applegarth subsequently resigned from Northern Rock), stresses that it is business as usual for the firm. Nobody believes that. The firm's shares plunge 32 percent in the City as worries circulate about Northern Rock's future viability.

Meanwhile, queues begin to form outside a number of Northern Rock branches, and people really were queuing from two o'clock in the morning. It was quite an incredible sight. That was the first run on a bank in England since 1866. The bank's website collapsed shortly afterwards and all its phone lines were jammed.

On the 17th of September the Chancellor, Alistair Darling, dramatically intervenes to try to end the crisis by agreeing to guarantee all deposits held by Northern Rock. Not many know this, but the deposit insurance for people with banks like Northern Rock, is actually very low. It's 100 percent of a sum up to £2000 and then 90 percent up to £35000, which is why people were panicking. Because if Northern Rock went into administration, all of those accounts would have been frozen and people would not have got their money.

On the 18th of September, the Chancellor's move does have the desired effect because the queues disappear and people walk away feeling their money is safe. On the 19th of September, the Bank of England announces that it will inject £10 billion into the money markets to try to bring down the cost of interbank lending — just one week after Mervyn King said the Bank of England would not intervene. So it was a complete 180 degree turn for him.

I think what happened was that the Treasury, the FSA, and the Bank of England did not work well together. I think the Bank of England was far too concerned with moral hazard and not looking at what was happening outside on the streets and the concerns people had. I think, eventually, we had a grenade with the pin taken out, which was being circulated between the Treasury, the FSA, and the Bank of England and that eventually, the gov-

ernment, in the form of the Treasury, gave it to Mervyn King, the Governor of the Bank of England, and said: "Look, you've got to be a man. Stick that down the front of your trousers and put money into the market." That's exactly what he had to do. Now it has damaged his credibility. There have been questions as to whether he will actually survive in the medium to long-term.

Mr. Szlezinger: Adrian, I was in the U.K. at the same time and saw those crazy street scenes. I know that one of the big worries when I was there was that it might spill over from Northern Rock into other lenders even though they had different business models. Ultimately, that might be why the Bank of England moved to do something. Do you think that was a real concern and the whole U.K. banking system could have been under threat?

A Race to the Bottom?

Mr. Harris: Yes. Because it was very difficult for Mervyn King, in his position as Governor of the Bank of England, to say one thing one week and to say something completely different a week later. So he was put under massive pressure.

The other thing that I think is worth bearing in mind, and it will probably come up later in the discussion we have is, I was at a dinner in London about a week ago and the speaker was the Chairman of Oaktree. He said he regards what has been happening as a race to the bottom. I thought that was a really good way to describe things because certainly in the U.K., we have had mortgage lenders who have been providing mortgages at six, seven times multiples of gross annual income.

We've had 110 percent loan-to-value ratios, we've had self-certification on wages. You've got to ask yourself the question, wasn't this bound to happen? And in my view, the real fault lies with the regulator because, in the case of Northern Rock, the FSA had not done a check on Northern Rock for 18 months before this happened. I think the regulators need to look very carefully at the way these banks lend money to people. If you are someone who can get 110 percent mortgage on a six or seven times multiple, of course you're going to take it, because you are not necessarily going to see what might happen if things turn against you. I also think the banks need to take more responsibility but because they are not doing it themselves, the regulator needs to enforce that.

Has the Credit Crisis Affected Restructurings in the U.S.?

Mr. Seife: Let us turn our attention to the U.S.. I don't think we've seen runs on the banks, but there are certainly tremen-

dous stresses on the banking system. And I think we've seen liquidity dry up. I think in recent months there has not been a lot of restructuring because credit has been much easier to obtain. It's much easier to refinance than address some fundamental issues. Eric, are we seeing a difference now? Has the liquidity change had an impact on restructurings in the United States?

Mr. Siegert: It certainly has. Both in terms of what we are going to see with new restructurings and what we are seeing with the wind-up of old restructurings. I think you mentioned that the default rate in the country still remains amazingly low. I think that is because the credit risk and the credit tolerance in the marketplace today did not cause an immediate run on the banks. It takes a lot of time for those deals to be done and for liquidity to dry up in those systems. It will be the rescue financing that doesn't come this time around.

I think you are going to see default rates go up because of the leverage ratios at which some of the deals over the last several years were originally done and I don't think you are going to see the rescue financing come in. There won't be second and third lien financings. Instead, you're going to see defaults happen. Five percent — that sounds amazing to me because, and I think it was Barclay's that made that prediction, if you apply a five percent default rate to the amount of debt that has been placed in the system over the last five years, we would have a restructuring market in the next five years that would put the last one to shame.

It would be exponentially worse than what we saw in 2001-2002. It is imminent. It is going to be very severe. Credits that are fundamentally poor performing, credits that were done with insufficient liquidity will go down. It will be across broad industries. It's not going to be industry-specific. There are obvious examples, Technical Olympic in home building is one. There are other obvious areas, like anything related to the oil industry where there are raw materials related. That will be where the earliest signs of this will materialize, but it will be across all industries in my opinion.

I don't know if it will come as early as mid-2008, but it's going to start to happen as we go into 2008. By 2009 we are going to have a flood of activity in this marketplace.

Mr. Murphy: Eric and Leon will be accepting resumes.

Leveraged Loans — Some Stress and Strains in the Marketplace

Mr. Seife: As we all will be. Tony, what's the climate at your bank? Has the spigot been totally turned off? Is there any liquidity at all coming out of the banks? Has the view

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toward lending changed dramatically in the past six months?

Mr. Murphy: The spigot isn't completely turned off. I think we are looking for the opportunities that you would at this point in the cycle. Home builders, for example, many of them will need capital. We are going to provide capital. We want to make money. But, we are being put in a position of having to use an awful lot of our capital defensively to protect our positions. Inevitably that will — it's not an unlimited pool — contribute in the long run to what Eric predicts, which is, if we are having to be more selective about who we provide financing to and where we use our capital, that, again, will fuel a slow down.

Mr. Seife: What does that mean, to "use your capital defensively," in layman's terms?

Mr. Murphy: As is evident in the markets, there are a lot of

continue to see them get done. So, we are not in a shutdown mode at all. We are hopefully in a trend toward deal activity resuming. I don't think living in the extremes is a good place to be, even for me, a guy who makes a lot of money in restructuring. We do need the capital markets to function and function effectively, even to get restructurings done.

Mr. Szlezinger: I think there was a lot of focus on the larger deals that didn't get done or got hung up. But I think in the mid-market, those deals did continue to get done. The credit crisis didn't affect the middle market anywhere near as much as was feared.

The Flight to Liquidity May Spread Subprime Woes to Investment Grade Markets

Mr. Murphy: I think it's a question of, as Howard asked, is there a run on the banks in this country? There isn't literally, but there is certainly a flight to liquidity. We started talking about subprime

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commitments that we and every other major bank and Wall Street firm have made throughout the Spring and early Summer, which we are still holding. Some of these have come to market and are being absorbed by the system. As we go through Fall, there is still a lot more to come.

Mr. Siegert: I think it is important to note though, the fact that these deals are getting done, perhaps with some stress and strain, but they are getting done. With the tightening of capital markets, even three weeks ago, it was almost an immediate shock where things were shut down — almost to a degree that's probably unprecedented. It didn't stay that way for long and we are starting to see conditions ease ever so slightly. I'm hearing a lot of cautious optimism that we're trending back towards the credit markets we had in June.

Certainly, there are deals getting done out there today. We will

markets. We're not talking about subprime markets at all any more. The question as to whether the real chaos and fear that was in the markets two or three weeks ago comes back really depends on how many more assets have to come to market. And if, in order to deal with the absence of short-term financing, people have to move from selling mortgage positions, to corporate loans, to investment grade corporate loans. You could continue to see significantly more technical pressure on prices, which could put us back to that point of fear one or two more times.

How Has the Liquidity Crisis Affected the Availability of Exit Financing?

Mr. Seife: There are some major Chapter 11's out there that are looking to get exit financing. Has this liquidity crisis had an impact on the ability to exit Chapter 11?

Mr. Siegert: Sure. There are three different examples. The first one is Calpine. They are in the marketplace now. They are actually going through the confirmation process. They have committed financing. Goldman Sachs has stepped up and as long as Calpine meets the timing deadlines, that exit financing will get gone. On the other hand, if they slip past their deadlines, that financing is totally up in the air. And as a result, that restructuring is being pushed through very aggressively. The judge [Honorable Burton R. Lifland] is aware of the timing. So you are seeing a deal where the absence of capital is forcing something to get done that otherwise might not get done, certainly in the timeframe that's required.

The extreme on the other side of that is Delphi. Delphi definitely had a deal signed up with all the parties, all the constituents. When that deal went to the market to get financed, it couldn't get financed. The parties could not find a financing commitment and the restructuring deal that everyone agreed to wasn't financeable. So now what? Now we are in the midst of sort of wholesale reinventing that transaction with the drivers being the capital markets as opposed to the drivers being the sharing and economics among the various constituents.

The third situation is Solutia. They took it to the exit financing market and instead of the market saying, "No, we can't do it," they simply said, "We'll do it, but it's going to be a heck of a lot more expensive." So it's changed the economics for all the players in the deal, but it hasn't caused a wholesale reinvention of those economics.

So those are the three deals with three totally different outcomes. I think this disruption in the exit financing market will be relatively short-lived, at least I hope so. I think these deals just got whipsawed. They are coming to the market at a very difficult time. They are coming to market when there is no market. But sometimes you just can't control the market.

Structured Investment Vehicles

Mr. Seife: Let me read a short quote which was on the front page of The Wall Street Journal last week, which hits on another factor that is roiling the credit markets.

"Fears are rife that dozens of SIVs, many of them affiliated with banks, will be forced to unload billions of dollars of mortgage-backed securities. Such a fire sale could cripple debt markets that play a crucial role in the global economy."

This presents a pretty damning view of the situation with SIVs. I think very few of us in this room had ever heard of SIVs a month or two ago. And now we find they are holding \$400 bil-

lion of assets and there are 30 of them out there. Joe, maybe you could tell us in layman's terms what is a SIV? What kind of assets does it hold? Who are the creditors? And why is this threatening the entire economy of the free world?

Mr. Smolinsky: SIV is short for "structured investment vehicle." They are used by banks to generate a tremendous amount of liquidity, which they then use for lending. We're all familiar with how regular mortgage securitizations work, where a loan originator or financial institution places mortgages or loan related assets into a pool, then issues mortgage-backed securities to other financial institutions and investors. That's good for the loan originator or the financial institution because it allows them to monetize these assets.

A SIV in turn purchases mortgage-backed securities and CLO's or CDO's and finances the purchase through the issuance of commercial paper and medium-term or short-term notes. That allows financial institutions to arbitrage the difference in interest rates between the long-term mortgage-backed securities, which (ordinarily) have higher interest rates, and the short-term commercial paper, which (ordinarily) have lower interest rates. The commercial paper is typically rated triple "A" by the rating agencies and, as a result of that rating, a lot of unsophisticated creditors buy the commercial paper for their portfolios.

The SIVs have been recently hit with a double whammy. The commercial paper market ceased to exist for a period of time. As a result, the SIVs were unable to roll-over their commercial paper on maturity. The second thing that happened is the mortgage-backed securities in the SIVs portfolio, which were supposed to be very liquid, were no longer liquid and could only be sold for a fraction of their prior worth.

So the SIVs were left with a problem. How do they refinance the maturing commercial paper? They could obviously sell portfolio securities, but only for bargain basement prices. But, since they couldn't get an organized group of commercial papers holders to meet and decide how best to liquidate those assets, they were left with a decision to make; that is, whether to sell the assets or to try to find another way to bridge the short-term liquidity problem.

This was a decision, in large part, jointly made by collateral trustees and SIV sponsors. A lot of SIVs did sell off their assets. Others chose not to, and tried to organize the commercial paper holders. Obviously, you have a difference in opinion between the short-term commercial paper holders in the SIV, and the capital noteholders in the SIV, because to the extent the assets are sold at a discount, the early-maturity commer-

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cial-paper holders will get paid, but the noteholders will be left only with the worst portion of the asset-pool.

So, while these SIVs sometimes have liquidity backstops issued by the sponsors or third parties, these backstops are often very modest in amount and are generally not available if there is an acceleration occurrence or some liquidity crisis. So, again, the capital is there, but not when you need it. I think everyone is trying to work through these SIVs and trying to prevent them from roiling the market. This area may lead to litigation where the targets may be the sponsors, collateral agents and the rating agencies.

Mr. Seife: Now, turning to you, Tony, and not in terms of the Citibank SIVs, putting your hat on as a creditor of SIVs, what's been your experience, and what's been the impact on the bank?

Mr. Murphy: Obviously, given what I do, we look at the least healthy ones. But we've seen a few cases of what, if it happened

been the establishment of a master liquidity enhancement conduit. You know that if the language is that complicated, the deal is going to be very complicated. But as I understand it, a number of major institutions would finance this new entity, which would be available to buy assets from those SIVs that need liquidity. But, according to published reports, they would be buying the better quality assets and presumably paying close to par. That would provide immediate liquidity to the SIVs to be able to meet their commercial paper and other short-term obligations. Maybe it's not a fair question for the panel, but, is that a solution that just postpones judgment day because you are taking out the best assets from these SIVs, leaving the troubled assets. Am I missing something here?

Mr. Murphy: It's sort of a confidence game. If that deal works, it never gets used. Because if you put the fund together, you signal to the market that these assets are bankable. Then, perhaps the commercial-paper market continues to function rationally.

The unwinding of SIVs could lead to the spread of financial dislocation from subprime mortgages to commercial paper.

on a more widespread basis, would cause some serious economic dislocation, which is SIVs having to unwind. This is how we get from subprime to leveraged loans to problems in the investment-grade world, to the commercial-paper market. You end up selling the thing with the most liquidity when you have to. So you follow the string from problems in this arcane part of the mortgage market in the United States to big pressure on investment-grade credits, which also, as I said earlier, leads us to have to make these decisions about how we use our capital defensively.

If we've got billions of dollars of assets that we finance that are going to go to market in a market like this, which is very uncertain, we are probably going to use our capital to buy them back, as most of our peers did. So it's not quite a run on the bank, but it's certainly a run on liquidity. Again, the ones we have dealt with have been in Europe and of relatively smaller scale. As Joe said, the aggregate number is mind boggling.

Mr. Seife: One of the solutions that's been kicked around has

That's really what you are trying to do is take the "Northern Rock" fear out of the market so people continue to act rationally instead of putting their hands in their pockets for a month or two. Because putting your hands in your pockets for a month or two here is going to cost a lot of money.

Mr. Seife: So it's a matter of rebuilding confidence in the market?

Mr. Murphy: That's not the question. I know absolutely nothing about the nature of the \$400 billion. But the question is, are these assets troubled, right? Because, effectively or not, they are just losing their financing force.

Mr. Seife: One of the holdover legacies that we are facing now in restructuring is the way the deals were structured and papered when there was tremendous liquidity out there. Borrowers had their choices of where to go and terms. Leon, we are dealing now with these so-called "covenant-lite" deals that the banks put together over the past few years. How has that impacted on restructuring? Has it made a difference?

Mr. Szlezinger: I don't think yet. But I think as we move forward, we are going to see a difference.

Covenant-Lite Loans

Mr. Seife: What is a "covenant-lite" loan?

Mr. Szlezinger: You might recognize it as a loan that doesn't have all of the traditional triggers that might make a banker raise their eyebrows and say, "Am I going to get repaid?" So what you will see as you go forward is that in a bunch of these loans, companies are going to be able to move forward and run their businesses and in many circumstances lose value without having somebody breathing down their neck. I think that's going to put an impetus on senior creditors, on banks, to be aware that even though they've got those deals out there with very little in the way of covenants, they've got to be aware of the problems they may have.

I think rather than focusing on the covenant-lite deals too much, because if you look at the number of covenant-lite deals and compare them with the deals that are done where the covenants are there, they are at a high level of leverage. To me, that's more the issue. Probably a combination of the two is going to lead to a lot in the way of restructuring.

Mr. Seife: Are the banks losing value because they are not able to address these problems at an earlier time? I suppose that we are not getting the covenant defaults that might trigger a restructuring.

Mr. Siegert: If you are the equity holder in a distress situation, you are playing for option value. The banks may not know what is going on. But the equity sponsors are tracking it very closely. They know that if there were covenants, they would be in default. They know that defaults may be imminent. It's all about option value. The longer they can preserve time, the more they preserve option value. They are going to hang on as long as they can while using other people's capital to try to create value.

I don't believe the fundamental triggers will change that much. There are probably not that many covenant-lite deals in the marketplace relative to the total number of all deals. Usually in a restructuring context when there's a covenant default, it's an opportunity for the banks to come in, take a look at the situation, charge some fees, get a forbearance agreement in place and start looking at it more carefully. It's not generally the trigger which brings down the house of cards. What brings down the house of cards is when a company runs into a liquidity crisis. When it can't make an interest payment or make the payroll — that's what causes the cards to fall.

That's what going to happen here ultimately. We don't know when it will happen. Perhaps it's a 15 percent decline in corporate earnings, maybe it's a combination of a flat-to-declining market, or even a slightly increasing economy given the leverage ratios. You are going to see payment defaults left and right. The timing of those probably won't vary all that much relative to where you would have been if you had covenants triggering earlier defaults.

Mr. Seife: But as a lender don't you want to address the problem before there's a payment default? Because after a payment default your hands are really tied.

Mr. Siegert: These are larger, more complex deals. The payment defaults are usually not at the bank level. They are going to be at the bond level.

Mr. Murphy: We're always thinking of the best interest of our clients. When there's covenant defaults, sometimes we are looking to promote our position vis-à-vis the rest of the capital structure for the event that Eric mentioned when there is a real reshuffling of the cards. I agree. The fact that we don't have any covenants on a lot of deals today isn't really going to change. It may make it a little harder for us to get more fees and more collateral as the process evolves. But it's still going to happen when Eric's recession scenario occurs. Right now, again, we're looking at a situation where many of these credits aren't any different than in April or May when we bought them. It's just that the market's appetite has changed.

Mr. Smolinsky: Eric is right that sometimes the lower you are in the capital structure, the more time you want to have to work things out. At the senior place in the capital structure, you may go to sleep one night thinking you have a covenant-heavy deal, and then you wake up the next morning and you find that 51 percent of the debt has traded and they have stripped out all of the covenants and now you're "covenant-lite." There's going to be a lot of gamesmanship in the next wave dealing with those types of strategies.

Problems Presented by Subordinated Lien Structures

Mr. Seife: Which leads us to our next topic. We have first liens, second liens and, in some cases, third liens. What kind of inter-creditor issues are we seeing? How are we coping as professionals and bankers? Particularly the banker that might be the agent at more than one level. What tensions are we seeing between the creditor groups? And how are those tensions getting resolved?

Mr. Siegert: You've got all these con- */ continued page 10*

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situencies now going into restructuring transactions. If you went back a number of years, you had a senior secured lender and some unsecured debt. The senior secured lender would take center stage and kind of dictate the terms on how you'd go into bankruptcy and how you would get DIP financing. That's kind of how the cases used to unfold.

Now you have got collateral that's been pledged all over the place. You've got adequate protection discussions with all these different constituents. It gets very complex. It is a fundamentally different process even getting into bankruptcy, much less getting out. You have people who have different liens on different assets. As you get to the exit, the players will have changed and will mostly consist of hedge funds — this, in itself, will change the dynamic of these restructurings significantly.

You are going to have a lot more cooks in the kitchen. It's just

agent for the first, second, and third lien debt, where you hold a piece of each slice. How do you cope with that? Do you have any protocols, or is each case different?

Mr. Murphy: Each case is kind of different but I think you can't hide what's going on in this market. So, at the end of the day, when it gets to the point where you have to make some decisions and the interests of different group diverge, you just have to be upfront about it. If we have to face this decision, if we've sold down an exposure and we're not particularly exposed to the credit, we have to face the decision if we don't hold any of the second lien and we do hold some of the first.

You end up with more informal organizations so that the folks who have an economic interest on the second lien are the ones making the decisions on behalf of the second lien. You try not to get too distracted by the official titles while satisfying all your obligations. But you try to make sure that the folks who have skin in the game are the ones that are making the decisions.

In the coming wave, you are going to see people fighting tooth and nail, using every ounce of leverage they have relative to the collateral they have, going through the loan documents aggressively looking for infirmities in other lenders' collateral.

going to be more complex and more difficult to get things done. I have found that in the last wave of restructurings, people have become much more aggressive about getting that last penny. Almost to a fault they are chasing that last penny and losing sight of the deal value.

If you go back 10 or 15 years, there was a lot less of that demand for the last penny, but I think you're going to see more of that going forward. You are going to see people fighting tooth and nail, using every ounce of leverage they have relative to the collateral they have, going through the loan documents aggressively looking for infirmities in other lenders' collateral. It's going to be a hay day for the law firms out there. People are going to be very aggressive using all these different elements to try and preserve or maximize their value, which, of course, they should be doing. That is the economy working properly.

Mr. Seife: Tony, as an agent, what do you do when you're the

That's the only way you're really going to get to a resolution. Otherwise you waste a lot of time.

Mr. Seife: Leon, how do you negotiate when you are representing an ad hoc committee? How do you deal with the composition of your ad hoc committee changing overnight? As a professional, how are you dealing with those things?

Mr. Szlezinger: I think it's a reality and you just have to deal with it as it happens. The reality of today is that you are going to have competing committees. You are going to have ad hoc committees at the same time as you have official committees. And the ad hoc's are going to be changing. At any point in time you may need to refocus. That's just the reality of the way the business is going to be.

Mr. Seife: Joe, when you are retained by a bank agent, what's your advice? How do you make sure that the bank agent avoids making a bad situation worse? Take a situation like Le-Nature, for example, which is the worst case scenario where Wachovia

made a loan to what turned out to be a fraudulent company, and now Wachovia is being sued for bad lending practices by their syndicated group, which now includes only hedge funds and not a single member of the original syndicate. How do you avoid those kinds of issues?

Mr. Smolinsky: I let the agent make their own decisions. I think every case is different. I think there are different dynamics in a case that may make it more or less imperative that the agent step out of one role or another. There are no hard and fast rules. But in my experience, the agent in these situations has tried to get to the right and fair result.

The problem is, certain constituencies are looking to get a result that's more than right and fair. The agent can no longer be in the middle of these disputes. That has led to the proliferation of ad hoc committees. Now we are seeing ad hoc committees of pure firsts, ad hoc committees of pure seconds and then you have ad hoc committees of pure lenders.

We have to find an equilibrium because if you have all these ad hoc committees that are looking to get paid by the companies, and you have an agent who is now split and resigns from one, and in that situation you have a new agent, a new counsel. The capital structure of the company is not going to be able to support so many different sets of professionals and agents.

It's just not going to work. We are talking about typically all the securities above the fulcrum security. We are not even talking about the financial advisors and the lawyers to the creditors really at risk. We are talking about spending huge amounts of money protecting those securities that are fairly safe in the capital structure.

I think we are going to have to find a way to deal with this issue and find an equilibrium. I think that agents are going to do a little bit less and ad hoc committees are going to do a little bit more. Ad hoc committees are going to have to step up and really demonstrate that they represent only the pure lenders in that facility or the agent is going to have to do more.

The other thing is, I think it's much more difficult for agents to find out what the needs and the desires are of the people in their group because so many of them are cross-overs. So many of them have other interests. It's really important today for agents to take straw polls to reach out to the lenders and really find out what they are looking to accomplish, because that's the only way the agent can interact with the company and get things moving. Of course, you never know who's trading anyway.

Mr. Szlezinger: Using LeNature as an example, I'm not sure how far that example goes because it's really a big fraud case. I wasn't

involved but I think there are certainly other situations where banks sued agent banks where, as in Enron, there are fraud allegations involved. So I think you are right. I think there is going to be a lot more warring between participants and agents. But I don't think taking a big fraud case necessarily makes that point.

Mr. Murphy: There was a case [Nelson Neutraceuticals] involving an interesting attack on first, second, third, and fourth liens and trying to force an early determination of whose interests were really at risk in the case. It was one where a party in the case forced an early evaluation hearing to try to determine who was out of the money. Do the lawyers think that's going to be the way of the future?

Mr. Seife: That's a good question but that was in the chapter 11 context. That's a Delaware case where at the outset of the case, which kind of turned things around, the debtor went in to get a valuation of the company, figuring if they knew where everyone was in the capital structure and the value of their positions, it was going to make doing a plan that much easier. That's what the Court did and a valuation was determined and they put a plan through. But, of course, values changed dramatically in the subsequent three months.

Is this going to be the pattern in the future? Is this one way to, at least in the Chapter 11 context, get the parties together by doing the valuation at the beginning of the case rather than waiting for confirmation at the end?

Mr. Smolinsky: I think this is a dangerous precedent. In a typical Chapter 11 case, you have three different periods of time. You have the crisis period where you are trying to stabilize the business. Then you have the business plan development stage where you are trying to develop your long-term business plan. Then you have the confirmation process.

It's very important that during the crisis period, you're dealing with the crises. Having management sit in depositions and dealing with requests from numerous expert valuers is not the best way to enter a Chapter 11 case. Besides the fact that the Bankruptcy Code talks about valuation at confirmation, not at a beginning of a case. So you might end up wasting money by doing it twice. I think it's an unusual circumstance. It may be forced upon us with so many people who don't have a stake in the game trying to create problems.

Mr. Siebert: You can say what you want about the U.S. bankruptcy system, but the one thing that it has fostered, and was designed to foster, was a dynamic for settlement — to have a process where people could engage in a lot of back and forth and, ultimately, to try get to a process at the end / *continued page 12*

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where you don't have a big contested valuation hearing. If you bring the valuation issue to bear at the outset, there's really no opportunity to settle. You're in litigation at the outset, and it just seems inconsistent with what we should all be trying to do.

The thing I have seen a lot of is when you go to committee formation meetings, you will have a situation where the bond-debt controls 80 percent or more of the outstanding unsecured claims, but there really aren't any bondholders willing to serve. You end up with the indenture trustees, which is helpful, but beyond that, you'll end up with a committee that is controlled by unions, trade-creditors, and landlords. They don't really have the lion's share of the economic stake, which leads to ad hoc committees of bondholders and the like. We have been in situations where we have been begging bond holders to participate on official committees, and they just won't do it.

Mr. Szlezinger: And sometimes when bondholders agree to serve, the U.S. trustee refuses to appoint them.

What Up with Rule 2019?

Mr. Seife: Joe, the disclosure rules for ad hoc committees have recently been examined and it may not be quite as attractive for hedge funds to join an ad hoc committee — what's going on with Rule 2019?

Mr. Smolinsky: Rule 2019 evolved from an old law that required members of an ad hoc committee, or any committee, to

disclose their holdings, when they purchased their holdings and the price they paid. I believe it stemmed out of the railroad reorganizations where Congress thought that it was important for everyone to know that new creditors who had just bought in at discounted prices may have a different agenda. I think that today most everyone assumes or should assume that any hedge fund that is in the deal has held its position for only a short period of time and purchased at deeply discounted prices.

I think this may be overblown, but I think that as a matter of practice if you are engaged in a litigation with an ad hoc committee, you are going to be able to get that information through discovery.

Mr. Seife: Some of the judges think hedge funds should disclose what they paid for their position, which is something they may be rather reluctant to do.

Mr. Smolinsky: Right. In one case the group changed their name mid-case from ad hoc committee to ad hoc group hoping they could avoid compliance with Rule 2019.

Mr. Seife: And people criticize lawyers. ☺

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