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Structured Products in Need Of Restructuring

Solutions for issues plaguing distressed SIVs.

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UNTIL the summer of 2007, structured investment vehicles (SIVs) were favored by various institutional investors because both the securities they issued—as well as the underlying assets that served as collateral for those securities—were highly rated. The financial markets have recently suffered from severe dislocation, including a full-blown liquidity crisis and a material deterioration in the value of the assets comprising many SIV portfolios. The severe dislocation has knocked the legs out from under the most basic tenets upon which SIV structures were built.

In a distressed market, the risks that arise from SIVs are twofold. First, there is a solvency risk if the value of the underlying assets in the SIV portfolio falls below the principal amount of the short term securities that the SIV has sold to investors. Second, there is a liquidity risk that, as the SIV borrows short term and invests long term, payments to investors may fall due before collections on the underlying assets are received. Unless the SIV is able to refinance its short term securities at favorable rates, it may be forced to sell its assets into an illiquid market.

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Because the financial markets had not appreciated the risks inherent in the SIVs' model of doing business, the program documents governing the obligations incurred by SIVs were generally not drafted with sufficient attention to or contemplation of potential distress or insolvency by the SIV. As a result, the SIV documentation tends to be overly mechanical and rigid where situations of distress or insolvency are concerned. Furthermore, the documentation is widely regarded as being ambiguous in several material respects. These ambiguities have led to the filing of an ever-growing number of lawsuits, necessitating court intervention to determine the rights of various parties.

This article will first describe in greater detail the structure and business model of SIVs generally and, then, examine some of the issues confronted by creditors of and investors in distressed SIVs as well as various solutions that have been implemented to address these issues.[1]

The Business Model of SIVs

SIVs financed their acquisition of highly rated, longer term assets by issuing their own highly rated, shorter term commercial paper (CP) and medium term notes (MTNs). The economic goal of the SIV was to earn a spread between the proceeds generated by the SIV's (longer term) asset portfolio and the costs of funding the (shorter term) debt obligations issued by the SIV.

SIVs were structured as open-ended investment vehicles, which meant that the investment manager was generally permitted to trade, invest and reinvest the SIV's assets. By employing hedging strategies and reinvesting the SIV's assets to comply with certain program requirements, SIVs had been able to maintain the quality of their underlying asset portfolios.

Because the SIVs' CP and MTNs matured on a regular basis, the SIVs' ability to maintain liquidity at all times was vital to their continued existence as going concerns. SIVs simply must be able to refinance their CP and MTNs in order to survive. SIVs typically maintained liquidity facilities that were designed to enable them to smooth over bumpy periods where the high net cumulative outflow of funds caused by a substantial volume of maturing debt outpaced the SIV's ability to refinance maturing debt or add on new debt. SIVs that experienced a liquidity crunch were forced to sell their assets to satisfy maturing debt obligations.

What Went Wrong

The documentation governing many SIVs was predicated on certain assumptions about the ratings of the SIV's underlying assets and the continued health and stability of the financial markets. These assumptions proved faulty. In the summer of 2007, there began an extended and severe dislocation in the financial markets. This dislocation not only resulted in a loss of confidence in subprime mortgage assets, but also rapidly spread to other structured products, including prime residential mortgages, commercial mortgages and obligations of monoline insurers.

As all of these assets deteriorated in value, the financial markets lost confidence in these asset classes. The deterioration in the SIVs' asset portfolios caused Moody's, Standard & Poor's and Fitch Ratings in November and December of 2007 to downgrade the CP and MTN programs of several SIVs because of their exposure to subprime mortgage assets, among other things.

The lack of confidence in the assets comprising the SIVs' portfolios and the ratings downgrades undermined a key assumption regarding the quality of the assets underlying the SIVs. This loss of confidence soon escalated into a full-blown liquidity crisis. The SIVs were no longer able to finance their short term debt obligations at a price that was lower than the returns they could achieve on their underlying assets. In other words, the yield curve had flipped. Without any ability to generate liquidity at a feasible price to replace or retire their senior obligations, the SIVs had to resort to selling assets into the depressed market.

Problems Arising

The performance of a SIV is monitored closely through various operating and liquidity tests. The sustained failure of an operating test or liquidity test may cause the occurrence of an enforcement event.[2] The ratings downgrades, the liquidation of some assets, and the default on some senior debt obligations triggered the occurrence of enforcement events in a number of SIVs.

The occurrence of an enforcement event generally results in limitations on the SIV's normal operations. SIVs may be restricted during enforcement from issuing new short term paper or from trading, investing or reinvesting in the SIV's asset portfolio, which can limit the SIV's ability to maintain liquidity. SIVs are typically required to draw down on their liquidity facilities in an enforcement state. The occurrence of an enforcement event, in some cases, may also trigger mandatory liquidation of the SIV's asset portfolio. In some cases, acceleration (or mandatory redemption) of the vehicle's senior liabilities may also be required; in other cases, acceleration will not be required.

As discussed in greater detail below, issues have arisen regarding the requirement that a SIV draw down its liquidity facilities upon enforcement, various mandatory liquidation provisions, the timing of acceleration (or mandatory redemption) and the determination of the interest rate to apply to the CP and MTNs following acceleration. In many instances, these issues have arisen because the SIV documents are viewed as lacking in flexibility or even ambiguous.

Mandatory Draw Down of Liquidity Facilities in Enforcement. The requirement that SIVs draw down on their liquidity facilities upon enforcement has created an untenable scenario for many liquidity providers. The mandatory draw down provisions mean that liquidity providers are contractually obligated to lend money to SIVs experiencing severe financial distress.

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Even though the liquidity providers are injecting new funds into the capital structure at a time of severe financial distress, their ability to recover these funds often ranks only pari passu with the SIV's other senior debt obligations. This means that the liquidity providers will share any pain resulting from the SIV's inability to repay its senior debt obligations in full pro rata with the other senior debt holders even though the liquidity providers' money comes in last and at a time of severe financial distress. In view of the level of commitment fees paid by the SIVs for these liquidity facilities and the interest rates payable on the funds extended, it appears that the underwriting for the liquidity facilities did not sufficiently take into account the level of risk involved.

Mandatory Liquidation of the Asset Portfolio. Many SIVs were not created with a flexible approach to liquidation scenarios because it was assumed that an immediate runoff of the assets upon the occurrence of an enforcement event would be sufficient in every case to retire the senior obligations of the SIV. While some SIVs afford a majority of the senior holders the right to direct the enforcement manager on how to proceed with respect to liquidation, other SIVs require mandatory liquidation upon the occurrence of an enforcement event.

The current dislocation in the financial markets cries out for a flexible approach to liquidation of a SIV's assets. Because there is a commonly held perception that some of the assets of the SIVs have an intrinsic value that is greater than the current market value of such assets, creditors may not want an immediate liquidation. They may prefer to retain the assets, or have the assets transferred to a "Newco"—and retain securities issued by "Newco"—or take a payment in kind distribution of the assets. Subordinated debt holders may prefer to forestall liquidation of the SIVs' asset portfolio because a sale into a distressed market could leave little or no proceeds for junior debt. To the extent that senior debt holders believe that the market value will only deteriorate further, they may prefer an immediate liquidation rather than risk continued volatility.

In an effort to achieve flexibility with respect to the mandatory liquidation requirements applicable to some SIVs following enforcement, the SIV documentation has been amended for certain SIVs to afford senior holders the opportunity to opt out of the mandatory liquidation procedures. In those instances where liquidation cannot be avoided, liquidation may take the form of a transfer of the assets to a newly formed company with more comprehensive restructuring features to be followed at a later time.

Ambiguities in the Documentation Regarding Acceleration. Conflicts have arisen in a number of SIV matters because of perceived ambiguities regarding the timing of acceleration (or mandatory redemption) of senior debt.

The timing of acceleration or mandatory redemption is one of the most critical issues affecting distressed SIVs because acceleration or mandatory redemption converts the vehicle from a "pay-as-you-go" model, which requires that the SIV 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 favors those senior creditors with early maturity dates because it increases the likelihood that early maturing debt holders will be paid in accordance with their maturity dates. The pari passu model favors holders with later maturing obligations because it terminates the continuance of sequential payments that might result in all funds and assets being exhausted before the later maturing obligations can be satisfied.

The import of all of this is that the timing of acceleration can drastically affect the amount of distributions to debt holders in various positions throughout the SIV's capital structure. Litigation has arisen among the various constituencies as to precisely when acceleration is required under the SIV documentation. For example, in *Deutsche Bank Trust Co. Americas v. Victoria Finance Ltd., et al.*, Index No. 600071/2008 (Sup. Ct. New York Co.), the SIV's collateral agent has commenced an interpleader action in the New York State Supreme Court with respect to the proper timing of acceleration. In that case, the collateral agent took possession of the SIV's assets and began the process of appointing an enforcement manager, in accordance with the SIV's documentation. However, according to the collateral agent, the SIV documents were ambiguous as to whether the SIV's senior obligations should be accelerated at the time the enforcement event was declared or, rather, at the time the enforcement manager determined that there should be a mandatory redemption of all 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, the collateral agent commenced the interpleader action on or about Jan. 9, 2008, seeking clarification of this issue from the New York State Supreme Court. The real stakeholders in such action will be, on the one hand, those senior holders whose debts matured during the "gap period" between the declaration of an enforcement event and the time when an enforcement manager declares a mandatory redemption, and the later maturing senior holders on the other.

Acceleration may also occur upon "insolvency." However, the SIV documentation is not uniform as to when an "insolvency" occurs. As *Cheyne Finance Plc* (*Cheyne*) demonstrates, this is another possible area of litigation.

The receivers appointed with respect to Cheyne by the High Court in London were unsure how to interpret the definition of "insolvency" as it was defined in the Cheyne Common Terms Agreement. They petitioned the High Court for clarification. See *In the Matter of Cheyne Finance Plc* (in Receivership), No. 6745 of 2007, dated Oct. 16, 2007, at ¶10.[3] The receivers were uncertain whether they should declare an insolvency event immediately, triggering pari passu treatment of all senior debt holders, based upon the fact that Cheyne was sure to run out of money on a date in the future. The alternative was to 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. Id. at ¶12, 18. As might be expected, those senior debt holders whose paper had an early maturity date advocated for the "pay-as-you-go" regime. Id. at ¶21. Those senior debt holders with later maturing paper, as well as the representatives for Cheyne's subordinated debt obligations, argued for the opposite conclusion. Id. at ¶21.

In the Cheyne Common Terms Agreement, an Insolvency Event was tied to one of two definitions of insolvency under §123(1)(e) of the United Kingdom Insolvency Act of 1986. The Court concluded, based upon its reading of the Common Terms Agreement and its interpretation of §123(1)(e), that the receivers may look into the SIV's ability to satisfy future debts in determining whether Cheyne was insolvent. Id. at ¶58. 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.

As the Cheyne case illustrates, many factors are involved in making an insolvency determination, including the applicable law governing the definition of "insolvency," the specific language and terms used in the SIV documentation, valuation findings with respect to the SIV's asset portfolio and the degree of uncertainty or volatility in the market surrounding the investment vehicle's underlying assets.

Ambiguity as to Interest Rates. Another area of possible litigation relates to the interest rate applicable to CP, MTN and hedge obligations of the SIV. The SIV documents generally contemplated that CP, MTNs and hedge programs would be satisfied upon acceleration, maturity or termination. In the case of many distressed or insolvent SIVs, however, these obligations may not be satisfied at such time. Yet, in some instances, the SIV documentation does not adequately address this situation and there is no clear answer as to what interest rate should be applied to unsatisfied CP, MTNs and hedge obligations.

Conclusion

Parties on all sides of many distressed SIVs have seized upon the rigid requirements and various ambiguities in the SIV documentation to advocate for outcomes and interpretations that are most advantageous to their position and interests. As a result, litigation relating to SIVs in distress has proliferated in recent months, and more can be expected.

In many cases, rational restructuring options and business solutions do exist, only some of which have been discussed herein. The continuing challenge will be for the interested constituencies to find a way to move forward with the restructuring and business solutions while providing room for court determination of the litigation. The danger is that "out of the money" or economically disadvantaged investors will attempt to seize on ambiguities in the SIV documentation to hold up a rational business solution achieved in a difficult financial environment.

1. The discussion herein reflects Kaye Scholer's experience with the following vehicles, among others: Cheyne Finance Plc, Ottimo Funding Ltd., Axon Financial Funding Ltd., Victoria Finance Limited, Premier Asset Collateralized Entity Limited, KKR Financial Holdings and Harrier Finance Limited. Confidentiality restrictions preclude the authors from addressing the issues discussed herein on a deal-specific basis.

2. The following enforcement events are typically found in most SIVs: (1) failure by the SIV to pay interest or principal on any of its notes when due after the application of any grace periods; (2) the initiation on a voluntary or involuntary basis of receivership, liquidation, winding up or insolvency proceedings with respect to the SIV; (3) a ratings downgrade by Moody's and/or Standard & Poor's, generally to non-investment grade, of securities issued by the SIV; or (4) a default by the SIV under one of its liquidity facilities that causes the commitment under such liquidity facility to be terminated.

3. The authors' firm represents certain investors in Cheyne. The firm appeared in the Cheyne litigation on behalf of one of its clients.