The Deal
REPRINT FROM FEBRUARY 4, 2008

BY GREG B. CIOFFI

Assessing CDO event of default risk

Since their inception in the late 1980s, collateralized debt obligations have been among the fastest-growing investment products in the asset-backed securities market. During this time, CDOs have gained increasing exposure to subprime mortgage bonds.

In the wake of the recent subprime crisis, it is essential that CDO investors understand the terms of the underlying CDO documentation to better assess the likelihood that an event of default, or EOD, will occur. Moreover, an investor's rights and remedies following an EOD can only be fully appreciated after a careful review of the acceleration, liquidation and other related provisions of the underlying CDO documentation.

The recent turmoil in the U.S. subprime mortgage market has brought about a heightened risk of EODs in CDO transactions, particularly for those CDO vehicles that include subprime mortgage-related securities in their portfolios.

Virtually all CDOs have one or more overcollateralization tests that are triggered when the CDO fails to maintain specified minimum levels of overcollateralization (the "OC tests"). The methods for calculating OC tests may vary considerably from transaction to transaction, and even within a single transaction, depending on the purpose for which the OC test is calculated. In many CDO transactions, the failure of an OC test will only result in a diversion of payments from subordinated noteholders to more senior noteholders in an effort to cure such failure.

However, certain CDOs also include an OC test failure as an EOD, thereby increasing the risk that underperforming portfolio assets will cause an EOD. This risk is amplified for CDO transactions, which include ratings-based haircuts on the CDO's portfolio as a component of the OC test EOD calculation. In the environment of widespread negative-rating migration for various asset classes, the inclusion of such haircuts in the OC test EOD calculation substantially increases the likelihood that the OC test numerator will be reduced, thereby creating a higher risk of an EOD.

Moreover, OC tests generally provide that if securities in the CDO portfolio that allow interest to be deferred or paid-in-kind ("PIK securities") defer interest beyond a specified period of time, such PIK securities will not, for purposes of computing such OC test, be valued at their par amount. Instead, such PIK securities will typically be valued in the same manner as "defaulted securities" — at the lower of their recovery amount (determined in accordance with the rating agency methodology) and their fair market value. This rule is customarily applicable to both OC tests that trigger EODs and OC tests that trigger a diversion of payments to senior noteholders.

CDOs comprised primarily of securities of other CDOs ("CDO squared") and other similar CDO products are uniquely susceptible to OC test violations. Since a CDO squared is collateralized by CDO notes and generally all but the most senior class of CDO notes constitute PIK securities, if the CDO squared collateral is backed by a portfolio with a high concentration of U.S. subprime securities, the possibility of an OC test violation in respect of such underlying CDO collateral will increase.

In the event that the OC test for the underlying CDO collateral is violated and the underlying CDO documentation calls for a diversion of interest payments to the senior

Copyright © The Deal.com – FEBRUARY 4, 2008 – LIC EXP 5/30/2008 – 100 COPIES

classes and a deferral of interest payments for the subordinated classes, this will result in the deferral of interest on the CDO squared's PIK securities. If the deferral lasts beyond the period of time specified in the CDO squared documentation, the probability of an OC test violation in the CDO squared transaction will likewise increase. Thus, an OC test failure in respect of the underlying CDO collateral may lead to a corresponding OC test failure in the CDO squared vehicle.

As these examples illustrate, it is essential that investors fully understand the nature and scope of the EODs in their CDO documentation in order to properly assess the probability that an EOD will occur.

When an EOD occurs, the underlying CDO documentation will often afford the most senior class or classes of noteholders (the "controlling class") a disproportionate influence over the collateral disposition process, potentially raising conflicts of interest between the controlling class and more subordinated noteholders.

If an EOD has occurred and is continuing, the controlling class will typically have the right to accelerate the maturity of the notes. The exercise of this acceleration right will often also trigger a reallocation of payments under the CDO's priority of payments, the most common form of which would require that after the payment of certain senior expenses, all proceeds of the CDO collateral be used to pay noteholders in full in order of seniority.

CDO documentation generally provides that if the trustee determines that the proceeds of the liquidation of the collateral will be sufficient to pay principal and interest on all classes of notes (other than the most subordinated, or "equity," class) and certain other administrative expenses, and the controlling class agrees with such determination, the trustee may liquidate the collateral pool and pay down the noteholders with the liquidation proceeds in accordance with the post-liquidation priority of payments. Since this scenario depends upon the determination that all senior notes will be paid in full, it generally should not cause a conflict of interest among senior noteholders.

In addition, CDO transaction documents generally provide that the requisite noteholders may also instruct the trustee to liquidate the CDO portfolio, irrespective of any determination that the senior notes will be paid in full. The terms of the transaction documents differ greatly regarding what constitutes the "requisite noteholders." The documentation may require that only a majority of the outstanding principal amount of each class of senior notes voting separately or as a single class may direct the liquidation of the CDO portfolio. Conflicts may, however, arise in the many CDO transactions that provide the controlling class with the right to unilaterally direct the liquidation of the collateral. As noted above, this determination may be made regardless of whether the proceeds of the liquidation will be sufficient to make the other senior noteholders whole.

In distressed market conditions, there are a number of situations where it may be advantageous for the controlling class to force a liquidation of the portfolio despite the potential negative impact of this decision on subordinated investors. Examples of such situations include the desire of the controlling class to remove a risk position from its books and instances where the controlling class is no longer receiving interest payments on its notes. Conversely, in transactions that require an affirmative vote of all classes of senior notes to effect a liquidation, subordinated noteholders may be motivated to forestall a liquidation so as to avoid locking in losses in an illiquid market.

To further exacerbate the challenges facing investors in understanding their rights and remedies following an EOD, there has been considerable discussion in recent weeks in the CDO industry regarding the proper legal interpretation of apparent conflicts between the terms of the post-acceleration priority of payments and the general subordination provisions contained in the underlying documents of certain CDO transactions. This discussion has yet to produce a clear resolution, thereby underscoring the importance of legal guidance when assessing investment risk in the CDO space. TD

Greg B. Cioffi is a partner in the New York office of law firm of Seward & Kissel LLP.

The Deal

Proprietary Rights. This article and all rights, title and interest therein, is and shall remain the exclusive property of The Deal LLC Copyright 2007 This article may not be reproduced by any means including digital or physical reproductions without the prior written consent of the publisher.