From:	McGee III, Hugh E [hmcgee@lehman.com].	Sent:8/13/2008 9:55 AM.
To:	Whitman, Brad [bwhitman@lehman.com]; Wieseneck, Larry [lwiesene@lehman.com].	
Cc:	.	
Bcc:	.	
Subject:	FW: Follow up to our call.	

From: Gary S. Barancik [mailto:gbarancik@pwpartners.com]
Sent: Saturday, August 09, 2008 11:09 AM
To: McGee III, Hugh E
Subject: Follow up to our call

Skip,

Further to our conversation, I thought it might be helpful to try to write down a few thoughts about where I think my client's head is at, which you may want to incorporate in some fashion should you decide it makes sense for Dick and E.S. to speak. As I said on the phone, even if such a call goes well, there are still an enormous number of issues/risks to getting a successful deal (including several on our side getting the government and consortium members on board), so it would be prudent for you to continue forward with some alternatives. Also, I'm trying to give you my client's perspectives - as best I'm able to read them --, recognizing that you have understandable reason on your end to feel frustrated with how discussions have progressed. That said, I hope the following will be helpful; the more you can give E.S. assurances on these points, the more likely, I think, we can get things on track.

* For everything that follows, you need to understand that E.S. has to solve for not only what he feels makes economic sense but for what he can "sell" to consortium partners and the government. What can generate the best potential return on investment is not nearly so important as perceived downside risk and risk of public embarrassment. By way of example, my client would rather pay $25 for CleanCo. than pay $25 for the whole company and have the risk that SpinCo loses value after the distribution. You may be able to convince him that retaining certain assets is a high ROE decision, but he will never be able to make those arguments convincingly to government bureaucrats.

* CleanCo. must be truly "clean" - this investment will be consolidated on K's books, and E.S. needs to be sure that a minimum of risky assets will be left behind and those that are, are so conservatively marked that there is almost no risk of future markdowns. He'll want to have independent valuation work done to get comfortable with this...and possibly some contractual protections as well.

* Rightly or wrongly, E.S. AND IMPORTANTLY consortium members and government officials have come to view the real estate assets (commercial and residential) as toxic. He will have little tolerance for retaining these assets at CleanCo. and, I believe, no tolerance (today at least) for a strategy that contemplates getting back into the origination business when conditions improve. One idea that perhaps might work for $10 billion of "attractive" commercial assets would be to

sell to a structured vehicle in which you retain a significant interest but are insulated from both liability and potential writedowns. But from E.S.' perspective it would be better/cleaner to exit this business completely, I think. Tactically, you are far more likely to get E.S. on board by committing to get both commercial and resi real estate exposure to as low a level as possible.

* E.S. will need to be comfortable that CleanCo. has been capitalized conservatively enough so that there is very little risk of the business requiring additional capital in the next 18 months following the spin. Part of this is addressed by how conservatively the balance sheet has been marked and its initial leverage levels. Another issue which was discussed yesterday is that although the accountants may permit you to mark the senior seller notes to SpinCo. at close to face, to the extent these notes have a lower market value, this needs to feed into valuation, credit views, etc. In particular, SpinCo. will need to have a conservative enough capital structure that there is no risk of having to consolidate SpinCo or of having to take marks on the senior notes. We believe that if there are $20+ billion of senior notes on CleanCo's balance sheet, that if they aren't viewed and valued as close to par instruments in the market, this could significantly and adversely impact CleanCo trading levels. Note: an aggressive sale of $20 billion of commercial assets in the next few months coupled with an off-balance sheet vehicle for $10 or $15 could be much more attractive to E.S. as it would eliminate any perceived risk of these assets causing problems for CleanCo.

* As a "foreigner", buying a minority stake in a company half way around the world, it is critical that K and your company have a high degree of trust and respect for one another. You'll be partners in every sense and it's critical that everyone feel this spirit of trust and partnership at every step - especially now. I'll represent to E.S. that our discussions yesterday were a significant step forward in openness and transparency - which is critical to any further discussions. In addition, it will be very important to E.S. and the K government that if things go seriously awry at your company in the future, there is an ability - to be blunt - for my client to step in and replace the management team. To be clear, this is NOT something that E.S. would want to happen, but having some ability to gain control if things go badly will be an important aspect of getting support at home. This is where he was coming from with his "MOU" governance proposal, but I suspect he feels even more strongly about the need for this protection today.

* You need to respect E.S.'s Sept 5 date...he can't get this done any earlier.

* I think it will be very tough for E.S. to sell making a significant "deposit" on the transaction. We can explore other options that might achieve the perception of certainty you're looking for (one is to eliminate the spin and to bulk sell or do something else with the RE assets), but insisting on 50% in advance will likely be an impediment to progress. This has to do with perception issues in K if the deal doesn't go through and the money is "refunded" - it's not about economic concerns, funding concerns or credit concerns, all of which I assume can be addressed.

* I understand some of the frustrations of negotiating with my client. Please keep in mind he REALLY wants to do a transaction, but he's just the newly-appointed steward of a government-owned institution and he is at the mercy of government officials and consortium partners. He's not able to perfectly predict how they will respond to certain

things so as a result, if we do go forward, there will inevitably be some cases where we get a conceptual agreement on things and then learn that we need to make changes in order for the deal to win support. This situation admittedly adds a lot of completion risk, but it is what it is. My personal sense is that E.S. has been acting honestly and in good faith, and what he has told you and Dick and others about his position is consistent with everything he's told me privately.

Best,

Gary Barancik

Partner

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