

BOEKEL DE NERÉE

Legal Houdini

To straighten out
the legal hitch

**Johan Jol
Angelique Thiele**

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Introduction

- Introduction
- Overview of year 2008
- Causes of the financial crisis
- What happens next?
- Documentation issues; a changed landscape
- Proposal on the new Dutch Insolvency Rules

What happened since February 2008, the Credit Meltdown

- Credit Crunch deepened into a Credit Meltdown



Bron Getty Images



Timeline I

- February 16: Grameen Bank of Bangladesh of Yunus has made its first micro-finance loans in New York
- May 22: Moodys acknowledges that \$ 4 billion of complex debt products are incorrectly rated AAA
- September 7: Freddie Mae en Fannie Mac nationalised
- September 15: Lehman announces it files for Chapter 11

Onder andere ontleend aan: http://www.uiowa.edu/ifdebook/timeline/Credit_Crisis_Timeline.pdf, Financial Times, Financiële Dagblad en voor wat betreft het NL deel ook: De Kredietcrisis van Willem Vermeend (2008)

Timeline II

- September 16: AIG is saved by US
- September 29: Fortis is (partly) acquired by NL, B, and Lux and Hypo Real Estate is rescued by D
- September 30: Dexia saved B, Fr and L
- October 1: Collapse of Sigma finance, last surviving SIV
- October : NL state makes state aid available in an amount of Eur 20 billion to financials and Eur 200 billion to guarantee loans to financials
- December 12: Madoff Ponzi Sceme detected

Madoff Ponzi Sceme

Kan lang goed gaan

Een piramidespel is gebaseerd op vertrouwen, domheid en rust.
Een rekenvoorbeeld

Stap 1

Initiatiefnemer verleidt negen vrienden om voor een bedrag deel te nemen in zijn project. Doorgaans worden buitengewone rendementen voorgespiegeld

Stap 2

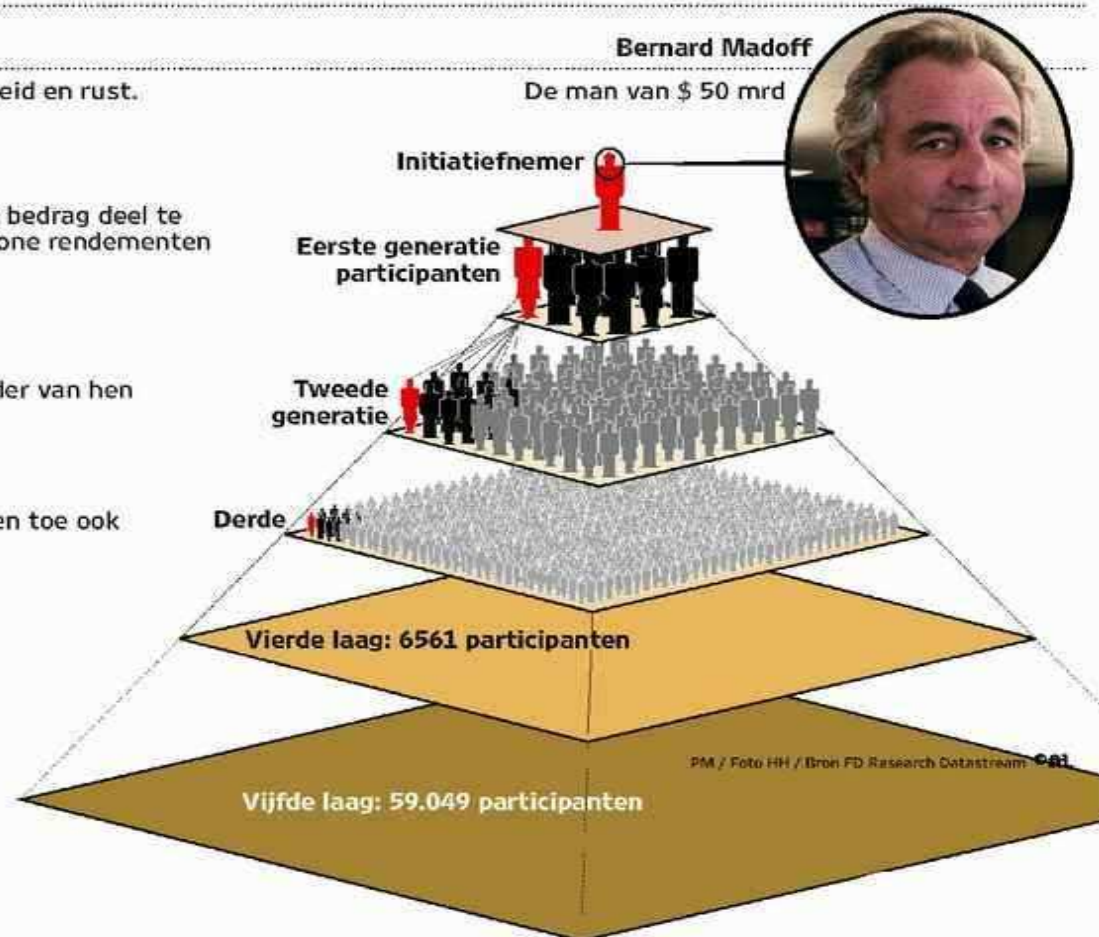
De eerste generatie treedt op als wederverkoper. Ieder van hen ronselt negen nieuwe investeerders, en zo verder

Stap 3

Initiatiefnemer houdt deelnemers tevreden door af en toe ook wat uit te keren

Maar het spel is eindig.

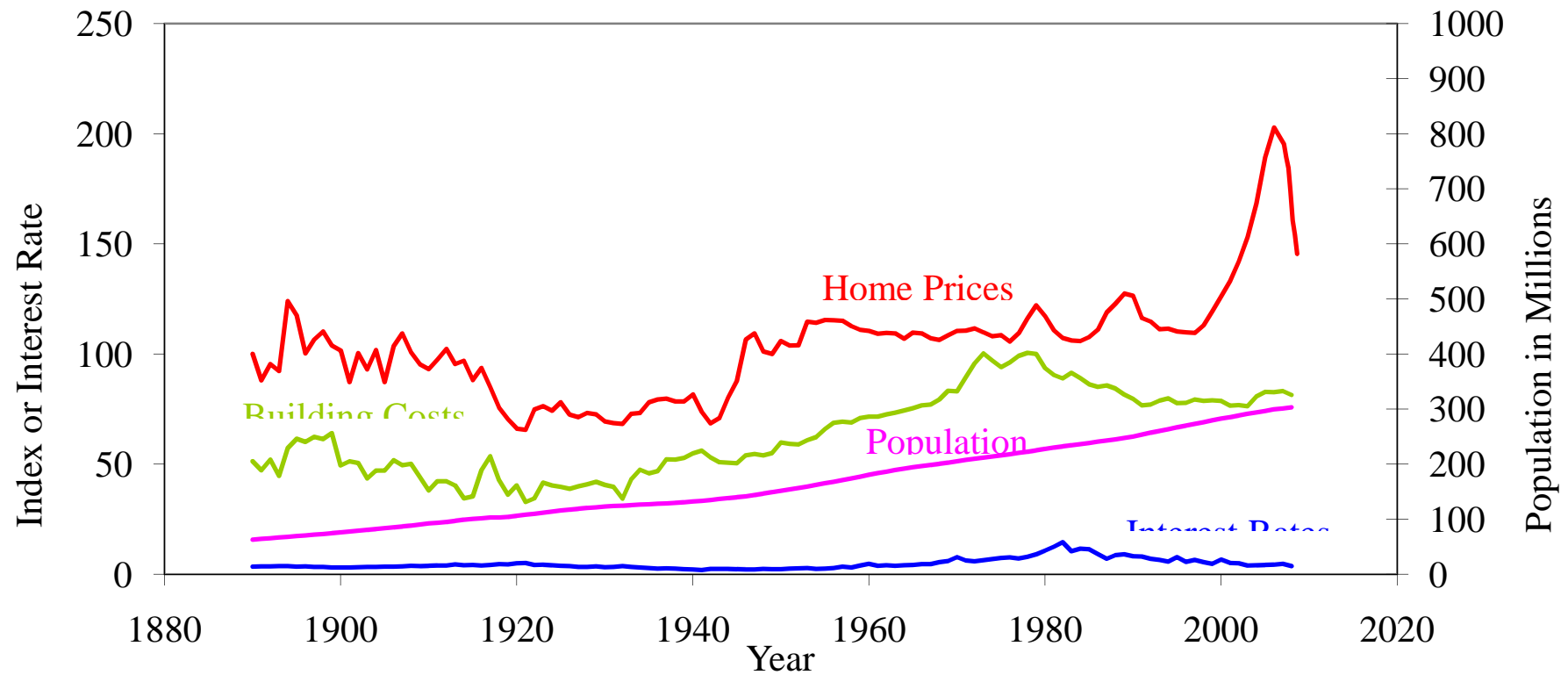
Op de tiende laag doet in theorie bijna de hele wereldbevolking mee



Causes of the Credit Meltdown

- US Real Estate Asset Bubble, combined and/or enhanced by the irresponsible lending methods
- Incentive structure in financial institutions
- Failure of checks and balances financial institutions
- Structured Finance has become too difficult
- Rating agents
- Lack of adequate financial regulation, shadow banking system
- Synthetic Asset Credit Risk Exposure

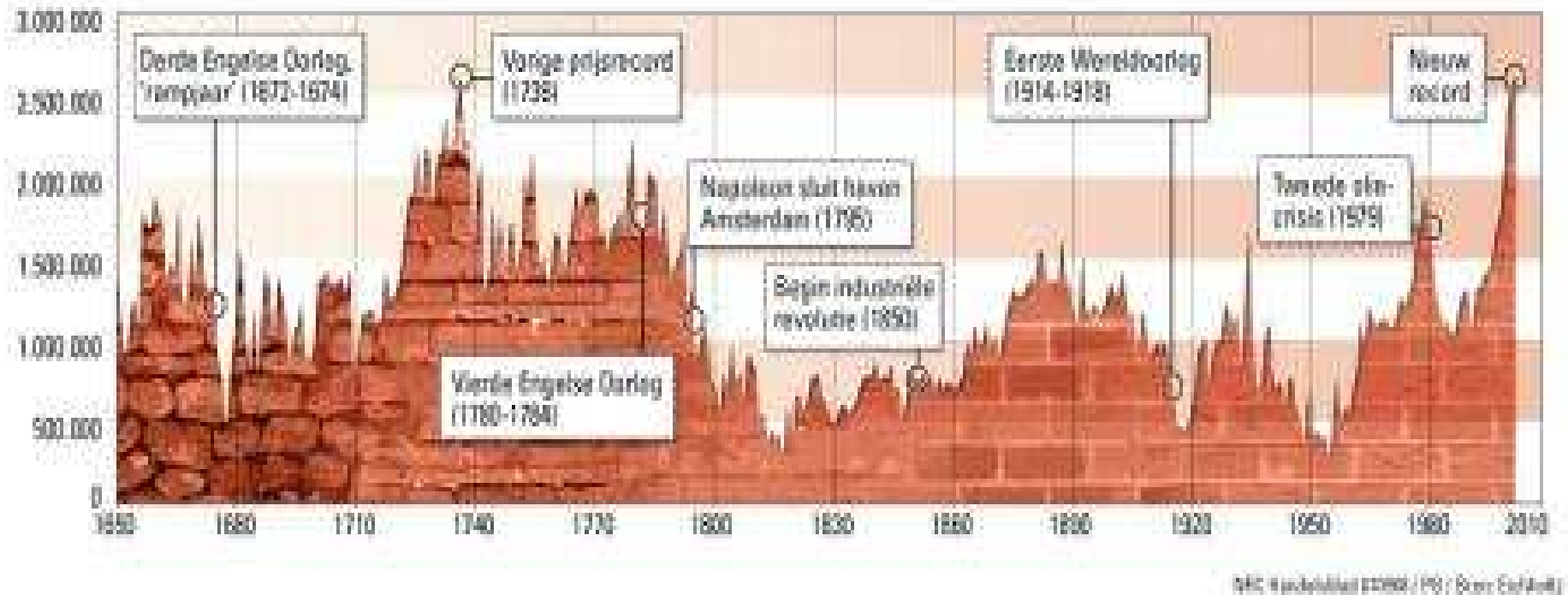
Real Estate Bubbel US



Real Estate Bubbel NL

Hoogste huizenprijzen in bijna drie eeuwen

Prijzenwikkeling woning aan de Herengracht die nu 2,9 miljoen euro kost, teruggerekend tot 1600, gecomponeerd voor inflatie



Bron: NRC 10 november 2007

http://www.nrc.nl/achtergrond/article1853451.ece/Hoogste_huizenprijzen_in_bijna_300_jaar

Zie ook: Eicholtz: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=598

Incentive structure in financial institutions

- Short term bonus
- Only upside, no downside
- Motivation is only focused on making profit
- Suggestion: Lower fixed salary and different variable component

Failure of checks and balances financial institutions

- Inadequate risk management
 - Credit risk
 - Interest risk
 - Market risk
 - Liquidity risk
- Corporate Governance issue: Supervisory Board not sufficiently involved
- Not enough “zelfreinigend vermogen”

Rating agents

- Misunderstood function of a rating, too much reliance on rating
- Conflict of interest: issuing entities pay for rating
- Rating agents make mistakes
- Registration and supervision on rating agents?
- More competition

Structured Finance has become too difficult

- Securitization / CDO / CDO Square
- Stable pools / substitution / managed pools

Lack of adequate financial regulation

- Micro supervision versus Macro supervision
- The shadow banking system
- Tsunami of dollars
- There is too much leverage going on

Synthetic Asset Risk

- A synthetic asset is only a virtual asset and not bankruptcy proof (as unsecured economisch eigendom of real estate)
- The credit default swap
- Solutions:
 - The collateralised credit default swap
 - The Clearing House solution

What happens next, what to do?

- Need of orderly deleveraging
- Credit crisis turns into economic recession
- Redefinition of function of banks?
- New supervision system?
- Redefinition of lending criteria, example of Grameen Bank?

Consequences for business to business lending (i)

Before Credit Meltdown

- Easy money period
- Shadow banking system results in extreme leverage, building up the pile of debt,
- a Ponzi scheme in leveraged finance, refinancing a deal with higher debt
- Huge amount of debt to service

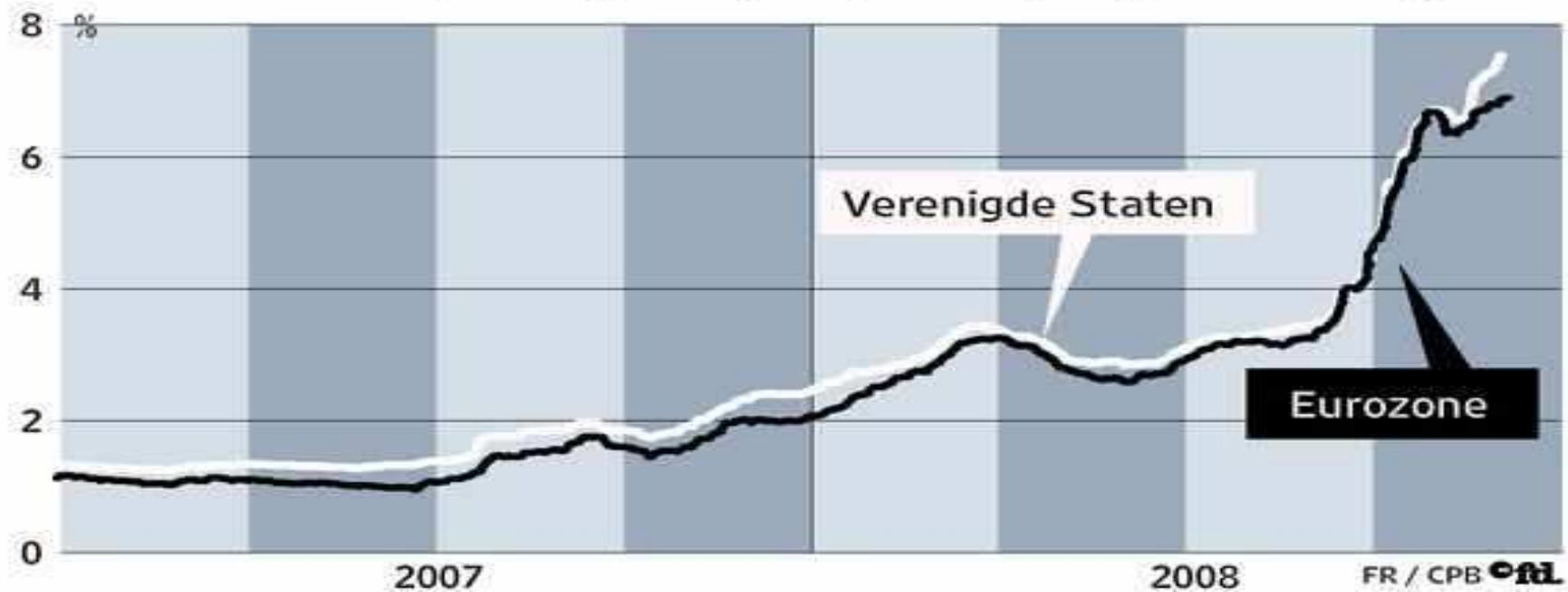
After Credit Meltdown

- Financing difficult to obtain
- No shadow banking system and banks struggling with their balance sheets
- Businesses still have higher debt to service
- Refinancing possibilities difficult
- Risk perception is changed

Consequences for business to business lending (ii)

Kredietrisicopremie kapitaalmarkt

Renteverschil bedrijfsobligaties (BBB) en 10-jarige staatsobligaties



Credit Documentation before Credit Meltdown

- Borrower friendly
- B and C only loans structures, highly leveraged, limited security
- Cov-lite/loose loans
- Toggle instruments, equity cure rights
- Fundable term sheets, bridge and interim funding agreements
- Reverse Flex and absence of upward flex
- Mulligan rights, “yank the bank” and “snooze you loose” provisions

Credit documentation after the Credit Meltdown

- More lender friendly
- Structural issues, return of the A loan
- Covenants, including full financial covenants
- Flex rights broadened
- Equity cure rights less aggressive
- Focus on restructuring issues: Defaults!



Apple

Sample issues in Credit Documentation

Governance Issues

- Amendments and waivers
- Resignation of an agent
- Transfer provisions
- Snooze and lose
- Delay and it's ok
- Yank the bank

Other Issues

- Material Adverse Change
- Market disruption

Amendments and waivers

- Majority Lenders Consent versus Supermajority Lenders Consent versus All Lenders Consent
- All Lenders often:
 - Extension of date of payment any amount
 - Reduction of Margin or principal, interest, fee or commission
 - Increase Commitment
 - Change Borrowers / Guarantor
 - Release Security

Resignation of an Agent

- Sidestep: Lender goes bust
- Facility Agent goes bust
- Security Agent goes bust
- Solution for Security Agent Problem: the bankruptcy remote Security Agent

Transfer provisions

- What is a transfer
- Restrictions on transfer
- Pros en cons

Snooze and loose

- Failure to response results in loss of voting rights
- Upside and downside

Delay it is ok

- Failure to respond results in deemed acceptance
- Upside and downside

Yank the bank

- Forcing out a lender
- But what's is the price

Material Adverse Change

- Market MAC versus Business MAC
- Drafting issues

Market disruption

- When applicable
- What is the result

Proposals on New Dutch Insolvency Rules

- Comments of market participants are out. Currently under review
- Too much to handle currently
- Does not help in restructuring practise but most likely hinders it even more

Contact details

Johan Jol

Freelance Legal Counsel, **Legal Houdini**

Telefoon: 06 51 28 30 11

Email: jtjol@legalhoudini.nl

www.legalhoudini.nl

Angelique Thiele

Partner **Boekel De Neree**

Telefoon: 020 795 35 20

Email: angelique.thiele@boekeldeneree.com

www.boekeldeneree.com