SIVs, CDOs and structured products in distress: cross-border and other issues for lenders and investors

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Summer 2007 marked the beginning of a severe dislocation in the financial markets that adversely impacted various structured vehicles, including structured investment vehicles (SIVs) and collateralised debt obligations (CDOs). The stress on the financial and liquidity markets initially began with securities backed by sub-prime mortgages and has more recently spread to securities backed with higher-quality collateral such as residential mortgage-backed securities, commercial mortgage-backed securities, obligations of monoline insurers and other structured products. This chapter:

- discusses various structures, business models and strategies applicable to SIVs;
- examines how certain SIVs and CDOs have been affected by the dislocation in the financial and liquidity markets;
- addresses the manner in which SIVs and CDOs are designed to deal with financial distress and various quandaries presented by the documentation, including the insolvency quandary, the acceleration quandary and the liquidation quandary; and
- analyses some of the most critical issues confronted by debt holders in SIVs and CDOs (eg, insolvency, acceleration and liquidation), with particular focus and attention on cross-border issues.

Structure of SIVs and CDOs

SIVs

An SIV is a bankruptcy-remote special purpose vehicle that issues to its investors debt securities that are secured by the assets the SIV purchases. SIVs are designed to be perpetual, open-ended, standalone investment vehicles. The general business model of an SIV involves the issuance of short-term commercial paper and medium-term notes to finance the acquisition of longer-term assets to be held by the SIV. The economic goal of the SIV is to earn the spread between the amounts generated by the SIV's asset portfolio and the costs of funding the SIV's liabilities. This spread will, after the payment of fees to the investment manager, be used to provide a return to capital note holders.

Moody's has reported that as of mid-November 2007, the nominal amount of assets under management by SIVs was $280 billion (see Henry Tabe & Rana Ameer, Moody's Investor Services, International Structured Finance, *Moody's Update on Structured Investment Vehicles* 5 (January 16 2008). An SIV's asset portfolio is typically comprised of highly rated assets carrying AAA or AA ratings. The short-term debt securities issued by the SIV were also traditionally very highly rated. The assets are originated predominantly in the United States or the United Kingdom, but may also be originated in other European countries, including the Netherlands, Germany and France (see *id* 8-9). SIVs are often organised in jurisdictions with favourable tax treatment such as the Cayman Islands. The underlying notes and collateral security documents may be governed by the laws of the United Kingdom or the United States.

SIVs invest in the highest-quality assets and employ hedging strategies to help support the quality of the assets. As principal is returned on the underlying assets or as asset quality deteriorates, the management of the SIV typically reinvests the SIV's assets into high-quality assets that meet the SIV's requirements.

The success of an SIV's business model depends on its ability to maintain liquidity at all times. Liquidity is necessary to assure that the SIV can meet all its short-term debt obligations – even during periods of high net cumulative outflow caused by a substantial volume of maturing debt. In order to maintain liquidity, the SIV must:

- be able to roll over existing commercial paper and medium-term notes – in other words, to issue new notes, the proceeds of which will be used to pay off existing notes; and
- borrow under its liquidity facilities to smooth over those eventualities where the amount of maturing liabilities exceeds the amount of debt that can be refinanced.

Another core feature of the SIV is the investment manager. The investment manager in an SIV is charged with the investment and reinvestment of the asset portfolio – as well as managing the liability side – and must actively manage the credit and liquidity risk of the asset portfolio, as well as hedge against interest rates and currency exposure.

In order to maintain normal operations, SIVs must regularly pass various operating tests. These tests may relate to prevailing interest rates, capital losses, foreign exchange rates, net asset values, ratings downgrades, liquidity and the SIV's solvency. The failure of different tests triggers restrictions on the SIV's operations. The greater the financial difficulty of the SIV, as determined by the various operating tests, the greater the limitations on the investment vehicle's normal operations. In every case, the precise triggers for a limited operating state are defined by the documents governing the particular SIV. Thus, the triggers discussed herein are merely illustrative.

In the least restrictive of the restricted operating states, an SIV's investment and reinvestment activities may be limited or prohibited, except in certain circumstances. SIVs may be restricted from issuing new short-term paper. SIVs may also be prohibited from increasing the overall risk profile of the asset portfolio. Payments to all mezzanine holders and capital note holders are generally shut off upon the triggering of a restricted operating state. SIVs may be permitted to return to a normal operating state if the SIV can remedy whatever caused it to fail an operating test within a certain specified period of time.

Sustained failure of an operating test or the failure of certain other more serious operating tests may cause the occurrence of an enforcement event. The following enforcement events are typically found in most SIVs:

- failure by the SIV to pay interest or principal on any of the notes when due after the application of any grace periods;
- the initiation on a voluntary or involuntary basis of receivership, liquidation, winding-up or insolvency proceedings with respect to the SIV;
- a ratings downgrade by Moody's and/or Standard & Poor's, generally to non-investment grade, of securities issued by the SIV; or
- a default by the SIV under one of its liquidity facilities that causes the commitment under such liquidity facility to be terminated.

In addition to the restrictions discussed above, the occurrence of an enforcement event in some SIVs will trigger the liquidation of the investment vehicle's asset portfolio.

In some cases the occurrence of an enforcement event may also result in acceleration (or mandatory redemption) of the vehicle's senior liabilities; in other cases there will not be acceleration. As discussed below, this has been a critical issue in some distressed SIVs (and a source of litigation) because the acceleration of the SIV's liabilities (or not) will affect whether senior debt holders continue to be paid sequentially in order of maturity (eg, the pay-as-you-go model), or whether senior debt holders will be paid *pari passu* with other senior debt holders, regardless of when the liabilities they hold mature.

CDOs

CDOs are also complex bankruptcy-remote special purpose vehicles that issue debt securities that are secured by the assets of the vehicle. CDOs typically issue three groups of tranches of debt:

- a highly rated senior tranche;
- a mezzanine debt tranche, usually with a rating of AA to B; and
- an unrated equity tranche.

In a CDO, the equity tranche may comprise a significant portion of the capital structure.

In contrast to SIVs, however, the asset portfolio of a CDO is ordinarily static and defined. Trading and reinvestment of the assets is generally limited or prohibited. Thus, the CDO's cash flow (eg, the principal and interest generated by the underlying assets owned by the CDO) must be sufficient to service and retire the notes the CDO issues. The theory is that a pool of defined assets will perform in a predictable manner, which permits the CDO to calculate the level of risk associated with certain pools of assets. The ratings of the debt issued by the CDO are tied to the probability that the cash flow generated by its asset portfolio will be sufficient to service and retire the notes.

A marked difference between CDOs and SIVs is the quality of the underlying assets. While CDOs generally have asset eligibility requirements, a CDO's assets may be of varying quality ratings. In addition, the asset portfolio may be comprised of a wide range of assets, including mortgage-based assets, bonds, loans, securitised receivables and senior, mezzanine or equity tranches of other CDOs or credit derivatives.

CDOs may also be required to meet certain collateral quality tests. Generally, CDOs allocate payments of interest and principal generated by the assets of the CDO to the various tranches of debt on specified distribution dates. Failure of a collateral quality test will affect the distributions to be made to these tranches under the waterfall structure contained in the documents. For example, the failure of a collateral quality test with respect to a particular tranche of debt may trigger a diversion of the CDO's cash flow (eg, principal and interest payments that might otherwise be allocated to more junior tranches are diverted to senior debt holders instead).

Some collateral quality tests are tied to required levels of overcollateralisation. Overcollateralisation is the extent to which the principal of the collateral not in default, or underlying assets not in default owned by the CDO, exceeds the principal of the liabilities issued by the CDO. To maintain overcollateralisation, the CDO will invest in more collateral than is required to meet the CDO's cash-flow requirements. The higher rated the notes issued by the CDO, the more stringent the collateral quality tests will be.

While CDOs generally feature a static asset portfolio, a less common type of CDO, known as a 'market value' CDO, permits some reinvestment of cash flows generated by the asset pool, provided that certain collateral quality tests are met. In these CDOs trading may be active and highly aggressive, and may include a hedging programme. However, as trading exposes the CDO's assets to market volatility, the overcollateralisation required in such CDOs is generally more stringent.

Critical issues affecting SIVs and CDOs

Summer 2007 marked the beginning of an extended and severe dislocation in the financial markets. The trouble began as a loss of confidence in sub-prime mortgage assets but rapidly spread to residential mortgages, commercial mortgages, obligations of monoline insurers and other structured products. The deterioration of these assets led to a general loss of confidence in the securities issued by entities that owned such assets.

In the case of both SIVs and CDOs, the deterioration of the investment vehicle's asset portfolio caused several rating agencies to downgrade the securities issued by the vehicle. For example, in November and December 2007, Moody's, Standard & Poor's and Fitch Ratings all downgraded the commercial paper and medium-term note programmes of several SIVs and CDOs because of their exposure to sub-prime mortgage assets and other asset classes held by structured vehicles. These ratings downgrades triggered limitations on the normal operations of the SIVs and CDOs.

The lack of confidence in the assets underlying the SIVs and CDOs soon escalated into a full-blown liquidity crisis. The SIVs and CDOs were no longer able to finance their short-term borrowings at a price that was lower than the returns they could achieve on their underlying assets. The yield curve affecting the SIVs and CDOs had flipped. The only financing available to SIVs and CDOs was at a cost greater than the yield they could achieve on their long-term assets – clearly an intolerable situation. Without any ability to generate liquidity at a feasible price to replace or retire short-term maturing liabilities, the SIVs had to resort to selling assets, which triggered limitations on the SIV's normal operations. Moreover, as a result of these events, it became necessary for some SIVs to draw on their liquidity facilities once they entered an enforcement state, which resulted in further limitations on their normal operations. At the same time, liquidity providers found themselves exposed, receiving commitment fees that are drastically low in view of the risks assumed by the liquidity providers in lending into a structure that was already in or near enforcement mode.

As SIVs and CDOs were formed without the pressures and difficulties of financial distress in mind, some of the legal documentation and offering materials are ambiguous on key issues that may affect interested parties when the SIV or CDO slides towards insolvency. Indeed, some litigation has already been commenced and more can be expected. Conflict has arisen among interested parties concerning the definition of 'insolvency', the timing of acceleration and liquidation and the priorities of payments under the documentation's waterfall structures. In addition, there are several important cross-border and other considerations relating to the restructuring of SIVs, CDOs and structured vehicles generally, including the commencement of insolvency proceedings as well as other non-judicial restructuring strategies.

The insolvency quandary

Although an enforcement event will typically be triggered by the insolvency of the vehicle, there is no uniformity among the SIV and CDO documentation as to when an insolvency occurs. In some deals, insolvency may require an actual court proceeding; in others, insolvency might contemplate a cash-flow test of insolvency; and in others, insolvency might involve a balance-sheet test. Even the application of the cash-flow test might not be the same from one deal to another, depending on the choice of applicable law (eg, UK versus New York law).

Due to the lack of uniformity, and in some cases ambiguity in the documentation, the determination of insolvency may present a challenge for the managers charged with the responsibility for making this determination.

The tensions between the pay-as-you-go model and the *pari passu* model, and the potential risks for fiduciaries in making or not making a determination of insolvency, played out in dramatic fashion before the UK High Court Chancery Division in *Cheyne Finance Plc*. Cheyne was placed into receivership before the High Court in London (see *In the Matter of Cheyne Finance Plc (in Receivership)*, No 6745 of 2007, October 16 2007, at p1). Unsure of how to proceed, the Cheyne receivers petitioned the High Court for clarification as to whether an insolvency event had occurred (*id* at p10).

It was clear in *Cheyne* that if an insolvency event had occurred, the senior obligations would be accelerated and the pay-as-you-go treatment of earlier maturing liabilities would cease in favour of *pari passu* treatment of senior liabilities. The term 'insolvency event' was defined in Cheyne's common terms agreement as: "[A] determination by the Manager or any Receiver that the Issuer is, or is about to become, unable to pay its debts as they fall due to Senior Creditors and any other persons whose claims against the Issuer are required to be paid in priority thereto, as contemplated by Section 123(1) of the United Kingdom Insolvency Act 1986" (*id* at p23).

It was clear to the *Cheyne* receivers that any decrease in the value of the underlying assets would ensure that Cheyne would be unable to pay all of its senior liabilities in full and on time (*id* at p12). Based on this certainty, the question at issue was whether the receivers should wait until Cheyne actually failed to meet one of its senior obligations as it matured – and in the meantime continue to pay senior liabilities on a pay-as-you-go basis – or whether the receivers should declare an insolvency event currently based on the fact that the vehicle was sure to run out of money on a certain date in the future (*id* at p18). The parties in charge agreed to certain stipulated facts and presented the following questions to the High Court for decision:

- In determining the question of cash-flow insolvency, to what extent (if at all) should the receivers look at debts which will become due at some point in the future?
- What degree of confidence must the receivers have that Cheyne will be unable to pay the relevant debts in order to declare properly an insolvency event? (*Id* at p24.)

Those senior creditors holding paper with early maturity dates advocated for the pay-as-you-go regime to continue and argued that the definition of 'insolvency event' required the receivers to continue to meet Cheyne's liabilities as and when they matured without regard for the possibility of a default at some point in the future (*id* at p21). In other words, according to the holders of early maturing commercial paper, Cheyne was not insolvent until the money actually ran out (*id* at pp27-28). Those senior creditors with later maturing paper, as well as the representatives for Cheyne's subordinated debt obligations, argued for the opposite conclusion (*id* at p21).

The court determined that the receivers should properly consider future debts in determining whether the vehicle was insolvent (*id* at p58). The High Court stated: "[I]ncurring a risk of future adverse events, such as [is] inherent in the pay-as-you-go regime during a run-off while insolvency is merely a risk rather than a probability, is different in kind from a contractual choice absolutely to prefer earlier senior debt where insolvency is not merely a risk but a dead certainty." (*Id*.)

The court held that the receivers could determine that there had been an insolvency event with respect to Cheyne as soon as it appeared on the balance of probabilities, or that it was more likely than not, that Cheyne could no longer expect to pay all of its senior obligations in full as and when they fell due (*id* at pp68, 78).

As the *Cheyne Case* illustrates, many factors may influence the question of whether a particular structured vehicle should be declared insolvent, including the applicable law governing the definition of 'insolvency', the specific language and terms used in the SIV or CDO documentation, valuation findings and the degree of uncertainty in the market surrounding the investment vehicle's underlying assets.

The acceleration quandary

The timing of acceleration or mandatory redemption is one of the paramount issues affecting any distressed SIV or CDO. If an acceleration or mandatory redemption occurs, the vehicle converts from a pay-as-you-go model, which requires that the SIV or CDO satisfy its senior obligations sequentially (in order of maturity date), to a structure in which all senior debt holders are treated *pari passu*. The pay-as-you-go regime obviously favours those senior note holders with early maturity dates. Holders with later maturing obligations are subject to the risk that they may be left at the end of the line and empty handed.

As acceleration can drastically affect the amount and timing of distributions to debt holders, conflict has arisen among the various interested parties as to precisely when acceleration is required under the SIV documentation even after an enforcement event has been declared. For example, in *Victoria Finance* the occurrence of an enforcement event required the collateral agent to take possession of the assets and appoint an enforcement manager. The collateral agent took the position that the SIV documents were ambiguous, and that it was unclear what should happen with respect to those liabilities that matured during the period between the declaration of the enforcement event and the determination by the enforcement manager that there should be a mandatory redemption of all senior liabilities. In other words, should the liabilities maturing during this period be paid in order of maturity in accordance with the pay-as-you-go method or should they be paid *pari passu* with the other senior liabilities? In view of the ambiguity perceived by the collateral agent in the documentation (as well as the collateral agent's desire to protect itself from any liability for making an erroneous determination in this regard), the collateral agent commenced an interpleader action in the Supreme Court of the State of New York on or about January 9 2008. The real stakeholders in such action will be those senior holders whose debts matured during the period between enforcement and mandatory redemption, on the one hand, and the later maturing senior holders on the other.

Even if the timing of acceleration is not disputed, conflict has arisen as to the priority of distributions under a vehicle's waterfall structures because of ambiguities in the documentation. In the case of *Sagittarius CDO I* a party took the position that the indenture trustee should apply all principal and interest proceeds from the Sagittarius CDO assets to the party based upon the occurrence of an event of default under the indenture. In view of certain perceived ambiguities in the documentation, the indenture trustee filed an interpleader action in the Supreme Court of the State of New York on or about December 3 2007, seeking a determination as to the appropriate interpretation of the waterfall provisions.

The liquidation quandary

Once an enforcement event has occurred, the SIV enforcement manager may also be required to liquidate or determine whether to liquidate the vehicle's portfolio of assets immediately.

In some CDOs, senior note holders are empowered to force a liquidation by a vote of a specified majority. Junior note holders alone in a CDO rarely have any power to affect the determination whether to liquidate the underlying assets following an enforcement event.

Depending on market factors, the liquidation of an SIV or CDO could produce harsh results. In a depressed market, subordinated debt holders may prefer to stave off liquidation because a run-off in a distressed market would leave little or no assets for junior note holders. Senior debt holders, on the other hand, may prefer an immediate liquidation rather than risk future volatility in the market. Where the assets have an intrinsic value that is perceived to be greater than the current market value, all debt holders, regardless of their position in the capital structure, might find it preferable to retain the assets for a longer term either to:

- realise on the underlying value of the assets as the assets perform; or
- benefit from an anticipated recovery in the market value of the assets over the longer term.

The documentation in certain SIV deals affords a majority of the holders the right to direct the enforcement manager how to proceed with respect to liquidation. In some instances, the holders have directed the enforcement manager simply to stand still. In situations where the documents do not grant holders this authority outright, the parties have amended the documentation to afford holders the opportunity to opt out of the mandatory liquidation procedures prescribed by the documentation. Even in those situations where liquidation either cannot be avoided or is preferable to keeping the assets in the vehicle, a liquidation can take the form of a transfer of the assets to a newly formed company with more comprehensive restructuring features to follow at a later time.

Commencement of insolvency proceedings

Another potential cross-border issue relates to the commencement of insolvency proceedings with respect to SIVs and CDOs in distress.

SIVs and CDOs are structured to be bankruptcy-remote entities that have already generally attempted through their documentation to address various insolvency and wind-down issues without the need for judicial determinations. Indeed, the SIV and CDO documentation contains detailed operating tests, defined triggering events and complex waterfall structures to address the liquidation or management of assets and the treatment of liabilities in the context of insolvency. Structured vehicles typically contain covenants that prohibit the vehicle and its investors from commencing insolvency proceedings with respect to the vehicle.

In the United States, a borrower's covenant not to commence a voluntary case under the Bankruptcy Code is generally unenforceable as a matter of public policy (eg, see *Klingman v Levinson*, 831 F 2d 1292 (7th Cir 1987); *In re Shady Grove Tech Ctr Assocs Ltd P'Ship*, 216 BR 386, 390 (Bankr D Md 1998)). This rule reflects a policy determination by the US courts that fiduciary duties of directors are paramount to contractual covenants. Like the United States, jurisdictions such as the Cayman Islands and the United Kingdom also take the position that the question of whether directors should commence insolvency proceedings on behalf of the corporate entity they serve is one of fiduciary duty. While certain vehicles may have been placed in receivership, the authors are unaware of any cases involving an SIV or CDO where directors have resolved this question in favour of a full-blown insolvency case. There are no reported US decisions addressing the enforceability of a covenant prohibiting creditors from commencing involuntary insolvency proceedings against a bankruptcy-remote vehicle. Even if the courts would permit an involuntary filing in the face of a covenant by a creditor not to file, creditors might be reluctant to commence a filing.

If an SIV or CDO commenced a voluntary case under the Bankruptcy Code, the impact would be palpable. The automatic stay would go into effect automatically and immediately upon the filing of a petition commencing the case (see 11 USC § 362). Notwithstanding the triggering events and waterfall structures set forth in the agreements governing the SIV or CDO, issues concerning acceleration of the notes, distributions and interest accruals (if any) might be made in accordance with the provisions set forth in the Bankruptcy Code. Such provisions could be inconsistent – or even at odds – with the SIV or CDO documentation. Indeed, if a US bankruptcy filing were permitted despite the bankruptcy-remote structure of SIVs and CDOs, there would be serious questions as to whether and to what extent bankruptcy courts would enforce the contractual provisions governing the SIVs and CDOs.

Other options for distressed SIVs and CDOs

Insolvency proceedings may not be a viable or favourable option for holders of debt and other investors in distressed SIVs and CDOs. Although the SIV and CDO documentation was generally not drafted to accommodate for the realities of a distressed situation, an insolvency proceeding may produce results that are at odds with the interests of debt holders and other investors. At the same time, the solution that the documents contemplated for distress was typically some sort of liquidation mechanic – either a fast or super-fast process controlled by an enforcement-type manager. While lenders and investors have generally been able to circumvent a harsh mandatory liquidation process, they should strive for additional creativity in developing restructuring solutions for distressed SIVs and CDOs.

In some cases, it may be possible for an SIV or CDO to avoid an enforcement event altogether by employing a rescue option. One rescue option involves the purchase of the SIV's senior debt securities by the sponsor or another friendly investor. Another option involves the sale by the vehicle of a portion of its asset portfolio to its capital note holders in exchange for cash infusions that are used to fund maturing short-term debt.

Where there is no rescue option available to the SIV and an enforcement event cannot be avoided, lenders may wish to seek a standstill agreement to prevent the immediate liquidation of the distressed SIV. Once a standstill is in effect, lenders and other interested parties should be creative in developing restructuring alternatives. For example, one possible long-term solution involves the transfer of the assets of the SIV to a newly formed cash-flow CDO. The conversion of the SIV to a cash-flow CDO changes the business model of the investment vehicle from an open-ended structure to a static defined structure. Insofar as a cash-flow CDO would have a defined lifespan and would permit limited or no trading activities, the cash-flow CDO would provide greater stability and more predictability with respect to the asset portfolio over time. Conversion to a cash-flow CDO eliminates market value default triggers and the mark-to-market volatility within the structure.

Interested parties may also negotiate the liquidation and sale of the investment vehicle's asset portfolio and the creation of a new investment vehicle. In this scenario, a sponsor would create a new investment vehicle to purchase the entire asset portfolio of the SIV. Senior creditors of the SIV would be granted the option to either exchange their notes in the now-defunct SIV for an allocation of the notes to be issued by the new sponsored SIV, or use the cash generated by the sale of the SIV's asset portfolio to subscribe to notes issued directly by the sponsor.

Another form of liquidation alternative is known as the 'vertical slice', which involves the making of *pro rata* distributions to senior creditors based on their vertical slice of the asset pool. Under this option, each senior creditor is distributed its pro rata share of each and every asset in the portfolio.

Conclusion

The solutions described here do not, by any means, reflect all the possible alternatives for distressed SIVs and CDOs. New and creative solutions are being implemented as distressed situations continue to emerge. Often the restructuring solutions are driven by particular concerns, such as regulatory issues. Business objectives, timing considerations and perceptions about the quality and value (both market value and intrinsic value) of the underlying assets are all factors that will continue to drive the development of new, alternative restructuring possibilities for distressed SIVs and CDOs.

In preparing this chapter the authors consulted with Daniel Hartnett, chair of Kaye Scholer's structured products group in Chicago, and David Rivera, a partner in the firm's London office.