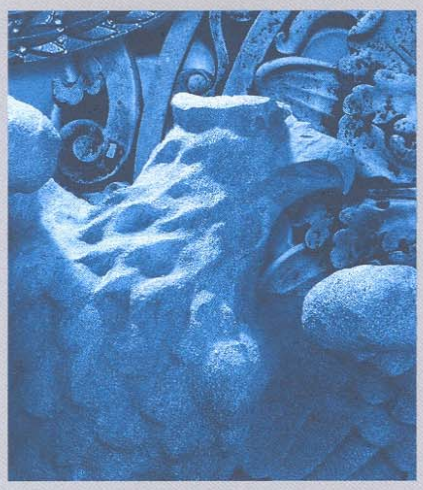

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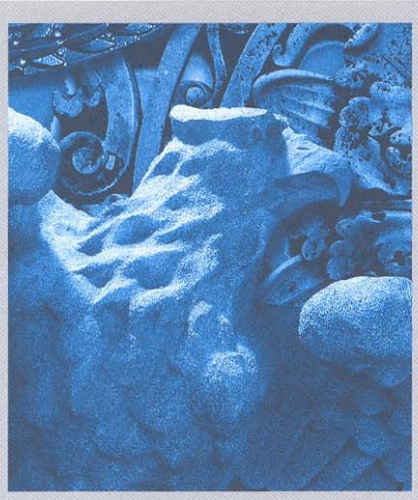
LENDING AND RESTRUCTURING ALERT
NOVEMBER 2008

Market Disaster Clauses: Not Just for Eurodollars Any More

Among the many first impression challenges facing institutional lenders lately has been the remarkable inversion between LIBOR and the prime rate. This extraordinary development caused many bank lenders' cost of funds to exceed the rates they could charge borrowers with base rate options that are tied to the prime or Fed Funds rate. Although the historical relationship between these rates has been restored (for the time being), banks will not soon forget that the mere exercise by borrowers of pricing options based on prime or Fed Funds actually cost lenders money they never expected to lose.

The Problem: The irony is, of course, that most of the loan agreements in question contain so-called "Eurodollar Market Disaster Clauses," which are designed to protect banks against costs attendant to Eurodollar lending that are not reflected in posted LIBOR rates. These "disaster clauses" provide that the lender may force the borrower to repay the loan or to pay at a prime or similar base rate in lieu of LIBOR when, among other things, a LIBOR rate will not "adequately and fairly reflect the cost" to a lender of making or maintaining the loan. In syndicated facilities, this right would typically be triggered upon notice by a specified percentage of lenders to the agent bank that they choose to invoke it. The problem that surfaced recently was that few, if any, loan agreements contain a parallel provision allowing the lender to force the borrower into LIBOR (or some other rate) when prime or a similar base rate does not "adequately and fairly" account for the lender's cost of funds.

Possible Solutions: For new credit facilities, or existing loan agreements where borrowers need amendments and/or waivers, lenders can insist on inserting provisions which establish a floor (such as one-month LIBOR plus a margin) in the determination of any floating rate based on the prime or Fed Funds rate. Other options are available, such as forcing the borrower to select a LIBOR-based rate unless the lender expressly elects otherwise (a sort of "Alternate Base Rate Market Disaster Clause"), or perhaps using a "market index" LIBOR rate (Wall Street Journal LIBOR, for example) that floats on a daily basis and is not fixed for specified interest periods, in lieu of a floating rate that is tied to the prime or Fed Funds rate.



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Lenders with prime or similar base rate options in existing commitments or loan agreements, where the borrower has not requested an amendment or waiver, are not in a position to address this problem at this time, at least as a contractual matter. The good news, however, is that the recent inversion that led to the problem ended relatively quickly. Nevertheless, we recommend that lenders act now to devise the necessary "boilerplate" language in case an inversion reappears. Whenever borrowers are looking for waivers or amendments, lenders should insist on adding the new language. Such opportunities are likely to arise in the coming months, as the economic downturn runs its course.

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