

CLIENT UPDATE

BANKRUPTCIES AND TAKEOVERS OF MAJOR WALL STREET FIRMS: THE EFFECTS ON BORROWERS



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In a year in which the financial markets have produced little good news and turmoil has been the order of the day, three recent developments raise significant questions for institutions which have issued debt or securities involving Merrill Lynch, Lehman Brothers or AIG. The specific developments, all of which occurred during the week of September 15, 2008 are: (1) the takeover of Merrill Lynch by Bank of America; (2) the bankruptcy filing by Lehman Brothers Holdings Inc. (Holdings), combined with the purchase of certain Lehman Brothers assets by Barclays Bank; and (3) the federal bailout of AIG.

This one week trifecta has significant impacts for borrowers because Merrill Lynch and Lehman Brothers have been major underwriting, remarketing and derivative forces in both the tax-exempt and taxable marketplace and AIG has been a major provider of guaranteed investment contracts (GICs). The potentially good news is that, for most borrowers with relationships with Merrill Lynch, Lehman Brothers and AIG, the takeovers and bailout should solidify, or improve, existing transactions. The primary, and very significant, exception is for borrowers with interest rate swaps or other derivative products with Lehman Brothers.

While this client alert focuses on the three entities making the headlines during the week of September 15, its princi-

ples will apply to the extent other major players in the debt and securities markets undergo similar changes.

The Merrill Lynch and Lehman Brothers situations have certain common elements: their businesses (or, in the case of Lehman Brothers, certain components) are going to be purchased by an economically stronger entity which has similar lines of business. In that respect, the takeovers are much like JPMorgan Chase's purchase of Bear Stearns in March, 2008, except that this round of purchases does not include government support.

Bank of America's purchase of Merrill Lynch should result in any interest rate swaps or other derivatives being upgraded in terms of ratings, much as the JPMorgan Chase purchase did for Bear Stearns' derivatives portfolio. Unless a borrower elects otherwise, as it typically is able to do, presumably Banc of America Securities will take over as investment banker and remarketing agent for Merrill Lynch's clients. In many cases, the professionals involved with a given borrower may remain the same.

With respect to AIG, the federal government bailout – which gives the government a majority ownership position in exchange for up to \$85 billion of short-term loans – may result in restoration of the highly-rated nature of AIG's GICs, making any borrower action under those agreements undesirable to the

extent they benefit the borrower. However, the initial ratings downgrade may, depending on the specific documents involved, permit AIG to terminate those GICs which are economically unfavorable to it regardless of borrower desires.

The Holdings bankruptcy filing is both the most complex and interesting development. It is important to note that Holdings, which formerly held “A” category ratings, and provided the guaranty (and related rating) for Lehman Brothers’ derivative products, is the only Lehman Brothers entity to have filed for bankruptcy protection as of this writing. Other Lehman entities, such as the investment bank and the derivatives entities, are not parties to, and should be substantially unaffected by, the Holdings bankruptcy. Barclays’ purchase of Lehman Brothers’ investment banking business should result in effects similar to the takeover of Merrill Lynch by Bank of America with respect to investment banking and remarketing relationships, again subject to the right of any borrower to replace Lehman Brothers or Barclays.

The transaction with Barclays does not, however, include Lehman’s derivatives entities such as Lehman Brothers Special Financing (Financing) and Lehman Brothers Commercial Bank (Commercial). Under the standard swap documents (ISDA Master Agreement and Credit Support Annex), Holdings’ bankruptcy is an event of default which would allow, but not require, a borrower to terminate its swap. Whether this is a positive or negative development will depend on what the specific documents provide, and any generalizations must be viewed in light of those specifics.

Assuming that Financing and Commercial do not become subject to

bankruptcy proceedings, a borrower should carefully assess whether terminating the derivative transaction makes sense. In order to do that, the borrower should take into account the following factors: (1) would termination result in a termination payment to, or from, the Lehman entity (or no payment in either direction)? (2) if the swap were terminated and Lehman would be required to make a termination payment, has the collateralization threshold been reached? (3) is the swap providing the economic benefits envisioned by the borrower at the time it entered into the swap agreement? (4) do the documents require, in the event of a ratings downgrade below a certain level (typically BBB or Baa2), that the Lehman entity assign the swap agreement to a party rated at least “A”? and (5) are there other remedies available to the borrower?

Because the ISDA documents generally provide that the non-defaulting party can terminate the swap upon a certain amount of notice, the best short-term strategy for a borrower would appear to be analyzing the documents – particularly the Confirmation, Schedule and Paragraph 13 to the CSA – carefully with counsel while making the economic determinations referenced above. If there appears to be no immediate harm in continuing the swap, it may make sense to do so and see whether Lehman’s derivatives entities are purchased by an economically strong party.

In summary, there are both potential benefits and risks that borrowers must evaluate and contend with when major players in the debt markets undergo the types of changes that have most recently affected Merrill Lynch, Lehman Brothers and AIG. Each borrower should carefully analyze the effects of these developments in order to make a decision that most benefits it.

If you have any additional questions regarding this Alert or have any other Corporate & Business needs, please contact any member of the Corporate & Business Law Group.

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