

July 30, 2007

MEMORANDUM TO: Clients and Friends of the Firm

FROM: Jon Kibbe
Julia Fu

RE: European Leveraged Loan Credit Default Swap

The much-anticipated standard terms of credit default swaps on leveraged loans for the European market (the “ISDA Euro LCDS”) has been published by the International Swaps and Derivatives Associations, Inc. (“ISDA”) on July 30, 2007.

The ISDA Euro LCDS is expected to trade in the market beginning August 6, 2007.

Although predicated upon the terms of its European predecessor and informed by the development of its U.S. counterpart, the ISDA Euro LCDS is a unique loan credit default swap product. Market participants should not assume that the terms of the ISDA Euro LCDS are the same as its European predecessor or its U.S. counterpart, even if similar concepts are used in related components. A simple comparison of the three instruments would not adequately highlight the many business and legal issues considered by the ISDA Euro LCDS working group during the product’s development, or the robust process undertaken by the working group to adapt the product to the European leveraged loan market.

Accordingly, this memorandum attempts to review the background, evolution and key features of the ISDA Euro LCDS in some detail.¹ Nonetheless, this brief review is not intended to capture the complexity of the ISDA Euro LCDS product. Should you have specific questions, or wish to discuss the product in more detail, please do not hesitate to contact us at your convenience.

A. Background

The credit derivatives market has experienced explosive growth in recent years. Aggregate notional amount of outstanding credit default swaps on unsecured bonds has grown to be multiples of the aggregate notional amount of the underlying bonds. In connection with the success of this product, the market demanded a credit derivative product based on a related asset class, leveraged loans. In June 2006, ISDA published a set of standard terms for credit default swaps on “syndicated secured loans” in the U.S.,

¹ Capitalized terms used but not otherwise defined herein have the meanings assigned to them in the ISDA Euro LCDS standard terms supplement.

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which were amended in May 2007 (“U.S. LCDS”).² Trading volume on the U.S. LCDS product has steadily increased.

In Europe, a number of dealers agreed on a “cancelable” form of standard terms for credit derivative transactions on leveraged loans in October 2006 (“Cancelable Euro LCDS”). The Cancelable Euro LCDS is the basis for LevX, a leveraged loan credit default swap index product. Immediately after the Cancelable Euro LCDS product was launched, ISDA convened a working group to develop a “non-cancelable” credit default swap product for leveraged loans.

B. The Cancelable Euro LCDS Legacy

Credit default swaps that are “cancelable” point to underlying Reference Obligations, and provide that, when all Reference Obligations are redeemed, repaid or canceled in full, the credit default swap will be terminated, or “canceled”. The Cancelable Euro LCDS focuses on Reference Obligations, which, in that product, are all obligations (i) of the same priority and (ii) secured by the same collateral under a specified Reference Credit Agreement with Reference Entity is defined as any borrower, guarantor, obligor or other surety, under a specific Reference Credit Agreement.³ The Reference Obligation and any obligation (i) senior to the Reference Obligation, and (ii) secured by the same collateral are Deliverable Obligations upon a Credit Event. Credit Events under the Cancelable Euro LCDS are Bankruptcy, Failure to Pay (the Reference Obligation), and Restructuring (of the Reference Obligation). Restructuring is subject to the requirements of Modified Restructuring Maturity Limitation and Conditionally Transferable Obligation (“Mod Mod R”) and expanded to include material diminishment of collateral. The Reference Obligation will not be deliverable if the collateral securing the Reference Obligation is materially diminished and the Buyer triggers the Restructuring Credit Event.

C. General Terms of the ISDA Euro LCDS

1. *Reference Credit Agreement.* The ISDA Euro LCDS product is also a Reference Obligation-based product. Parties designate a Reference Credit Agreement in the Confirmation. Similar to the Cancelable Euro LCDS product, the Reference Entity is any borrower, guarantor, obligor or other surety under or in respect of the Reference Credit Agreement. The Reference Obligation includes any tranche (the “Designated

² For a description of the U.S. LCDS product and the 2007 amendments thereto, please do not hesitate to contact us.

³ By way of comparison, a Reference Entity-based credit default swap is focused on the credit risks of a particular level of the Reference Entity’s capital structure, rather than the obligations under a specific agreement. For example, the Reference Obligation of a U.S. LCDS is defined to include any syndicated secured loan of the Reference Entity of a designated priority.

Tranche”) under the Reference Credit Agreement as identified in the Confirmation, as well as any “Additional Tranche” that is made available in accordance with the terms of the Reference Credit Agreement if it (i) is secured by security interests over the same assets as secure the Designated Tranche, and (ii) benefits from the same or equivalent guarantees and other collateral as the Designated Tranche, in each case having a priority or ranking equal to the Designated Tranche.

2. *Continuity.* Under the ISDA Euro LCDS, when the Reference Obligation is redeemed, repaid or otherwise discharged in part or in full, the impact on the credit default swap depends upon parties’ selection as to whether “Continuity” is “Applicable” in the Confirmation. If the parties select “Continuity Not Applicable”, then the credit default swap will not be changed in any way in a partial redemption, repayment or discharge, and will terminate, similar to the Cancelable Euro LCDS, if the Reference Obligation is redeemed, repaid or otherwise discharged in full. If the parties select “Continuity Applicable” or make no selection in the Confirmation, then the Substitute Reference Obligation provisions, as amended by the standard terms supplement, will apply as described below in “Refinancing”.

3. *Credit Events and Publicly Available Information.* Similar to the Cancelable Euro LCDS, Credit Events under the ISDA Euro LCDS include Bankruptcy, Failure to Pay (the Reference Obligation) and Restructuring (of the Reference Obligation). The definition and application of Restructuring, however, have been amended from the Cancelable Euro LCDS, as more fully explained below in “Restructuring”. Either party can trigger a Credit Event by delivery of a Credit Event Notice and Notice of Publicly Available Information. Information received from or made available by a facility agent, agent bank or other agent will be deemed “Publicly Available Information”. Both parties agree that they may not refuse to take receipt of a Credit Event Notice or a Notice of Publicly Available Information, and that each will take reasonable steps to take receipt of such notice, including entering into confidentiality agreements on reasonable terms, putting in place information barriers or providing contact information of a designated individual or department which is able to take receipt of such notice.

4. *Deliverable Obligations.* Deliverable Obligations include the Reference Obligation and any "Senior Loan". A Senior Loan is a Loan of a Reference Entity which, as of the effective date (“NOPS Date”) of the Notice of Physical Settlement (“NOPS”), is secured by security interests over the same assets as secure the Reference Obligation, and benefits from the same or equivalent guarantees and other collateral as the Reference Obligation, in each case having a priority or ranking at least equal to the Reference Obligation. Deliverable Obligations must meet the Deliverable Obligation Characteristic of Specified Currency at the NOPS Date of the Notice of Physical Settlement (“NOPS”). Specified Currency has been expanded to include the currencies of Canada, Japan,

Switzerland, the United Kingdom, the U.S., Australia, New Zealand, Norway, Denmark, Sweden and Singapore and the Euro.

5. *Settlement Provisions.* Settlement of an ISDA Euro LCDS transaction is by default Physical Settlement, unless the parties select “Cash Settlement Only” in the Confirmation. The Buyer will deliver a NOPS, which cannot be amended (other than to correct errors) after the NOPS Date. If, after the NOPS Date but prior to Delivery, (i) a Deliverable Obligation specified in the NOPS is redeemed and/or canceled in whole or in part, and (ii) in connection with such redemption and/or cancellation, holders of the Deliverable Obligation receive cash, reduction of commitment, securities, rights or other assets (“Assets”), then the Assets may be Delivered in connection with a Physical Settlement, or valued in connection with a Cash Settlement. The settlement provisions will be more fully described below under “Settlement”.

6. *Legal Standard.* One of the most significant ways in which the ISDA Euro LCDS differs from the U.S. LCDS is how determination as to the “secured” characteristic of an obligation is made. The U.S. LCDS defines the “Syndicated Secured” characteristic by reference to a “trading standard”, and the result from a dealer poll in this regard is binding. By contrast, the ISDA Euro LCDS provides legal definitions for “Additional Tranche”, “Senior Loan”, and “Secured” in the context of a Refinancing (as described below under “ISDA Euro LCDS Key Provisions -- Refinancing”). No dealer poll is specified in the ISDA Euro LCDS.

D. ISDA Euro LCDS Key Provision: Refinancing

If parties specify “Continuity Applicable” in the Confirmation, then the Substitute Reference Obligation provisions, as modified in the ISDA Euro LCDS standard terms supplement, will apply. The goal of the amended Substitute Reference Obligation provisions is to enable the credit default swap transaction to follow the Reference Obligation or the assets securing the Reference Obligation in a Refinancing.

1. *Definitions.* A “Refinancing” occurs when part or all of the Reference Obligation is redeemed, repaid or otherwise discharged in three situations: (i) the Reference Obligation is repaid by the proceeds of the drawdown of a credit agreement which is Secured, (ii) all or part of the assets securing the Reference Obligation are acquired by the proceeds of the drawdown of a credit agreement which is Secured, and (iii) all or part of the assets securing the Reference Obligation cease to secure the Reference Obligation and instead secure the new credit agreement which is Secured. “Secured” means that the new credit agreement is secured by security interest on any assets (irrespective of the identity or value thereof) and entitled to receipt of the application of any proceeds realized following enforcement of such security interests, in each case having a priority or ranking equal to that of the Reference Obligation

immediately prior to the Refinancing. The Calculation Agent will determine the occurrence of a Refinancing by reference to (i) an executed credit agreement, (ii) information received from or published by any borrower, guarantor, obligor or any agent of an executed credit agreement, or (iii) any relevant information published by Markit Group Limited.

2. *Finding a Successor Credit Agreement.* The Calculation Agent is required to perform a numerical test comparing (i) the portion of Aggregate Current Notional Amount (pre-Refinancing) of the Reference Obligation that remains outstanding after the Refinancing, (ii) the portion of Aggregate Current Notional Amount of the Reference Obligation that has been redeemed, repaid or otherwise discharged, (iii) the Aggregate New Notional Amount of all new credit agreements that Refinanced the Reference Obligation (“Qualifying Credit Agreements”) identified, and (iv) the New Notional Amount of the Qualifying Credit Agreement. In general, “Successor Credit Agreements” include (i) the Original Credit Agreement if 25% or more of the Aggregate Current Notional Amount of the Reference Obligation remains outstanding, and/or (ii) a Qualifying Credit Agreement the New Notional Amount of which constitutes 25% or more of the Aggregate Current Notional Amount of the Reference Obligation and 25% or more of the Aggregate New Notional Amount of all Qualifying Credit Agreements identified. The Calculation Agent must identify a Successor Credit Agreement, if any, within 90 days after the date of the Refinancing.

3. *Finding a Substitute Reference Obligation.* Substitute Reference Obligations are obligations of the relevant tranche under the Successor Credit Agreement which are Secured and which satisfy the Substitute Reference Obligation Characteristic, Specified Currency. As a result of a Refinancing, an ISDA Euro LCDS transaction may (i) continue unchanged if the Reference Obligation has not been redeemed, repaid or otherwise discharged in full, and no Substitute Reference Obligation has been identified, (ii) split into multiple transactions, each based on a Substitute Reference Obligation, or (iii) terminate if the Reference Obligation has been redeemed, repaid or otherwise discharged in full, but no Substitute Reference Obligation has been identified. In case of (ii) above, the notional amounts of the new derivative transactions will depend upon (A) the percentage of the Aggregate Current Notional of the Reference Obligation that has been redeemed, repaid or otherwise discharged, and (B) the number of Successor Credit Agreements.

E. ISDA Euro LCDS Key Provision: Restructuring

Under the ISDA Euro LCDS terms, a Restructuring Credit Event is not subject to the Mod Mod R requirements. “Subordination” under Restructuring has been amended to mean lien subordination, rather than payment subordination as set forth in the 2003 Credit Derivatives Definitions (the “Credit Derivatives Definitions”). Diminishment of

collateral continues to be a potential triggering event of Restructuring as in the Cancelable Euro LCDS, but only to the extent of a release or discharge of all security (other than if (i) the security is immediately replaced, or (ii) the proceeds of such release are used to repay secured debt which has a priority or ranking which is equal to or senior to the Reference Obligation, or otherwise disposed of in a manner expressly provided for in the credit agreement). It is worth noting that, contrary to the Cancelable Euro LCDS, (i) material but less than full release of collateral is no longer a Restructuring Credit Event, and (ii) the Reference Obligation will be deliverable even if all security interests have been released and Buyer triggers the Credit Event.

F. ISDA Euro LCDS Key Provision: Settlement

The default settlement regime of the ISDA Euro LCDS product consists of (i) an initial Physical Settlement phase, (ii) followed by Seller's Cash Settlement Election (simulating a buy-in process), (iii) followed by Buyer's Cash Settlement Election, and (iv) finally a termination date in the event of delayed Delivery ("Cap on Delivery"), following which the credit default swap transaction will terminate.

1. *Physical Settlement.* Prior to the 75th Business Day following the Physical Settlement Date, Buyer may effect novation of the Deliverable Obligation by delivering an LMA Confirmation (as amended by the Annex to the standard terms supplement of the credit default swap) and the transfer certificate or assignment agreement required under the relevant credit agreement. Buyer makes the Standard Representations and Warranties for Distressed Trade Transactions as incorporated by reference in the LMA Confirmation. If the parties mutually agree, Delivery may be effected by participation.

2. *Seller's Cash Settlement Election.* If Delivery has not been effected on or prior to the 75th Business Day following the Physical Settlement Date (other than due to impossibility or illegality), Seller may deliver a notice of Seller's Cash Settlement Election. The Final Price is determined in accordance with the terms of Article 7 of the Credit Derivatives Definitions with some modifications: The Quotation Method is Offer and the Valuation Method is Lowest. To the extent that neither Full Quotation nor Weighted Average Quotation is obtained in the time periods prescribed in Section 7.7 of the Credit Derivative Definitions, Buyer may deliver a notice of Cash Settlement Election and the terms relating to Buyer Cash Settlement (as described below) will apply. The Seller's Cash Settlement process is aimed at affording Sellers an opportunity to buy in the loan, thus Final Price is only valid if Seller enters into an arms-length, binding contract to purchase at that price. Buyer is permitted to submit quotation in the Seller's Cash Settlement, but to the extent that the Buyer's quotation is the Final Price, Seller is only required to pay the Cash Settlement Amount to Buyer when the sale of the Cash Settled Deliverable Obligation from Buyer to Seller is settled.

3. *Buyer's Cash Settlement Election.* If (i) Delivery has not been effected on or prior to the 75th Business Day following the Physical Settlement Date and on such 75th Business Day it is impossible or illegal to Deliver the Deliverable Obligation, (ii) Seller has not made the Seller's Cash Settlement Election by the 85th Business Day following the Physical Settlement Date, or (iii) a Final Price could not be determined in the Seller's Cash Settlement, Buyer may deliver a notice of Buyer's Cash Settlement Election. Buyer's Cash Settlement Election must be effective no later than the 115th Business Day following the Physical Settlement Date. The Final Price is determined in accordance with Article 7 of the Credit Derivatives Definitions with some modifications. To the extent that neither Full Quotation nor Weighted Average Quotation is obtained in the time periods prescribed in Section 7.7 of the Credit Derivative Definitions, the Calculation Agent will attempt to obtain quotations on the basis of participation for five additional Business Days. If no Full Participation Quotation or Weighted Average Participation Quotation is obtained, then the Final Price will be determined by reference to the weighted average of any firm quotations at the Valuation Time on the last Participation Valuation Date with respect to the portion of the Quotation Amount for which such quotations were obtained and a quotations deemed to be zero for the balance of the Quotation Amount for which firm quotations were not obtained.

4. *Cap on Delivery.* If a Final Price is determined, Seller is required to pay the Cash Settlement Amount to Buyer on the third Business Day following the calculation of the Final Price, unless the Final Price is determined by reference to Buyer's Quotation. The credit default transaction will terminate on the 145th Business Day following the Physical Settlement Date to the extent of any Deliverable Obligation that has not been Delivered by Buyer to Seller, except for the portion in relation to which a Final Price has been determined.

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This memorandum has been prepared as a service to clients and other friends of RK&O to report on recent developments that may be of interest. This memorandum is not intended to be a full description of all material terms of the ISDA Euro LCDS. The information in it is therefore general, and should not be considered legal advice.

Should you have any questions with respect to the ISDA Euro LCDS product, please do not hesitate to contact Jon Kibbe at +1 212.530.1860 (jkibbe@rkollp.com); or Julia Fu at +1 212.530.1892 (jfu@rkollp.com).

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