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Commercial Paper Conduits and CDOs Under Assault From FIN 46

Two Established Financing Vehicle Types Become Collateral Damage from the FIN 46 "Principles Approach" to Enron Problems

Background

In one of its "final" actions in response to the recent wave of accounting and corporate management scandals, the Financial Accounting Standards Board (the "FASB") issued Interpretation No. 46 ("FIN 46"), which modifies and purports to finalize the principles to be applied in determining whether certain "variable interest entities" must be consolidated with other entities.

Overview of FIN 46 Provisions

FIN 46 provides an exception from the general rules of consolidation in Accounting Research Bulletin No. 51 ("ARB 51") — i.e., that a particular business enterprise should be consolidated with another business enterprise that has a direct or indirect controlling financial interest in the business enterprise in question. Prior to FIN 46, there was a consensus that a special purpose financing vehicle established for the benefit of a single entity would be consolidated with the unrelated holder of the equity interest in that financing vehicle if such holder (a) had voting control of the vehicle, and (b) had a real economic interest in that financing vehicle (i.e., an equity investment in the financing vehicle at the outset of the transaction equal to 3% or more of the gross assets of the financing vehicle).[1]

FIN 46 preserves the application of the ARB 51 consolidation principles to entities the equity in which meets the following tests (the "FIN 46 Controlling Financial Interest Test"): (i) some of the equity investors that participate significantly in profits and losses

[1] It was also generally accepted that if the financing vehicle was established for the benefit of multiple unrelated entities and the interests of each were not contractually isolated from the other so that the financing vehicle would not be viewed as several individual special purpose vehicles, a minimum 3% equity might not be required.

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Sarbanes-Oxley Act

Disclosure of Off-Balance Sheet Arrangements and Aggregate Contractual Obligations

In the wake of the recent wave of accounting and corporate management scandals involving public issuers, the Securities and Exchange Commission (the "SEC") promulgated the Sarbanes-Oxley Act of 2002 (the "Act") on July 30, 2002. Section 401(a) of the Act added Section 13(j) to the Securities Exchange Act of 1934, which required the SEC to adopt final rules regarding disclosure of off-balance sheet arrangements by January 26, 2003. The final rules implementing Section 401(a) of the Act were issued on January 22, 2003.

The final rules, which became effective April 7, 2003, clarify the extent and form of the disclosure that registrants must make with regard to their off-balance sheet arrangements. A registrant is now required to provide an explanation of its off-balance sheet arrangements in a separately captioned sub-section of the registrant's Management's Discussion and Analysis ("MD&A"). The final rules also require all registrants (other than certain small

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Commercial Paper Conduits

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have a total equity investment at risk sufficient to permit the entity to finance its activities without additional subordinated financial support;[2] (ii) the equity investors as a group are obligated to absorb the expected losses of the entity if they occur; (iii) the equity investors as a group have the direct or indirect ability to make decisions about the entity's activities through voting or similar rights;[3] and (iv) the equity investors as a group have the right to receive the expected residual returns of the entity if they occur. If any of these requirements is not met, the entity in question is a variable interest entity ("VIE") the consolidation of which is governed by the primary beneficiary test of FIN 46, unless the entity is a type specifically exempted from the operation of FIN 46.

Since FIN 46 is not limited to special purpose entities, it can reach any type of entity or arrangement that does not have the controlling financial interest that satisfies the FIN 46 Controlling Financial Interest Test described above. However, certain types of entities and arrangements are specifically exempted from the application of FIN 46,[4] including QSPEs under FASB Statement No. 140 ("Statement 140"), unless the holder of a variable interest in the QSPE can unilaterally liquidate the QSPE or unilaterally cause the QSPE to no longer qualify as a QSPE.

FIN 46 provides that any entity or arrangement, which is not specifically exempted from FIN 46 or is not excluded from FIN 46 by virtue of meeting the FIN 46 Controlling Financial Interest Test, is treated as a VIE that must be consolidated with its "primary beneficiary," if there is one.

The primary beneficiary of a VIE is that holder of a "variable interest" in such VIE that either: (a) is obligated to absorb a majority of the expected losses of such VIE, or (b) is entitled to a majority of the expected residual returns of such VIE if no variable interest holder is obligated to absorb a majority of the expected losses of such VIE. If a VIE has no primary beneficiary, the VIE is not required to be consolidated with any other enterprise. These rules are referred to herein as the "FIN 46 Primary Beneficiary Test."

The term "variable interests", as it is used in FIN 46, is extremely broad and includes all contractual, ownership, or other pecuniary interests in a VIE, that change with the changes in the VIE's net asset value. Variable interests generally include equity interests in a VIE, subordinated beneficial interests in the cash flows of a VIE and subordinated debt issued by a VIE that would absorb expected losses. Variable interests generally do not include senior beneficial interests in the cash flows of a VIE and senior debt issued by a VIE, unless the subordinated interests are not sufficient to absorb the expected losses or unless imbedded derivatives expose those senior interests to expected losses. Almost all variable pecuniary interests in a VIE that fall between those poles are treated as variable interests including: (a) guarantees, asset put options, forward contracts to purchase assets or similar obligations that protect the holders of senior interests from expected losses of the VIE; (b) hedge contracts, swaps and derivative contracts with VIEs that expose the holder to expected losses of the VIE; (c) service contracts with a VIE for compensation other than at market rates; and (d) long term leases with VIEs that are not at market rates at the outset of the lease or that have residual value guarantees or similar features.

As noted above, the key to application of the FIN 46 Primary Beneficiary Test is whether a holder of a variable interest in a VIE would absorb a majority of the expected losses of such VIE or realize a majority of the expected residual returns of such VIE, if those expected losses or expected residual returns were to occur.

One of the principal criticisms of FIN 46 is that it does not use an established methodology (like that used by rating agencies) to determine expected losses or expected residual returns. Instead, in FIN 46 the FASB creates its own methodology. Moreover, the FASB, citing the desire to limit itself to statements of principle, has declined to offer further guidance. As a result, the accounting profession is having difficulty reaching a consensus as to how to determine the expected losses and the expected residual returns of the VIE. This uncertainty impacts both the application of the FIN 46 Controlling Financial Interest Test and the FIN 46 Primary Beneficiary Test.

[2] There are three ways to satisfy this test: (a) have equity equal to, or in excess of, expected losses; (b) actually finance the business without other subordinated financing; or (c) have equity in an amount consistent with other similar businesses operating without other subordinated financing. This requirement is rebuttably presumed not to be met if the total equity investment is less than ten percent of the gross assets of the entity. However, ten percent equity does not create a presumption that this requirement is met.

[3] There is considerable disagreement among accountants as to the precise meaning of this requirement.

[4] Other exempted entities include most: (1) not-for-profit organizations; (2) employee benefit plans; (3) registered investment companies; and (4) separate accounts of life insurance companies.

FIN 46 Problem for ABCP Programs

In the case of many single sponsor ABCP programs not structured as QSPEs, the current consensus view is that where USGAAP is applicable, FIN 46 may require a change in the current consolidation treatment of the commercial paper vehicle. In some cases, where the ABCP vehicle is currently not consolidated with the sponsor, FIN 46 may require such consolidation if: (a) the third party equity interest is not the type and magnitude necessary to satisfy the FIN 46 Controlling Financial Interest Test; and (b) the seller/sponsor, as a result of its retained subordinated interest or servicing fees, is required to absorb a majority of the expected losses or is entitled to receive a majority of the expected residual returns under the FIN 46 Primary Beneficiary Test.

In the case of most existing multi-seller ABCP programs sponsored by third parties, such as banks, the current consensus view is that where USGAAP is applicable, FIN 46 may require consolidation of such ABCP vehicles with the third party sponsor if the sponsor would be deemed to bear a majority of the expected losses or would be deemed to be entitled to a majority of the expected residual returns.

While multi-seller ABCP programs could theoretically be structured to utilize the so-called "silo" provision of FIN 46 to limit the impact of FIN 46 on the third party sponsor, this particular provision of FIN 46 is very confusing and would seem to require that each seller's interest in the multi-seller ABCP vehicle, as well as the related commercial paper, function essentially as a separate ABCP program thus eliminating many of the existing advantages of multi-seller ABCP programs as compared with single seller ABCP programs.

Initial proposals to restructure ABCP programs as QSPEs have been frustrated, at least temporarily, by indications by the FASB that it is considering interpretations of, or amendments to, Statement 140 that would limit the ability of QSPEs to manage the liability side of their balance sheets. Such limits could potentially limit the ability of QSPEs to vary the maturity of the commercial paper they issue from time to time in a manner that may render the use of QSPEs unpractical in this application.

Some industry participants have expressed the hope that the effect of FIN 46 mandated consolidation on banks sponsoring multi-seller conduits could be mitigated by obtaining regulatory relief from resulting capital requirements. To date, the applicable regulators have not provided any final guidance in this regard.

Enterprising industry participants are considering the formation of funds designed to provide sufficient equity to satisfy the FIN 46 Controlling Financial Interest Test or to provide loss coverage sufficient to become the "primary beneficiary" under the FIN 46 Primary Beneficiary Test. However, implementation of this alternative currently is being delayed while a consensus is formed among accountants as to the quantitative (primarily the computation of expected losses) and qualitative requirements of the equity required to apply the FIN 46 Controlling Financial Interest Test and as to the expected loss and expected residual return computation and allocation mechanics necessary to apply the FIN 46 Primary Beneficiary Test.

FIN 46 Problems for CDO Programs

While there are many different ways to categorize CDOs, from the point of view of FIN 46 two particular categories are helpful to bear in mind — static pool CDOs and actively managed CDOs.

It is generally thought that most static pool CDOs can be structured as QSPEs, as they are currently defined, and thus avoid the full impact of FIN 46. However, as noted above, the FASB is proposing to redefine the definition of QSPEs in ways that are not yet clearly understood.

The current consensus view is that, to the extent USGAAP is applicable, CDOs probably have a sufficiently diverse group of equity participants bearing the expected losses and sharing in expected residual returns that the FIN 46 Primary Beneficiary Test would not require consolidation of the static pool CDO entity with any particular equity participant. However, the consensus view is that the FIN 46 Primary Beneficiary Test may require consolidation of actively managed CDOs with the manager, if it is deemed to be a decision maker, since the management fees may result in the manager being deemed to own a majority of the expected residual returns of the CDO.

Some accountants have suggested that it might be possible to restructure actively managed CDOs to satisfy the FIN 46 Controlling Financial Interest Test, and thus avoid the FIN 46 Primary Beneficiary Test, by adding sufficient equity of the type

required to exclude the CDO entity from the application of the FIN 46 Primary Beneficiary Test. As noted above, enterprising industry participants are considering the formation of funds designed to provide this equity. However, for the time being implementation of this alternative is being delayed while a consensus is formed among accountants as to the detailed requirements and computation mechanics.

Concluding Observation

Most of the practicing accountants and other industry participants still hope for further guidance from the FASB that may address some of the difficult issues described above. However, in the meantime, many of the existing ABCP and actively managed CDO programs will have to be restructured. Lawyers practicing in the area of structured finance and their clients will have to understand not only the FIN 46 Controlling Financial Interest Test but also the FIN 46 Primary Beneficiary Test in order to effectively structure or restructure special purpose financing vehicles of these types.

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Sabanes-Oxley Act

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business registrants) to provide an overview of certain known contractual obligations in tabular form.

Registrants must comply with the disclosure requirements for off-balance sheet arrangements in their registration statements, annual reports, proxy statements and any information statements which are required to include financial statements for their fiscal years ending on or after June 15, 2003. Registrants must disclose in tabular form certain of their contractual obligations in their registration statements, annual reports, and proxy statements and any information statements which are required to include financial statements for their fiscal years ending on or after December 15, 2003.

Disclosure of Off-Balance Sheet Arrangements

What is an Off-Balance Sheet Arrangement? It is a contractual arrangement to which an entity that is not consolidated with the registrant is a party, under which the registrant has:

- any obligation under a direct or indirect guarantee contract or similar arrangement;
- a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for the transferred assets;
- any obligation or liability under certain derivative instruments; or
- any obligation or liability arising out of a material variable interest held by the registrant in an unconsolidated entity that provides financing, liquidity, market risk support or credit risk support to the registrant or engages in leasing, hedging or research and development.

Disclosure Threshold. The SEC elected to institute a "reasonably likely" disclosure threshold. In applying the "reasonably likely" threshold, a registrant's management must identify and analyze the registrant's off-balance sheet arrangements and assess the likelihood of the occurrence of any known trend, demand, commitment, event or uncertainty that could affect the off-balance sheet arrangement. If the registrant concludes that such an event is not reasonably likely to occur, no disclosure is required. If a registrant cannot make such a determination, it must objectively evaluate the consequences of such event on the assumption that it will come to fruition. Unless the registrant can determine that a material effect on its financial condition is not reasonably likely to occur even if such event transpires, disclosure of the off-balance sheet arrangement is required.

It is important to note that a contemplated off-balance sheet arrangement must be contractual in order to be the subject of mandatory disclosure and no obligation to disclose an off-balance sheet arrangement will arise until such arrangement is unconditionally binding. Furthermore, contingent liabilities arising out of litigation, arbitration or regulatory actions are not considered to be off-balance sheet arrangements.

Required Disclosure. Once the disclosure threshold is met, the final rules require a registrant to disclose all material facts and circumstances surrounding the off-balance sheet arrangement that are necessary to provide investors with a clear understanding of the off-balance sheet arrangement and its material effects, including:

- the nature and business purpose of the off-balance sheet arrangement;
- the importance to the registrant of the liquidity, capital resources, market risk support, credit risk support or other benefits provided by the off-balance sheet arrangement;
- the amounts of revenues, expenses and cash flows arising from the off-balance sheet arrangement;
- the nature and amounts of interests retained, securities issued and other debt incurred by the registrant in connection with the off-balance sheet arrangement; and
- any known event or trend that will result in the termination of the off-balance sheet arrangement.

In addition, this disclosure must include any information that the registrant deems necessary for a clear understanding of the off-balance sheet arrangement and its specific material impact on the registrant.

Separation of Discussion. Under the new rules, a registrant must disclose its off-balance sheet arrangements in a separately captioned section of its MD&A to highlight such disclosure for readers.

Disclosure of Contractual Obligations

The new rules also require disclosure of certain contractual obligations. This disclosure relates to the registrant's prior year-end balance sheet date. Under the new rules, registrants (other than small business issuers that file small business reporting forms) will have to disclose in tabular format the amount of payments due under certain contractual obligations, aggregated by category of contractual obligation, and broken down by the time periods in which such payments are due. The contractual obligations are broken down into the following categories: "long term debt", "capital lease obligations", "operating leases", "purchase obligations" and "other long-term liabilities reflected on the registrant's balance sheet under GAAP", and then further broken down by when such payments are due. A registrant may disaggregate the categories to the extent it better reflects the registrant's specific business so long as the table includes all of the obligations that fall within the categories listed above. The tabular disclosure can be accompanied by footnotes to describe provisions that affect obligations, changes from previous years or other pertinent data to the extent necessary to create a greater understanding of the contractual obligations.

Registrants that prepare financial statements in accordance with non-U.S. GAAP should include contractual obligations in the table that are consistent with the classifications used in the GAAP under which its primary financial statements are prepared.

Location of Discussion. In contrast to the rule for disclosure of off-balance sheet arrangements, the tabular disclosure of contractual obligations can be placed in any location in the MD&A that the registrant deems to be appropriate.

Application to Foreign Private Issuers

The new disclosure requirements apply to foreign private issuers that file annual reports on Form 20-F or Form 40-F. However, unless a foreign private issuer files a securities registration statement that must include interim period financial statements and related MD&A disclosure, it will not be required to update its disclosure more frequently than annually.

Safe Harbor for Forward Looking Statements

The new rules also provide a safe harbor for forward looking information so long as the forward looking statement is identified as forward looking and is accompanied by "meaningful cautionary statements" that identify important factors that could cause actual results to differ materially. The safe harbor applies the existing statutory safe harbors protecting forward looking statements to the information required by the new rules.

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Final Tax Shelter Rules

More Limited Impact on Securitization and Structured Finance, but Careful Attention is Still Required

Background: On February 27, 2003, the United States Treasury Department (the "Treasury") and the Internal Revenue Service (the "IRS") issued final regulations (the "Final Tax Shelter Regulations")[1] under Sections 6011 and 6012 of the Internal Revenue Code of 1986, as amended (the "Code") and two Revenue Procedures (the "Tax Shelter Revenue Procedures" and together with the Final Tax Shelter Regulations are collectively referred to herein as the "Final Tax Shelter Rules")[2] setting forth details concerning the disclosure, record keeping and list keeping requirements of Sections 6011 and 6012 of the Code as those requirements apply to listed tax shelters and other "reportable transactions".

The Final Tax Shelter Rules respond helpfully to many of the comments made by the structured finance and securitization industry in response to the regulations initially proposed by the Treasury and the IRS on these issues last November. Nevertheless, these new Final Tax Shelter Rules still present significant issues in the context of securitization and other structured finance transactions.

Overview of Provisions: In general, the Final Tax Shelter Rules:

(a) require all taxpayers (i.e., persons and entities required to file United States federal income tax returns) to disclose, on a special form to be attached to those returns, information concerning any "reportable transaction" in which such taxpayer "participates";

(b) require any such taxpayer to retain copies of all documents and other records relating to such reportable transaction that are material to an understanding of the tax treatment or tax structure of such reportable transaction; and

(c) require "material advisors", in respect of a "reportable transaction", to maintain lists of persons that participate in such reportable transaction.

"Reportable transactions" include:

(a) Listed Transactions (i.e., transactions that have been formally identified as tax avoidance transactions by the IRS) and transactions that are the same as, or substantially identical to, Listed Transactions;

(b) transactions offered under "conditions of confidentiality";

(c) transactions providing for "contractual protection" if projected tax benefits are not realized;

(d) transactions resulting in "Section 165 Losses" (i.e., certain losses that are deductible under Section 165 of the Code adjusted for any salvage value, or insurance proceeds or other compensation received) that exceed, over one or more taxable years, thresholds that vary from \$50,000 to \$20 million depending on (i) whether the taxpayer is a "C" Corporation (i.e., a corporation subject to the regular corporate tax regime), an "S" Corporation (a corporation subject to Subchapter S of the Code), a trust, or an individual, and (ii) whether the single year or multiple year test is being applied;

(e) transactions resulting in certain book-tax differences that exceed a \$10 million threshold in any taxable year; and

(f) transactions that involve a brief asset holding period and tax credits exceeding certain thresholds.

As in the case of the initially proposed regulations, the Final Tax Shelter Regulations define the term "material advisor" with respect to their list maintenance requirements quite broadly to include with respect to any reportable transaction: (a) any person required to register such reportable transactions if it is a tax shelter under Section 6111 of the Code, and (b) any person who receives or expects to receive a "Minimum Fee" with respect to the reportable transaction and who makes a "tax statement" about the transaction. The Minimum Fee includes all fees for advice or implementation and is generally \$50,000, unless every person to whom the advisor makes a tax statement is a corporation subject to the normal corporation tax under Subchapter C of the Code, in which case the minimum fee is generally \$250,000. However, there are numerous exceptions to these rules, including a reduction in those amounts to \$10,000 and \$25,000, respectively, in the case of potentially abusive tax shelters that are Listed Transactions. These exceptions and many unanswered questions regarding the application of the applicable minimums create much uncertainty regarding these list maintenance requirements.

[1] See TD 9046.

[2] See Rev. Proc. 2003-24 and Rev. Proc. 2003-25.

The Final Tax Shelter Regulations generally apply to transactions entered into after February 28, 2003.[3] While the first information returns will not be required until Federal income tax returns are required to be filed for periods which include the effect of such transactions, the record keeping and list maintenance requirements are now in effect.

Helpful Changes in Final Tax Shelter Rules

The originally proposed tax shelter reporting rules contained a number of exceptions that were designed to take routine transactions out of the scope of these rules. However, many structured finance and securitization transactions were being swept into the scope of these rules primarily due to three elements of the initially proposed rules: (i) they were being offered under "conditions of confidentiality"; (ii) they involved some tax indemnification provisions which were treated as "contractual protection"; or (iii) they involved significant book-tax accounting differences. The Final Tax Shelter Rules preserve certain exceptions from the initial proposals and incorporate changes that permit most structured finance and securitization transactions to be structured to escape treatment as "reportable transactions":

(a) A taxpayer will not be treated as participating in a reportable transaction solely as a result of "conditions of confidentiality" if either (i) the taxpayer's tax return does not reflect any tax benefits (as broadly defined in the Final Tax Shelter Rules) from the transaction, or (ii) the taxpayer receives from each person who has made a statement concerning the potential tax consequences of the transaction a written authorization (in the form provided in the Final Tax Shelter Rules) authorizing the unlimited disclosure of the tax treatment and tax structure of the transaction and all materials of any kind (including opinions or other tax analysis) that are provided to the taxpayer relating to the tax treatment and tax structure of the transaction.

(b) A taxpayer will not be treated as participating in a reportable transaction solely because the taxpayer is indemnified against loss of certain anticipated tax benefits with respect to such transaction. For the time being at least, only arrangements for refunding up-front fees constitute the kind of contractual protection that gives rise to a reportable transaction.

(c) A taxpayer will not be treated as participating in a reportable transaction solely because such transaction results in one of a long list of approved book-tax differences. This list includes the helpful exceptions incorporated in the initial proposals, including the ability to disregard differences that result from: (i) transactions between a disregarded entity and its owner; (ii) transactions between members of an affiliated group filing consolidated tax returns; (iii) book losses or expenses occurring without, or prior to, corresponding tax deductions or losses; (iv) inclusion of gain or income for tax purposes without, or prior to, corresponding book income or gain; or (v) different methods, depreciation or amortization periods or conventions used to compute depreciation or amortization for book and tax purposes. New approved book-tax differences include differences that result from (i) debt for debt exchanges; (ii) treatment of a transaction as a sale, purchase, or lease for book purposes and as a financing arrangement for tax purposes; (iii) treatment of a transaction as a sale for book purposes and as a nontaxable transaction under certain provisions of the Code; (iv) varying application of mark-to-market rules for book and tax purposes; and (v) varying application of hedge accounting for book and tax purposes. Finally, the Final Tax Shelter Rules increase the threshold for application of the book-tax difference test to non-reporting business entities to $250 million (from $100 million) of gross assets for book purposes, and clarify that that threshold must be met at the end of the financial accounting period that ends with or within such entity's taxable year in which the transaction in question occurs.

[3] February 28, 2003 is the date the Final Tax Shelter Regulations were filed with the Federal Register. However, taxpayers may elect to have the Final Tax Shelter Regulations apply to transactions entered into after January 1, 2003.

Continuing Need for Tax Review of Structured Finance and Securitization Transactions:

Notwithstanding these helpful changes, several aspects of structured finance and securitization transactions continue to require evaluation under the Final Tax Shelter Rules.

- First, as to the new exceptions from reportable transactions arising from "conditions of confidentiality":
  - (a) the meaning of "tax benefits" is not entirely clear; and
  - (b) the means of documenting the tax disclosure authorization and coordinating the required authorization with requirements of the securities laws are still being debated by the organized bar.
- Second, all such transactions that may result in significant book-tax differences must be carefully screened to verify either:
  - (a) that the differences fall within an approved class of book-tax differences; or
  - (b) that the differences are not of a magnitude that would cause the transaction to be treated as a reportable transaction.
- Third, all such transactions that might produce Section 165 Losses must be evaluated to determine whether those losses are likely to reach the levels that will categorize the transactions as reportable transactions.
- Fourth, the category of transactions that might be treated as Listed Transactions or transactions substantially similar to Listed Transactions is constantly changing. Accordingly, this category must be carefully monitored and each novel structured finance and securitization transaction should be reviewed in light of this potential trigger.
- Finally, because both the sponsor of the transaction and the lawyers that participate in the preparation of offering documents or that give tax advice in connection with the transaction might be "material advisors" required to maintain lists of participants, each must be satisfied that these transactions are not reportable transactions.

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Case Study: Conseco Bankruptcy Proceedings Create Additional Uncertainty in the Securitization Market

The Conseco bankruptcy case is causing reexamination of certain of the standard assumptions regarding the impact of originator bankruptcy on asset backed securitizations.

In December 2002, Conseco Inc. filed for protection under Chapter 11 of the U.S. Bankruptcy Code. In connection with the bankruptcy proceedings, a notable conflict emerged when Conseco Finance Corp. ("CFC"), and U.S. Bank National Association, as trustee (the "Trustee") filed a joint motion in the U.S. Bankruptcy Court (the "Court") to modify the terms of various Pooling and Servicing Agreements (the "Servicing Contracts") pursuant to which CFC acts as servicer for approximately 137 securitization trusts (the "Securitization Trusts") which collectively own approximately $32 billion in home equity, manufactured housing and credit card loans originated by CFC. Holders of multiple tranches of "pass through" certificates (the "Certificates") issued by the Securitization Trusts, represented by the members of the *ad hoc* committee (the "Committee"), filed a motion objecting to such modifications.

The Committee objected to a proposed increase in the servicing fees that CFC is entitled to receive under the Servicing Contracts. CFC was entitled to receive a servicing fee of 50 basis points per year under its Servicing Contracts relating to the securitization. The modified arrangements increased this servicing fee to 125 basis points. The Trustee and CFC maintained that the increase was necessary to prevent "immediate irreparable harm" to the Securitization Trusts. The Committee argued that the increase to 125 basis points was excessive and presented the following four reasons why it believed approving the modification would be improper:

- *Failure to Negotiate in Good Faith.* The Committee claimed that CFC and the Trustee did not negotiate in good faith to reach a fair, market compromise as contemplated in the Procedures and Notice for Final Hearing on Servicing Agreements (the "Interim Order") issued by the Court. The Committee claimed that the Trustee did not respond to attempts by the Committee to negotiate and instead continued to insist on a flat 125 basis point servicing fee.
- *Lack of Jurisdiction.* The Committee argued that the Court lacked jurisdiction over any proposed compromise since CFC and the Trustee had in fact asked the Court to approve

a reorganization plan rather than settle a live controversy between them. Furthermore, the Committee claimed that such a change in servicing fees would, as an amendment to the Servicing Contracts, require the written consent of Certificate holders. This raised the question as to whether a bankruptcy court can approve a unilateral change in an executory contract that would constitute a material breach of that contract. The Committee argued that under existing bankruptcy law an executory contract cannot be modified without the consent of the contracting parties.

- *Lack of Authority to Exculpate the Trustee.* The Committee argued that the bankruptcy court lacked the authority to approve the Trustee exculpation provision in the Interim Order, which absolved the Trustee from any liability for claims, demands and suits arising out of its involvement in the Interim Order, because it was a non-consensual release of a non-debtor third-party for debts owed to other non-debtors outside the context of a plan of reorganization. The Committee stated that in this instance the increase in the servicing fee to 125 basis points will create a claim of at least $700 million by the Certificate holders against the Trustee. The Committee cited cases in which courts refused to uphold such a release even in the context of a plan of reorganization. The Committee argued that when a court has seen fit to uphold such a release, it was done only after taking into account certain factors such as whether the non-debtor has contributed substantial assets to the reorganization and whether the impacted class has overwhelmingly voted to accept the plan, factors that were not present in this case.
- *Significant Economic and Policy Concerns.* The Committee also argued that entry of the final order would be inconsistent with fundamental bankruptcy policy and disruptive of national securitization markets. The Committee contended that a final order permanently increasing the servicing fee without Certificate holder approval would have dire consequences for the nation's securitization markets. The Committee argued that as a matter of public policy such a unilateral modification of the servicing agreements cannot be permitted. Rather, the parties should be given additional time to negotiate a framework so that they may attract other qualified servicers and competing bids. The alternative, according to the Committee, is a "fundamentally flawed and doomed" result, the effect of which on the $7 trillion securitization market will be "devastating and long-lasting." The Committee concluded its motion by impressing upon the Court both the significance of the securitization market as a critical source of capital for the manufactured housing sector and the effect a negative impact on the securitization market, investors in which rely upon the certainty of their investments, servicing agreements and the bankruptcy process, may have on an already low investor confidence.

Court Ruling

On March 14, 2003, the Court approved the sale of CFC, following the decision by Fannie Mae, the largest Certificate holder, to let the high bidder for CFC's assets, CFN Investment Holdings LLC, take over the servicing obligations on its share of the portfolio. The sale is expected to close by May 31, 2003, at which point the servicing fee will be increased to 125 basis points for the first 12 months, after which it will be decreased to 115 basis points. It is unclear at this time as to what will occur as to the non-Fannie Mae portion of the portfolio. The date of the confirmation hearing for the *Conseco* reorganization plan has been extended from the proposed date at the end of April to May 28, 2003, allowing more time for the preferred-debt group to examine the plan.

Impact on Securitizations Generally

In addition to the concerns of the Committee regarding the effect that the *Conseco* decision will have on securitizations, there are many other potential impacts on the field of asset backed securitization. Of note, a central concept of asset backed securitizations is to isolate the credit quality of the originator from the credit quality of the securities issued. The *Conseco* case calls this concept into question, since in the typical structure the originator or an affiliate of the originator is also the servicer.

At least one rating agency has publicly expressed concern that the *Conseco* case may impact its ratings policies, suggesting that there may be a closer link in the future between changes in the credit quality of a seller/servicer and changes in the ratings of structured transactions, in the absence of mitigating factors.

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The Impact of FIN 46 on the Application of Rule 2a-7 of the Investment Company Act

The release by the Financial Accounting Standards Board (“FASB”) of Interpretation No. 46, *Consolidation of Variable Interest Entities* (“FIN 46”) may result in the consolidation of certain special purpose entities utilized in asset backed securitization transactions on the financial statements of the “sponsor” of such transactions. As a result, questions have been raised as to whether following any such consolidation, the sponsor of the special purpose entity should be considered the “issuer” of the securities issued by such special purpose entity for purposes of Rule 2a-7 (“Rule 2a-7”) promulgated under the Investment Company Act of 1940, as amended (the “Investment Company Act”).

Rule 2a-7 establishes diversification requirements which limit the amount of securities relating to any single issuer in which a money market fund may invest. Rule 2a-7 does not provide a separate definition of the term “issuer.” It does, however, state that “[a]n ‘Asset Backed Security’ acquired by a [money market] fund… shall be deemed to be issued by the special purpose entity that issued the Asset Backed Security.” A special purpose entity is defined as “a trust, corporation, partnership or other entity organized for the sole purpose of issuing securities that entitle their holders to receive payments that depend primarily on the cash flow from “Qualifying Assets”, but does not include a “registered investment company.” Although Rule 2a-7 does contain rules that may require an issuer of Asset Backed Securities to treat certain obligors (“Ten Percent Obligors”) of the assets held by such issuer to be issuers of a pro rata portion of such securities, the reasoning behind such provisions is that the creditworthiness of such obligors affects the credit quality of the primary issuer’s securities. Rule 2a-7 does not contain any provisions requiring similar treatment based on accounting presentation. In the absence of any special rules, it would appear proper to interpret the definition of “issuer” contained in Section 2(a)(22) of the Investment Company Act based on the literal language thereof. Section 2(a)(22) defines “issuer” as “every person who issues or proposes to issue any security, or has outstanding any security which it has issued.”

Although there has not yet been any formal guidance on the matter, it would appear that the term “issuer” should, for purposes of Rule 2a-7, be read as referring to the Special Purpose Entity that issues the Asset Backed Securities (including any applicable Ten Percent Obligors) and not to any other entity with whom such Special Purpose Entity is consolidated for accounting purposes under FIN 46. Such treatment would appear to be consistent with the treatment of an issuer for other purposes of the federal securities laws. For example, under the Investment Company Act, in the case of tax-exempt bond issuers, the Securities and Exchange Commission treats as a separate issuer an agency, authority, instrumentality or other political subdivision if its assets and revenues are separate from those of the government creating such agency, authority, instrumentality or subdivision and the security is backed only by the assets and revenues of such agency, authority, instrumentality or subdivision.

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Heads Up: Relation Back of Precautionary Filings Made Under the UCC

Prior to the 2001 effective date of revised Article 9 of the Uniform Commercial Code (the "UCC"), many secured creditors followed a practice of filing UCC-1 financing statements relating to accounts, general intangibles and other similar collateral both in the jurisdiction of the debtor entity's chief executive office, as required by the then current version of Article 9, and in the debtor's jurisdiction of organization. Although the filing in the jurisdiction of organization (a "precautionary filing") was not required by the law at that time, certain secured creditors felt it would be useful in providing actual notice to third parties as to the existence of the security interest.

These secured creditors may have felt a sense of vindication when revised Article 9 provided that the location of a "registered organization" debtor (such as a corporation, limited partnership or limited liability company) is its jurisdiction of organization for purposes of determining the appropriate filing jurisdiction. The previous precautionary filing became an effective filing due to the change of law, the effectiveness of which could be continued indefinitely by the filing of appropriate continuation statements in the jurisdiction of organization.

There is, however, a loophole in the protection provided by these prior precautionary filings that may not be widely appreciated. The effective date of such a precautionary filing is the date on which revised Article 9 became effective (July 1, 2001, in New York and Delaware), rather than the date on which the precautionary filing was made. Accordingly, a precautionary filing originally made in September of 1998, for example, is currently effective and can be continued by the filing of a continuation statement in the jurisdiction of organization. However, the secured party does not get the benefit of having the perfection of the security interest by means of the precautionary filing relate back to September 1998, but only to July 1, 2001. The secured creditor may find that a security interest or lien which attached after the date of the precautionary filing but prior to the effective date of revised Article 9 will take priority over the secured creditor's security interest (at least following the period during which the effectiveness of the secured creditor's filing in the previous Article 9 filing jurisdiction is grandfathered by UCC 9-705(c)) if the creditor decides to rely solely on the precautionary filing. A secured creditor facing such a prospect should make an "in lieu" filing in the jurisdiction of organization of the debtor relating to the original filing in the previous Article 9 filing jurisdiction, which has the effect of creating a new filing in the jurisdiction of organization effective as of the date of such original filing in the previous Article 9 filing jurisdiction.

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Recent Noteworthy Transactions

The following are recent noteworthy transactions in which the Structured Finance Group has participated:

- Premier Asset Collateralized Entity Limited Structured Investment Vehicle Program
  - U.S. Commercial Paper Notes
  - Euro Commercial Paper Notes
  - U.S. Medium-Term Notes
  - Euro Medium-Term Notes
- SLM Student Loan Trust 2003-2
  - Student Loan-Backed Securities
- Hedged Mutual Fund Fee Trust 2003-1 $100,000,000
  - Series 2003-1 Floating Rate Asset-Backed Notes, Class 1
  - $75,000,000 Series 2003-1 Fixed Rate Asset-Backed Notes, Class 2
- Mutual Fund Fee Trust XXI
  - Series 2002-3 Fixed Rate Asset-Backed Notes, Class 1
  - Series 2002-3 Floating Rate Asset-Backed Notes, Class 2
- Zais Investment Grade Limited V
  - $401,000,000 Senior, Subordinated and Composite Notes in a "CDO of CDO's" structure
- Sale of substantially all of the lease portfolio assets of DrkW Finance Inc. to JPMorgan Leasing Inc.

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