FROM CONVENTIONAL SECURITIZATION TO SYNTHETIC SECURITIZATION: DOCUMENTATION AND LEGAL ISSUES

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1. INTRODUCTION

The underlying principle of securitization is risk transfer. Conventional securitization involves transfer of income producing asset[1] to investors through a Special purpose vehicle (hereinafter: SPV). Resultantly, the investors only bear the risk of loss associated with the securitized assets and not that of the transferor/owner. Securitization technique [2] has been revolutionized by the innovation of credit derivative technology. Synthetic securitization, which uses credit derivatives, separates only credit risk of the borrower and transfers it to the investors through SPV. The rest of the risks associated with the ownership of the asset remains with the owner of the asset.[3]

Securitization, conventional or synthetic, however, has its own problems and associated risks. One of these is the legal and documentation risk. Conventional securitization involves the transfer of assets from originator (seller) to the SPV mainly through legal technique of assignment.[4] From a legal perspective, the assignment, legal or equitable, needs to be absolute,[5] commonly referred to as true sale. However, absolute assignment of receivables may get problematic, for example, due to non-assignment clauses in the agreement between the obligor (borrower) and the originator. Similarly, the terms of the agreement between the originator and the SPV, such as recourse clauses, may bear on the nature of assignment. This may result in the SPV becoming part of the bankruptcy estate of the originator or re-characterization of the transaction as a security interest, which may be void for want of registration. Moreover, there is a legal risk that the SPV may get bankrupt or it may be substantively consolidated with the originator. The true sale structure is also important from rating perspective.

Synthetic securitization is also beset with its own legal and documentation issues. Synthetic transaction, which uses credit derivatives to transfer credit risk, faces the legal risks inherent in credit derivative technology. Credit derivative contracts employ ISDA[6] documents.[7] Benefits of standardization notwithstanding, the ISDA documents do not envision synthetic structures; therefore, these are modified in

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[1] Nearly all types of income producing assets could be securitized e,g, trade receivables, credit card, loans, mortgages, hospitals, aircrafts.

[2] Also referred to as newest wrinkle of securitization, See, eg, Andreas A Jobst, 'Collaterized Loan Obligations(CLOs)- A Primer' (2003) 1-4(6) *Securitization Conduit Philadelphia* 7, 34.

[3] If he holds the asset. As discussed below, the originator, protection buyer, may not hold the reference obligation.

[4] Other legal techniques for transfer of assets are *Novation, declaration of trust, subparticipation.* However, this paper focuses on assignment only.

[5] However, in some case, securitization may be a secured transaction. Discussed below.

[6] International Swaps and derivative Association. Among credit derivatives, the focus would be on the Credit Default Risk.

[7] As discussed below the ISDA documents do not envisage synthetic securitization, these are usually modified to reflect the nature of the transaction and agreed terms. This may give rise to further legal complications.

order to reflect the negotiated terms.[8] Synthetic securitization may present legal issues, such as triggering of credit event, confidentiality of information. Depending upon the terms of the contract, the transaction may be recharacterized as insurance contract which may have its own legal implications.

This paper focuses on the legal and documentation issues[9] presented by conventional and synthetic securitizations.[10] To this end, the paper has been divided into 4 parts, with parts 2 and 3 divided into subparts. Part2 briefly discusses structure and benefits of conventional securitization. Subpart 2.1 discusses assignment of receivables and related issues; subpart 2.2 discusses bankruptcy remote SPV, with analysis of the issues of true sale, bankruptcy of SPV and substantive consolidation. The discussion is mainly in the light of the US and UK cases.

Part 3 discusses synthetic securitization, with brief discussion on legal structure and different forms of synthetic securitization. Subpart 3.1 discusses the types of credit derivatives and risk transfer mechanisms; Subpart 3.2 briefly discusses working of the ISDA documents, main conceptual issues and their use in synthetic transactions. Subpart 3.3 discusses legal issues in respect of credit events, *ultravires* transactions, confidentiality and recharacterization.

2. CONVENTIONAL SECURITIZATION: LEGAL STRUCTURE AND DRIVING FORCES

Project finance can be raised by using various legal-cum-financial techniques. It can be raised by offering equity or by contracting debt on the security[11] of assets including receivables.[12] Another way of raising finance is the sale of assets, such as goods or receivables.[13] Securitization[14] relies on this technique. It makes it possible to separate the risk associated with the receivables from the risk of the originator. Plain vanilla securitization involves the transfer of the ownership of

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[8] Being non-standardized, the negotiated terms may increase the legal risk. However, the operational mechanism of the documents remain the same. That is all the documents constitute one single agreement. See discussion below.

[9] This paper does not discuss legal issues in cross border securitization transactions and tax implications. For cross border transaction see, PAU Ali, The Law Of Secured Finance: An International Survey Of Secured Interests on personal property (2002) [ch10]. Also see, Spiros V Bazina, 'Multijurisdictional Receivables financing: UNCITRAL's impact on Securitization and Corss-border Perfection' 12 *Duke J. Comp. & Int'l L*. 365; Steven L. Schwarcz, 'The Universal Language of International Securitization' 12 *Duke J. Comp. & Int'l L* 285.

[10] The purpose is not to draw any comparison between the legal issues raised in the two forms of securitization; rather it analyses the legal risks/issues separately for each form. However, it may indirectly give a comparison of the legal issues/risks inherent in the two forms of securitization.

[11] The security interest, in common law jurisdiction, may take different forms such as legal mortgage, equitable mortgage, pledge or charge(fixed or floating).

[12] Traditional forms of borrowing expose the lender to the twin risks: (1)quality and timing of cash flows out of the investment made by borrower; (2) risk of the borrower. Thomas E Plank, The Secuirty of Securitization and the future of security, 25 *Cardozo L. Rev*. 1655, 1661.

[13] It was accepted by Dillon LJ in *Welsh Development Agency v Exfinco* [1992] BCC 270, 273, 286 while commenting in context of factoring of book debts.

[14] In this section securitization means conventional securitization.

receivables from originator to the SPV[15] for consideration which, in turn, issues securities to investors who are willing to take on the risk.[16] The securities are normally tranched in order to cater to the demands of different investors. First priority security interest in the receivables is granted to a trustee for the benefit of the investors.[17]

Securitization helps access cheap funding mainly due to separation of the risk of originator. It has other advantages as well. The originator, if a bank can get regulatory relief;[18] it frees up otherwise unproductive capital due to transfer of risk to the investors. It converts otherwise illiquid assets into a liquid form by issuing securities which can be traded in the market like any other security. Securitization also cleans the balance sheet[19] and results in better financial ratios which are vetted by the creditors/shareholders for gauging the financial health of originator. Not only this, securitization also helps diversify concentration of risks such as country specific, industry specific. No less important advantage is the management of debt equity ratio. It is because, subject to relevant tax law, if debt equity ratio exceeds a specified limit, the deduction of debt may be disallowed by taxation law which can adversely affect the after-tax earnings of originator.

Securitization also offers considerable benefits to the investors. They can diversify risk by investing in the securities issued by the SPV. Due to tranching, they can invest in high risk, low risk or their combination as per their risk appetite. Investors can have exposure to risks which they otherwise could not take on such as due to any legal impediment, legal complexities. It also offers a good way for portfolio management. Securitization makes it possible to repackage the risk and issue securities with different risk profiles[20] as per the demand of the investors, ranging from investment grade to equity tranche.[21]

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[15] The primary reason for using the SPV is that notes issued by it could be rated independently than the rating of the originator which in turn bears on the cost of funding. To this end, the SPV needs to be bankruptcy remote. This is discussed below.

[16] The transaction may involve other actors such as , credit enhancers(to provide credit enhancement to the transferred assets for better rating, liquidity provider(to overcome problem of mismatch between the cash flows and payments and servicer(to administer/manage the cash flows. It may be a third party or the originator), underwriters if securities are to be placed in capital markets, trustee who is granted first priority security interest in the assets of the SPV for the benefit of the security holders.

[17] If it is not a true sale structure. This security interest needs to be perfected. See, eg, Fitchratings, 'Rating Trade Receivable' p4 <www.fitchratings.com>. Also see See, eg, Fitchratings,'Asset backed Commercial Paper Explained',11-13 <www.fitchratings.com>.

[18] For capital relief and brief discussion on Basle accord see Antuliao N. Bomfin, *Understanding Credit Derivatives and Related Instruments (2005)*, 31-33(hereinafter: Bomfin).

[19] Securitized assets(true sale) are not shown on the balance sheet.

[20] The process of issuing securities with different risk profiles is called tranching. The payment on the securities is made on waterfall basis. That is, the senior most securities, at one end of spectrum, are paid first, and junior most securities, at the other extreme, are paid last. The losses are first adjusted against the junior most tranche and the senior most are the last to be adjusted. Each tranche is defined by attachment and detachment points.

[21] First loss tranche which is unrated.

2.1 *Assignment of securitized assets*[22]

Assignment is the most important legal technique employed in conventional securitization for transferring assets and risks associated therewith. Assignment simply means sale of asset. More precisely it is 'the immediate transfer of an existing proprietary right, vested or contingent, from the assignor to the assignee.' [23] Assignment may be legal or equitable. Former is the absolute transfer of interest in property including the legal title while the later is the transfer of equitable/beneficial interest in property without transferring the legal title.

Most of the commercial transactions including securitization involve equitable assignment of assets from originator to the SPV. It is because, in order to effect a legal assignment, subject to relevant jurisdiction, certain conditions prescribed by statute have to be fulfilled. These, among other things, include absolute assignment of proprietary rights, written instrument, and issuance of notice to the debtor.[24] The fulfillment of legal formalities render legal assignment complex; the issuance of notice to the debtor may not find favor with the originator. It may be due to, for example, restrictions incorporated in the loan agreement between the obligor (debtor) and the lender (originator); it may not be desirable as it may damage the future business relations with the obligor.[25] In addition to, this there may be stamp duty on transfer of assets (receivable). [26] Therefore, legal assignment is usually complex, inefficient and expensive. On the other hand, assignment under equity mainly requires the evidence of intention of the assignor.[27] Another important thing to note is that law only recognizes complete assignment of '*choses in action'* such as debt.[28] Equity, on the hand, recognizes assignment of part thereof[29] which may be more desirable in conventional securitization.[30] It is important to mention that equitable assignment transfers only

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[22] The discussion is in the context of the common law system.

[23] See(Australian case) Windeyer J in *Norman v FCT*(1963) 109 CLR 9, 26.

[24] See Marke Rainnes And Gabrielle Wong, Aspects Of Securitization Of Future Cash Flows Under English And Newyork Law,*12 Duke J. Comp. & Int'l L.* 453, Fn 3(hereinafter: Rainnes & Wong). also see Gerard Mccormack, Secured Credit Under English and America Law(2004), p224(hereinafter: Mccormack). The issuance of notice may not be practicable, especially when the transaction involves numerous obligors: See, eg, comments of Millet LJ in Agnew v CIR(PC) 2 AC 710, 721, [17], [18]. He also refers to equitable assignment as the most preferred way of doing business, especially due to notice requirement in legal assignment. The proceeds would be held in trust with assignor as trustee(with usually fixed charge on the book debts)

[25] see, eg, Richard Ambery Simon Bowmer "Why Don King Needs A Haircut" - Transfer And Assignment Of Contracts: How To Sell Trade Receivables Under Englishlaw' (2000) 15(9) *J.I.B.L.* 216, 216.

[26] See,eg, Paul U Ali, Credit Derivatives and Synthetic Securitization: Innovation and Fragility, 20 *B.F.L.R.* 293, foot note 17.

[27] However, under English law of property Act, equitable assignment of interest in receivable requires written agreement unlike assignment of receivable. See, Rainnes & Wong, above n 24, 455.

[28] see, eg, Micheal Evans, *Outline of equity and trusts*(3rd ed), 46.

[29] Ibid

[30]It may be desirable as the investors may require the originator to retain equity tranche of the notes issued by the SPV to cover counterparty risk and moral hazard issues.

the right to cash flow.[31] That is to say, it does not transfer the obligations set out in the agreement between the originator and the obligor.

Although the assignment under equity is efficient and less costly, it has its own vulnerabilities. Two important are: (1) if debtor/obligor pays to the assignor (originator) he would be discharged of his liability.[32] That is to say he will not have any liability towards the assignee, if he discharges it to assignor. Moreover, the assignee cannot sue the obligor in its own name.[33] (2) the rule invoked in *Dearle v Hall*.[34] As per this rule, if receivable/asset is again assigned for value by the originator to a third person, who does not have any notice of previous assignment, he may get legally valid title to asset. Of the two assignees the one who is the first to give notice to the debtor will have priority. Moreover, if subsequent assignee gets legal title to the assets without knowledge of previous assignment, his interest will prevail.

Importantly, where notice is not given, the SPV acquires the debt subject to rights of set-off available to the obligor against the originator before the assignment. [35]

Assignment of Future Receivables

Validity of the assignment of future receivables is important in respect of securitization.[36] Under English law, there cannot be any legal assignment of receivables before their existence.[37] However, equity does recognize any such assignment for value as an agreement to assign when receivables come into existence.[38] Moreover, the subject-matter must be identifiable upon coming into existence.[39] When future receivable comes into existence, the agreement to assign would become a valid assignment under equity against the assignor and its creditors.[40] The agreement would be effective not from the date of creation of the receivable but from the date of entering into agreement to assign i.e. before the receivables exists.[41]

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[31] See,eg, Ali, above n 26, foot note 17.
[32] *Brice v. Bannister 3 Q.B.D*. 569, 569 (1878)
[33] See, Mccormak, above n 24, 225, fn 62 and 63.
[34] *Dearle v Hall*(1828) 38 ER 475.
[35] In assignment where it is desired that the originator should act as servicer, notice of assignment is not given to the obligor; however, where it is intended that the SPV collects/services the debt notice is given to the assignee. See Mccomark, above n 24, 226, discussing the issue in context of factoring agreement. In the case of an assignment of a debt, the assignee takes subject to all rights of set-off and other defences which were available against the assignor, but only those existing when the debtor receives notice of the assignment.
[36] For example, expected export proceeds or trade receivables on revolving basis. See Rainnes &Wong, above n 24, 455-6.
[37] See, Evans, above n 28, 63-4. Also see, Rosaleen Manzi, Legal Considerations For CDO Transactions' (2002) 5(1-4) *Securitization Conduit* Philadelphia 82,
[38] Evans, above n 28, 64. *Norman v FCT*(1963) 109 CLR.
[39] Mccormack, above n 24, 224.
[40] See Rainnes & Wong, above n 24, 455-6. Also see Evans, above n 28, 64.
[41] Subject to qualifications, Rainnes & Wong, above n 24, 455-6, Foot notes,6,7 (see Tailby v. Official Receiver, 13 App. Cas. 523, 523 (H.L. 1888)) The proprietary rights would come into existence only when property is acquired by the assignor; before this assignor would be having only contractual rights. Julie K Maxton, Negative Pledge and Equitable Principles (Sep1993) *JBL* 458, 462-3.Also see

Anti-Assignment and Negative Pledge Clauses

Another important legal aspect to be taken note of is the presence of anti-assignment clauses in the agreement between the originator and obligor. It is because assignment of receivables in violation of anti-assignment clauses my render the assignment ineffective under the relevant law. For example the House of Lords, in Linden Garden Trust v Lenesta Sludge Disposal Ltd.,[42] declared the assignment in breach of anti-assignment clauses ineffective.[43] However, the exact effect of such clauses is a matter of construction of the terms of the contract.[44] Under article 9 of the US UCC assignment of receivables in breach of such an agreement is likely to be effective.[45]

As far as negative pledge clauses[46] are concerned, breach thereof is not likely to affect the assignment of the receivables under English law. However, the affected party may sue for contractual claims. Again, if the assignor enters into assignment agreement with the knowledge of negative pledge clause, he may be liable for to the beneficiary for inducing or assisting the breach; he may incur a tortuous personal liability.[47] However, the proprietary rights of the assignee

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comments of US District Court in *Bruice Goldstein v Madison National Bank of Washington DC* 89 BR 274 1988 US District(Lexis 15385). The agreement provided for the part assignment of the future receivables. The court commented, p275, that absolute assignment of part of the receivable enforceable from the date of execution of contract while if assignment gives rise to security interest, it would be effective when funds are received.

[42] [1993] 3 All ER 417.

[43] See, eg. Mccormack, 'debts and nonassignment clauses' (2000) JBL 421, 430-33. The assignor could not sue the obligor for want of validity of the assignment. However, despite anti-assignment clauses, securitization transactions usually involve the assignment of the proceeds to the SPV. These transactions rely on the principle that the proceeds of the contract are a different property from the contract itself(principle invoked in *Re Turcan* (1888) 40 CH D. 5 CA). Importantly, under such structure, no legal rights under the contract between the originator and obligor are transferred to the SPV, it is only the right to proceeds which arises only when the originator receives proceeds from the obligor. There is no privity of contract between the SPV and the obligor and the former cannot, directly or indirectly, sue the latter for any default or breach. In such transactions risks and rewards of contracts are not passed to the SPV. See Ambery and Bowmer, above n 25, 217-8. Also see it for various options to transfer the rights in choses in action if assignment thereof is prohibited.

[44] Lord Browne Wilkinson, *Linden gardens v Lenesta Sludge* [1993] 3 All ER, 416, 429. Also see, Queen's Bench Decision in *Circuit Systems Ltd And Basten V Zuken-Redac* (Uk Ltd(Formerly Racal-Redac (Uk) Ltd**)** *42 Con LR 120, (1995)(Lexis)*. See comments of Judge Richard Harvey QC referring to Lord Browne Wilkinson in Linden Gardens that prohibition on assignment is a matter of contruction that 'it is clear from the Linden Gardens Trust Ltd case that an assignment of contractual rights in breach of a prohibition against such assignment is ineffective to vest the contractual rights in the assignee. Also see *Don King Productions Inc v Warren and others* [1999] 2 All ER 218, Assignment may give rise to a resulting trust with assignor holding choses in action for the benefit of the assignee.

[45] see9-406(d) Clause d(1) renders ineffective to the extent the loan agreement contains, among other things, stipulation requiring consent of obligor for assignment; Clause d(2) of the article render among other things, ineffective to the extent assignment gives rise to breach. For indepth analysis of the affects of the scope of article 9 and securitization see, Lois R Lupica, 'revised article 9, Securitization and Bankruptcy Dynamics' (2001)9 *Am. Bankr. Inst. L rev* 287

[46] Negative pledges are usually incorporated not by the debtor, but by a third party such as creditor of the originator. It is protect its own security interest.

[47] See Mccormack, above n 24, p232. Also see A. Mc Knight, Restrictions on Dealing Wit Assets in Financing Documents: Their Role Meaning and Effect' [2002] *JIBL* 193, 201. Being unsecured

would not be affected as negative pledge clause does not give rise to any proprietary interest over the assignor's present or future assets.[48]

In the US, Article 9-401(b) deals with the Alienability of debtor's rights. It stipulates that transfer of debtor's rights would be effective despite prohibition in the agreement between the debtor and the secured party. However, debtor may be held responsible for the breach to the secured party.[49]

2.2 *Bankruptcy Remote SPV*

It is always important to ensure that the SPV is bankruptcy remote.[50] The primary reason is that if the SPV is not structured as a bankruptcy remote entity, there is likelihood of its becoming the part of the bankruptcy estate of the originator.[51]It is worth-mentioning that the term bankruptcy remote does not mean bankruptcy of proof. It is because no business entity can be bankruptcy proof.[52] Being bankruptcy remote SPV requires to: (1) protect the assets of the SPV from becoming the part of the estate of the originator upon its bankruptcy (true sale);[53] (2) minimizing the chances of bankruptcy of the SPV[54] by restricting its activities;[55] (3) avoid consolidated Bankruptcy.

2.2.1 *True Sale of securitized assets*[56]

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creditor the convenantee would have no direct claim against the third party. As far as tortious claim is concerned, the covenantee would have to prove that it had suffered an actual loss due to breach. Also see US case *Wyoming Bank v Mudge* (1988) 748 p 2d 713(Lexis). At p 715, the court remarked that 'It is well established in Wyoming that the elements of a claim of tortious interference with a contract that the plaintiff must prove are: (1) the existence of the contract; (2) the defendant's knowledge; (3) intentional and improper interference inducing or causing a breach; and (4) resulting damages.' It was also remarked by the court, p717, that if the interference is in good faith and bonafide, it would not give rise to any tortious liability.

[48] It does not create a charge. Maccormack, above n 24, 232.

[49] However, the SPV(investors) may risk tortuious action if it is proved that it was having knowledge.

[50] This separates the asset risk from the risk of the originator. Other legal issues which need be taken care of is Fradulent conveyance under the relevant law. This issue may crop up, eg, if originator transfers assets in order to defeat the claim of any creditor or it is on the verge of bankruptcy. See, eg, Patrick C Sargent, Structural And Legal Issues In Commercial Mortgage Securitization Transactions 23-*NOV Corp. Couns. Rev*. 241, 249.

[T]In addition, the securities issued by it would not usually get credit rating better than that of the originator. It may defeat the purpose of reducing the cost of funds See, eg, Sandard and Poors, Guide to Legal Issues in Rating Australian Securitization, p15, www.standardandpoors.com.(hereinafter S&P Australia). If the SPV is not bankruptcy remote, it is could not be rated more than the entity it is dependednt on. This is referred to as weak linking. P16. Also see,eg,, Fitch, Global Rating Criteria for Collaterized Debt Obligations, (September 2004) p23, www.fitchcdx.com.

[52] See, eg, S& P, Australia above n 51. Also see, Sheryl A. Gussett, Bankrucptcy Remote Entities in Structured Financing'*15-2(march 1996) ABIJ 14*.

[53] Also termed as involuntary bankruptcy, see, eg, Schwarz, below n 54, 3-21. Also see the committee, below n 55, 553.

[54] Also termed as voluntary bankruptcy. See, eg, Steven L. Schwarcz, *Structured Finance: A Guide To The Principles Of Asset Securitization* (3rd Ed), 3-2(hereinafter: Schwarz)

[55] The committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of NewYork, 'Structured Financing Techniques' *50 Bus Law* 527, footnote 80.(hereinafter: the committee)

[56] Securitization may involve secured loan transaction instead of true sale. However, in this case, securities issued by the investors can have higher rating(higher than that of originator) only in

As already mentioned securitization of receivables involves transfer of assets from originator to the SPV. The assignment, legal or equitable, of receivable/assets, which transfers all the economic benefits and risks associated with the ownership, is usually termed true sale.[57] True sale is also important from recharaterization and rating perspectives.[58] It is important to note that there is no bright line test which could determine the issue of true sale. It simply depends on the facts and nature of contract in a particular case. There are various court rulings, both US and UK, which give an idea about the outer limits of the concept of true sale.[59] Importantly, courts take into account various factors; however, none of the factors is by itself determinative of the issue.[60] The main factors which are taken into account by the courts are as under:

Degree of Recourse/Risk of Loss

Recourse granted to the SPV against the originator does not necessarily affect the true sale character of the transaction. It all depends on whether the presence of recourse bears on the risk associated with the ownership of the asset.[61] If the nature of recourse is such that the SPV[62] could call for indemnification/compensation in case of loss, irrespective of the form, there would be potential likelihood of the transaction going out of the ambit of true sale.[63]

US case of Major's Furniture Mart v Castle Credit Corp,[64] provides useful guidance. Major Furniture, the seller of accounts, guaranteed the quality, timely collection and legality of the accounts, subject matter of the transaction.[65]

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limited circumstances, eg, originator is single business entity, quantum of liquidity support. First priority security interest must be granted to the SPV over the underlying assets of the originator. In order to reduce risk of true control a first-priority fixed charge over all the present and future assets of the originator may be granted to the SPV. If it is a registrable security interest. See, eg, S & P, above n 51, p16-19, www.standardandpoors.com Also see, Standard and Poor's, Legal Criteria for US structured Finance Transactions, [Ch2] www.standardandpoors.com(hereinafter S & P, Legal Criteria). It does not require true sale structure for SPEs such as municipalities, FDIC-insured banks.

[57] It is argued that the term is misleading as the transfer of receivables may be a sale for accounting purpose or tax purpose but may not be a sale for bankruptcy purposes. See also Schwarz, above n 54, 4-2. Also see,Rosaleen Manzi, Legal Considerations For CDO Transactions, *Securitization Conduit Philadelphia* (2002) 5(1-4)82. Most of the balance sheet CDOs (involving FDIC-insured banks or US branches of foreign banks) rated by standard and poor have been structured as participations wherein S & P only requires the creation of valid perfected security interest. However, in respect of non-FDIC-insured banks true sale opinion must be obtained.

[58] Discussed below. Implications of recharacterization also depends on the relevant jurisdiction. If it is not a true sale, the rating assigned to the securities is likely to be affected.

[59] Schwarcz, *above n 54*, p4-5

[60] See, eg, comments of the Court of Appeal in Orion *Finance Ltd. V Crown Financial Management Ltd*. [1996] BCC 621. *Unhappily there is no single objective criterion by which it is possible to determine whether a transaction is one of sale and repurchase or security*

[61] ibid

[62] That is the investors.

[63] for a list of recourses which are usually inserted in such agreements see, The committee, above n 55, 543-4

[64] *Major's Furniture Mart v. Castle Credit Corp*., 449 F. Supp 538 (E.D.P.A. 1978), 602 F.2d 538(3d Cir. 1979)

[65] The case is important in that the assignor contended that the transaction was nothing more than security interest while the purchaser argued it a true sale. The dispute between the parties arose as

Moreover, the agreement also contained a provision regarding indemnification to buyer in the event of loss and repurchase of account.[66] The court refused to treat the transaction as true sale on the ground that all the risk was contracted to be borne by the seller (assignor).[67] It is, however, important to note that presence of guarantee in respect of quality, collect-ability and legality of account[68] or promise to indemnify SPV, in the event of breach of any limited warranty, would not likely to effect the true sale of the assets.[69] On the other hand, recourse e.g. in the form of a put option with a fixed strike price and date without accounting for the performance of the underlying asset may result in re-characterization.[70]

In English case *Llyods & Scottish Finance v Cyril Lord Carpet Sales*,[71] the obligations of the assignor were guaranteed by its parent(Cyril Lord Ltd.). Nonetheless, the House of Lords upheld the transaction as sale of receivables rather than a debt arrangement.[72] In the *Welsh Development Agency v Exfinco*(hereinafter: Exfinco),[73] among other things, the agreement granted recourse to the Exfinco,[74] the buyer, in the event of loss, damages etc as a result of breach or failure by the exporter, seller, to comply with any of the conditions/warranties set out in the master agreement.[75] Dillon LJ,[76]commented that the transaction was a sale, rather than a charge; it is despite the fact that the purchase had recourse against the seller in the case of default in payment of debt by the debtor. What is important is to distinguish between recourse in the case of default by the obligor and the recourse in the event of loss. The former seems not to affect true sale while the latter is likely to affect it.

In securitization, it is not uncommon to provide internal credit enhancement. This is done to satisfy the investors[77] or to get better rating for the securities issued by

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to the claim to surplus out of the receivables. The assignor laid claim to the surplus on the ground of transaction being security arrangement.

[66] See Major's Furnitue Mart 602 F.2d 538, 540-2. Facts explained.

[67] See comment of court In *Major Furniture Mart* 602 F.2d 538, 545

[68] See comments of the court at 545. Aslo see Schwarcz, *above n 54*, p4-7, foot note 14, Schwarcz maintains that ' *such warranties be no different than warranties ordinarily given by the seller of a product.*' Also see The committee, above n55, p 545-6.

[69] Schwarcz, ibid. p4-8.

[70] The committee, above n 55, 543. Also see Mccormack, above n 24, 226.

[71] [1992] BCLC 609.

[72] This was one of the factors considered by the House of Lords. Commenting on guarantee, Lord Wilberforce observed that "In the present case, the fact that the purchasers wanted guarantees, or security, or reserves to ensure that they received the whole of what they had brought, cannot convert a transaction of purchase into one of charge". It is important to net that the Uk courts start analysis, in case of sale v charge, by first examining whether the trasaction is a sham. This methodology was followed in the Exfinco and Orion finance. Also, see, Fidelis Oditah, 'Financing Trade Credit: Welsh Development Agency V Exfinco' (Nov1992) *Jb.L.* 541.

[73] *Welsh Development Agency v Exfinco* [1992] BCC 270

[74] *Welsh Development Agency v Exfinco* [1992] BCC 270

[75]*Welsh Development Agency v Exfinco* [1992] BCC 270 Cl 10 of the agreement,

[76] Dillon LJ, [1992] BCC 270, 273 referring to Re *George Inglefield Ltd* (1888) 13 App.Cas. 554, and *Lloyds and Scottish Finance Ltd* [1992] BCLC 609

[77] It may be due to the issue of moral hazard.

the SPV. It, among other things, involves creation of senior subordinated securities which are first to absorb any loss and paid after the claims of the holders of senior securities are satisfied. The subordinated securities may be held by an associate of originator.[78] In order to stave off recharacterization, it is important that the associate would not be substantively consolidated with the originator. Another possibility is that subordinated securities may be held by the originator itself. It may bear on the true sale character of the transaction.[79]

Retained Rights and Rights to Surplus

The simple rule is that the originator should not retain any ownership rights.[80] However, the agreement for the assignment of receivables may grant repurchase option, *reverter*, to the originator. Again the presence of this right does not by itself is sufficient to raise the issue of characterization. However, absence of this right is likely to support the true sale nature of the transaction.[81]

Recent US cases show that the return of surplus to the originator may be accepted as part of true sale agreement and not a secured loan.[82] It is on the basis of what is termed as theory of Binary Recourse.[83] This has been approved on the ground of sale of only part of a receivable. In such a scenario, lender is entitled to collect only part of the debt covered by the sale price. The remaining, being outside the sale transaction, should either be returned back to the originator or paid for. This is not very different from equitable assignment of the part of the debt. The reason for its acceptance is that both the originator and the SPV are exposed to risks. The SPV is exposed to the risk associated with that part of the debt which is contracted for sale. The originator, on the other hand, is exposed to the risk to the extent of the surplus. Importantly, this is different from the right of redemption.[84]

The situation under English Law is no different. The option to repurchase the asset, granted to the originator, does not invalidate true sale treatment, provided the contract does not create debtor/creditor relationship between the originator

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[78] The committee, above n55,549-550. The credit enhancement may be external, eg, financial guarantees, letter f credit by banks, cash collateral, subordinate loans from third parties. See structured finance.

[79] See, Schwarz, , above n 54, 2-18. Also see the committee, above n 55 foot note 64,p 550. It is a mater of degree. However, it can be defended on the ground of economic loss and benefits. As in case of economic benefit, it would not exclusively go to the investors. Originator would claim the economic benefit in accordance with the size and the interest rate offered on subordinated securities.

[80] The committee, above n 55,547

[81] Schwarcz, , above n 54, 4-8.

[82] Initial US case laws suggest that the originator's right to any surplus, over and above the agreed return to the SPV is not likely to be treated a true sale. For example in *Evergreen Valley Resort Inc*. 23 B.R.659, the bankruptcy court held that the assignment of amount in excess of the transaction amount created security interest and not sale

[83] See Schwarz, , above n 54, 4-29. Also see *Goldstein v Madison Nat'l Bank*, 89 B.R. 274(DC 1988). The case involved assignment of a portion, $200000, of the future receivables, $1000000. Also see decision of Court of appeals 807 F.2d 1070(D.C. 1986)(Lexis 36387), especially remarks at p1074.

[84] Schwarcz, , above n 54, 4-31. Right of redemption is indicative of a secured transaction which is different from the part sale.

and SPV. Moreover, it has been asserted that even if originator is under obligation to repurchase, it will not imperil the true sale nature of the transaction.[85] For example in Exfinco,[86] the contract contained a reverter clause which granted right of repurchase to the seller (Parot), similar to equity of redemption.[87] Nonetheless, the Court of Appeal refused to characterize the transaction as a loan arrangement.[88] It has been contended that 'Reverter or relinquishment clauses are necessary to ensure that the financier does not receive more than the value of the assets purchased, be these goods or receivables.[89] Originator simply has subrogation rights to ensure that the SPV does not get more than the fair market value of the asset transferred.[90] Another reason seems to be that the SPV and originator have a real risk of loss and gain despite the reverter clause.

Pricing of Interest Assigned

The fixed or adjustable nature of the purchase price may affect the nature of true sale. If price is fixed at the outset without any adjustment for subsequent changes such as interest rates,[91] losses, it is likely to be treated as a true sale; however, if the contract provides for the adjustments in the price based on changes in interest rates it may affect the legal nature of the transaction.[92]

The English Court of appeal took a more liberal view when it discussed the issue of discount in Exfinco,[93] wherein the purchase price was fixed by discounting the export price.[94] The issue got complicated as the actual price to be paid by the buyer (exfinco) was to be adjusted from time to time based on the actual credit period granted to the overseas importers.[95] Dillon LJ commented that '*But even if the adjustments in line with actuality are made from day to day*[96] *that does not negate the transaction being one of sale and purchase'*.[97] Similarly the mode of payment may be determinative of the character of the transaction. For

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[85] Oditah, above n 72, 541-569. The author refers to the comments of lord *Cranworth inAnderson v White* (1858) 2 De G. & J. 97.

[86] *Welsh Development Agency v.* ***Exfinco*** [1992] B.C.C. 270. Dillon LJ commented :" As for the right of retention, that does not… differ in substance from the 25 % reserve and "topping process'. There is nothing in these matters…to negate the transaction being one of sale and purchase."

[87] Also see *orion Finance* for discussion on right of redemption in financial transactions.

[88] Oditah, above n 72, 541-569. Similar position was taken by the court in *Re George Inglefield Ltd* (1888) 13 App.Cas. Oditah, 554.

[89] Oditah, above n 72, 541-569

[90] See, Ibid.

[91] Schwarcz, above n 54, 4-9

[92] Ibid, 4-9. Cf the comments of Lord Millet J in Orion finance. There was a limited liability provision which provided for changes in price with changes in the interest rates.

[93] *Welsh Development Agency v Exfinco* [1992] BCC 270

[94] See, Oditah above n 72.

[95] i.e. credit period granted by the exporter(Parrot) See, Oditah above n 72.

[96] referring to interest rates.

[97] *Welsh development Agency v* Exfinco [1992] BCC 270, 284.

example, if the originator receives consideration in the form of subordinated note, it is not likely to be treated as a true sale.[98]

Intention of Parties and Post Transfer Control

The intentions of the parties, originator and the SPV must be truly reflected in the agreement.[99] It must not provide for any sort of security arrangement or prohibit the free transferability of the assets by the SPV.[100] For example the SPV should not be prevented from encumbering the assets.

Administration and Servicing

Assets transferred to the SPV require continuous monitoring, recording and administration. It is not uncommon for the seller,[101] usually termed as seller servicer,[102] to provide these services to the SPV. To this end, it is important that the seller servicer or its associate acting as servicer must contract for arm's length servicing fees.[103]Moreover, in order to avoid any doubt, it is important that the employees of the servicer doing monitoring and administration must keep separate books, accounts and record transactions in the name of the SPV.[104] The servicer should act like a true agent and SPV must have the power to replace it with a third party, especially in the event of unsatisfactory performance. Importantly, the agency relationship needs be properly documented.[105]

Commingling Issue

Commingling becomes an important issue for the SPV in the case of seller-servicer.[106] It arises when servicer/originator is allowed to mix the funds arising out of the assets with its own cash. For example seller may use its own account for depositing such funds. If before repatriation of funds to the SPV, originator goes bankrupt, they may become the part its bankruptcy estate.[107] The funds in

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[98] Payment conditioned on the actual collection by the SPV is not likely to be a true sale. See, eg, Sandard and Poors, Legal Criteria for US structure finance transactions Apendix 1, p 170(hereinafter: S&P, US), <www.standardandpoors.com>

[99] The committee, Structured finance above n 55, 548

[100] Ibid.

[101] Ibid

[102] Ibid

[103] Ibid

[104] Ibid

[105] Ibid, 552

[106]Commingling risk also bears on the rating. It is because presence of commingling gives rise to two risks: (1) risk of the originator/seriver (2) risk of the bank wherein the account of the originator/servicer is held. See, eg, Fitchratings, 'Commingling Risk in Structured Finance Transactions: Seriver and Bank Account Criteria' <www.fitchratings.com> . Also see eg, 'Asset backed Commercial Paper Explained', 11-13, <www.fitchratings.com>. See S&P, Australia above n 51, p29-31. Another issue that may arise is the set-off risk. It may include payee set-off or account bank set-off.

[107] In US case *Re Bullion reserve of North America* 836 F.2d 1214., the US court of Appeals, affirming the decision of district court, 1217(9th Cir. 1988) observed that bullion purchased out of commingled bank account, becomes part of the debtor's estate. It could not be traced to any particular creditor due to commingled bank account. See, also, Foot note 3 in the judgment. Also see *Henderson V Alfred(re Western World Funding Inc*.) 54 B.R. 470, 475. Constructive trust could not be allowed due to lack of tracing.

originator's account are the property of the debtor.[108] What is required is that these funds must be identifiable in the hands of the seller-servicer.[109] This can be achieved, for example, by opening separate account in the name of the SPV or using lock box accounts kept for the benefit of the SPV or trustee for the investors.[110]

Implications of Recharaterization

It is important to note that if the assignment of receivables is a true sale it may not required to be registered under the relevant law.[111] However, in a secured transaction,[112] the security interest needs to be registered under the relevant law. For example s 396 of the Companies Act 1985 requires that the security interest needs to be registered[113] in order to be enforceable. Therefore, if a transaction designed as a true sale is recharacterized as security arrangement by the courts, it would be void against the creditors as well as trustee in bankruptcy of the originator for want of registration.[114] On the other hand, in the US, sale of receivable, whether it is a true sale or a secured transaction,[115] comes within the ambit of article 9 of the UCC. However, article 9 sets out that sale of receivables would automatically perfect upon *attachment*.[116] That is to say, the automatic perfection rule eliminates the filing requirement.

2.2.2. *Bankruptcy of SPV*

Conventional securitization also requires that the chances of bankruptcy of the SPV should be minimized. This can be achieved in a number of ways. First is by restricting the activities of the SPV. For example, SPV may be legally restricted from contracting loans due to provisions in the constituent document of the SPV.[117] However, there have to be certain exceptions. It includes, for example, liquidity provider/credit enhancement (external). Importantly, new debt should be structurally subordinated to the rated securities.[118]

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[108] *re bullion Reserve of North America*836 F.2d 1214.

[109] The committee, Structured Finance above n55, 553.

[110] Ibid.

[111] For example, Outright sale of receivables is outside the UK Company Law. See Mccormak above n 24, 225.

[112] That is assignment is not absolute.

[113] If it is a registrable security interest. See, eg, S&P, Australia above n 51.

[114] Also see comment of LJ Dillon in Exfinco, 271. Registration under English law does not determine priority. It only makes a security interest enforceable.

[115] Cari Eherlich, 'Nevada's Failure To Secure Its Future: An Analysis Of The Omission Of U.C.C. § 9-318(A) And Its Effect On Asset Securitization' Waters 3 *Nev. L.J.* 115, 125-6(the article initially discussed article 9 and then its relevance to Nevada state). Also see Mccormack above n 24, 245-247. Also see, S&P, Australia above n 51, p16-19. S 9-309.

[116] A security interest is attached when it gets enforceable between the creditor and debtor while it is perfected by filing whereby the interest becomes enforceable against third parties. The first to perfect has ffirst priority. See Mccormack above n 24, p73.

[117] The committee above n *55, 554*

[118] Subordinated creditors would have less incentive to press for bankruptcy. Capacity to contract new debt is taken into account for ascertaining the rating of the securities. For detailed discussion, see, eg, S&P, Australian above n 5, p17. This report also specifies alternative mechanics of the new debt.

Similarly, SPV may be prevented from undertaking any business apart from those necessary to administer, monitor or execute its activities as to the receivables.[119] To this end, restrictive clauses are incorporated in the constituent documents[120] or the transaction documents. [121] Furthermore, constituent documents may prohibit mergers or selling of assets,[122] provided the relevant jurisdiction does not restrict or forbids doing so.[123]

In order to protect the SPV from the claims of the creditors and the consequent bankruptcy, restrictions on granting lien over the assets of the SPV may be incorporated in the constituent documents. [124] It can also be achieved by granting first ranking security interest[125] over all assets of the SPV, including the shares, to the holders of rated securities.[126]

The chances of voluntary bankruptcy of the SPV against the wishes of the investors may be minimized by corporate governance.[127] It may not be legally allowed to altogether prohibit the SPV from filing bankruptcy. [128] However, constituent documents may limit the circumstances[129] under which SPV may file bankruptcy. This is also achieved by prescribing the appointment of independent directors having fiduciary duties to the investors.[130] In addition, it may condition the filing of the bankruptcy to the approval of an independent director.[131] Another way of limiting the chances of voluntary bankruptcy is to issue certain classes of voting stocks to the investors. The decision to file for bankruptcy may be conditioned on the approval of the investors holding that stock.[132] It does not seem unjustified on the ground that it is the investors who are the major stake holders. The same result can also be achieved issuing limited stock to a third unrelated party together with super majority voting rights.[133]

2.2.3 *Substantive Consolidation*

In substantive consolidation[134] assets of both the originator and the transferee SPV are consolidated and the creditors of both the entities acquire claim against

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[119] See, eg, S&P, Australian above n 51, p9.
[120] Referred to constitutional restrictions. Ibid, p15.
[121] Referred to as contractual restrictions. Ibid.
[122] Also Ibid, p9.
[123] see the committee, above n 51, footnote 79.
[124] Ibid, 555.It may allow for lien in pursuance of its business activities, eg, lien in favour of liquidity provider.
[125] It needs to be perfected as per the legal requirements of the relevant jurisdiction.
[126] This minimizes incentive for filing bankruptcy. Also See, S&P, Australia, p10.
[127] The same purpose can be achieved by using orphan SPV.
[128] See the committee, above n 55,556
[129] see Schwarz, above n54 3-3.
[130] S&P, Australia, above n 51, p9.
[131] Schwarz, , 3-3, an independent director may be a person who is not the director of associate of the director of the parent or any of its related parties, officer, employee of the originator etc.
[132] Ibid, 3-12. Also see the committee, above n 55, 557.
[133] The committee, above n 55, 557.
[134] This factor is also taken into account for raking purposes by the rating agencies, eg, see Fitch, Global Rating above n 51, p23.

the resulting common pool of assets.[135] This is a judicial discretion. Courts pierce the corporate veil only when it is considered equitable to consolidate the two entities. Before piercing the veil, courts take into account the nature of relations between the entities and creditors and likely effect of consolidation on the (creditors) investors.[136] This depends on the facts of a particular case such as consolidated financial statements, commingling of assets and business activities,[137] unified assets, same office, SPV managed by the employees of the originator, 'relationships among the SPV, originator and the creditors', possession and control of the SPV's assets, securitization of assets which form the core of the business of the originator and could not be separated.[138] In order to avoid consolidation, the entities usually execute a separateness covenant.[139]

3. Synthetic Securitization

Synthetic securitization is a revolutionary financial innovation. It involves the use of credit derivative technology[140] to pass on the credit risk. A typical Synthetic securitization[141] transaction involves two steps: (1) a credit derivative agreement between protection buyer, sponsor/originator, and the protection seller, the bankruptcy remote SPV,[142] for the transfer of credit risk of the reference entity, the obligor; (2) the transfer of credit risk by the SPV to the investors, usually by issuing credit linked notes (hereinafter: CLNs)[143] with embedded credit derivative.

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[135] The committee, above n 55, 567.

[136] Ibid, 559-60. Also see, Schwarz, above n 54, 3-23.

[137] Schwarz, above n 54, 3-23

[138] Ibid, 561-2. Days Inn In re Buckhead Am. Corp., Nos. 91-978 to 91-986 (Bankr. D. Del. filed Sept. 27, 1991). The core assets in Day inn included include the trade marks, licensing fees, goodwill See Ibid ,p 561-2, footnote 105. 'The facts of the case, as presented by the court in the findings used to support its order of substantive consolidation, included commingled bank accounts, payment of all debtors' expenses from one joint account, reliance by creditors on the unified assets of all debtors and interrelationships among the debtors that were so entangled that attempts to untangle them would cause undue delay and expense'

[139] Also see, eg, S&P, Australia, p10.

[140] Mainly the Credit Default swap.

[141] SPV is nothing more than a conduit as in conventional secuitization. See, eg, BISTRO, broad Index Secured Trust Offering, transaction, undertaken by JP Morgan in December 1997. The notional value of the Credit Default Swap was US$9.72 billion to hedge credit exposure to its corporate customers. The vale of the credit notes issued by the SPV, BISTRO, were US$697millions. For details of this transaction see, Satyajit Das, *Credit Derivatives, CDOs And Structured Credit Products* (3rd ed, 2005)(hereinafter: Das), p328 through 36. For examples of Synthetic securitization also see Basel Committee on Banking Supervision, Consultative Document, Asset Securitization, 2001 <www,bis.org>.

[142] As discussed above. The reason for using the SPV is that the Clns issued by it could get rating independent of the rating of the protection buyer/sponsor. See, eg, Elizabeth Uwaifo, 'Key Issues In Structuring A Synthetic Securitisation Transaction - A European Perspective' (2001) 16(4) *J.I.B.L* 98, 100(hereinafter:Uwaifo). For non-SPV structures see, HAUS 2000-2 transaction undertaken by Duetche Bank AG, p 100.

[143]CLNSs are, in-effect, the securities with embedded credit derivative. These are typically used in combination with other credit derivatives.. These are chiefly used to fund derivative/securitization transactions. They are also important in that they convert illiquid assets and derivative transactions into liquid securities which can be freely traded in the market. Clns are also used to cater to the varying demands of the investors or protection buyers by tranching credit risk. They help repackage the risk and distribute among the investors as per their risk appetite. Investors, who cannot directly enter into credit derivative transaction due to the legal complexities or legal impediments, may prefer to invest in the CLns. As Clns have embedded credit derivative, the pay-

It reflects the nature and the extent of the risk assumed by the SPV through Credit derivative.[144] Importantly, the protection payment by the SPV to the protection buyer is contractually senior to the payments on the CLNs.[145]

Synthetic securitization may be *funded, unfunded* or *partially funded*. In case of the funded one, CLNs are issued to the investors in return for upfront payment. The proceeds of the notes are invested in highly rate bonds or securities.[146] The interest payment to the investors is made out of the periodic payments received from the protection buyer and the pool of securities[147] until a credit event happens or the maturity of credit derivative, as the case may be. On the occurrence of credit event, protection buyer is paid out of the collateral and the balance, if any, is paid to the investors.[148] It is important to mention that the security interest of protection buyer in the collateral has priority over that of the investors. In case of unfunded synthetic securitization, investors are only called upon to make contingent payment upon the happening of credit event.[149] In partially funded structures,[150] credit linked notes accounting for only 5% to 15% of the notional amount of reference obligation[151] are issued.[152] To hedge the remaining exposure, protection buyer usually enters into a Credit derivative agreement, called super senior swap with a third party.[153] It is important to mention that the holders of securities, issued by the SPV, are contractually subordinated to the super senior investor (party).[154]

Synthetic securitization may be classified as static or dynamic/managed. In the former the pool of the reference obligations remain unchanged throughout the period of the transaction. Static structures are legally simple and less costly. In dynamic/managed synthetic securitization,[155]which are legally complicated and costly, the portfolio of reference obligations is actively managed by a

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off thereon depends on the credit quality of the reference obligation and the credit events set out in the credit derivative agreement. If any credit event happens it directly affects the cash flow on the Clns. Importantly, Clns may be issued privately or publicly.

[144] See, eg, BISTRO, Das above n 141, 328-36.

[145] See, eg, fitchratings, Counter party Risk in Structured finance Transactions P 7, <www.fitchratings.com>

[146] Usually government securities.

[147] See, eg, Nomura, CDOs in Plain English p5, <www.securitization.com> .

[148] See, Nomura, CDOs in Plain English.

[149] The investors are paid out of the periodic payments made by the protection buyer. Therefore, the interest rate paid on the unfunded transactions is usually less than in the funded ones.

[150] The partially funded structures are gaining ground Ali, 20 BFLR 293, 304

[151] See Ali, above n 26, 304.

[152] See a Partially funded synthetic CDO structure in Nomura, CDOs in Plain English, p6. The SPV and resultantly the investors hedge only a small portion of the total credit exposure.

[153] The periodic payments paid in this second CDS are normally lesser due to the buffer provided by the holders of notes. This structure is preferred to the fully funded structure due to easy placement of securities, less interest payments and servicing of securities. Ali, above n 26, 304. Bistro tansaction(Das, above n 141) was a partially funded, with JP Morgan retaining the super senior risk.

[154] That is to say, the super senior, usually monoline insurer or OECD bank, is required to make payment only if the value of default exceeds the value of the funded portion. Nomura, CDOs in Plain English, p6.

[155] See Paul Ali And Jan Job, *Synthetic, Insurance And Hedge Funds Securitization* (Law Book Co. 2004)(hereinafter Ali &Job), [ch 4].

manager.[156] To this end, the protection buyer has the option to add/remove reference obligations during the ramp-up period.[157] However, he has to give a written notice[158] to the seller setting out the nature of the new obligations which must meet the eligibility test[159] originally agreed between the parties.[160]

Synthetic securitization may be either balance sheet securitization or arbitrage securitization. Balance sheet securitization[161] is undertaken with the purpose of obtaining regulatory capital relief; while arbitrage securitization[162] is undertaken with the motive of exploiting difference between the returns on assets and the payments on the securities issued by the SPV.[163]

3.1 *Credit Derivatives, Types and Mechanics of Risk Transfer*

An asset has various attributes. It is considered a bundle of rights and risks.[164] Financial engineering, with the help of derivative technology, has made it possible to strip these risks, rights and attributes from the ownership of an asset, with the result that the asset may be held/owned by one entity and the risks, rights or attributes held by a different entity/entities. Credit risk is one of the attributes associated with an asset. Credit risk includes credit default risk, down grade risk and credit spread risks.[165] Credit derivatives[166] help detach credit risk of the issuer from the asset[167] and transfer to the investors who have appetite for such risk.

The purpose of stripping the credit risk may be the replication, transfer or hedging of credit risk.[168] Credit derivatives may also be used for speculating on the credit quality of an entity. Credit derivatives are special in that they transfer the credit risk of the obligor without transferring legal title thereto. In this way, the protection sellers/investors are able to reap the economic benefits associated

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[156] On behalf of the protection buyer.
[157] See Steven Edwards, 'the Law of Credit Derivatives' (Nov 2004) *J.B.L.* 617(hereinafter: Edwards, credit Derivatives), 644-5.
[158] Ibid, 645.
[159] Ibid.
[160] The purpose of incorporating eligibility criteria is to enable seller monitor the risk implications of the additions/removals Edwards, Credit Derivatives, 645.
[161] Balance sheet transactions are usually static. See, Ali &Job above n155, p93.
[162] These may be dynamic or managed.
[163] See, Ali & Job above n 155 p49.
[164] Das, above n 141, p3
[165] See, Mark J.P. Anson etal et al, Credit Derivatives, Instruments, Applications and Pricing (2004 John Wileyeand Sons) p5, [ch2] 23-46. Default risk means that the obligor will not be able to pay the interest payments and principle fully or timely. Downgrade risk sensitivity to the rating of obligor assigned by a rating agency. It changes with change in the ratio of income to the debt of the entity. Credit spread risk is that the spread of obligation of the obligor over reference obligation will increase.
[166] Das, above n 141,P6: *Credit derivatives are defined as a class of financial instruments, the value of which is derived from an underlying market value driven by the credit risk of private or government entities other than the counterparties to the credit derivative transaction itself*
[167] Das, above n 141, p5. However, credit derivative, such as total return swap can be used to separate all the economic risks associated with asset including credit risk.
[168] Das, above n 141, p6.

with the ownership of the assets.[169] What is noteworthy is that it does not disturb the relationship between the original borrower and the lender [170] as the ownership of the asset/receivables remains with the lender/protection buyer.[171] There are no issues of assignment and true sale. Protection buyer continues to monitor and administer the receivables. Therefore, synthetic securitization is much cheaper than its conventional counterpart. It is also beneficial to the investors due to simple structure in the sense they need not bother about the administration, monitoring and servicing of asset. Moreover, there may not be upfront payment from the investors to the buyer.

There are generally 3 types of credit derivatives, namely, *Total Return Swaps, Credit Spread Options* and *Credit Default swaps.*[172] Total return swaps are used to synthetically replicate the ownership of the reference asset such as bond which may or may not be held by the protection buyer. In a typical total return swap the investor synthetically assumes all risk associated with the ownership of the asset. The investor agrees to pay any appreciation in the value of the reference asset and a periodic payment comprising LIBOR and a fixed spread, both calculated on the basis of notional amount of the referenced asset. On the other hand, the investor (protection seller) agrees to pay any depreciation in the value of the asset and coupon cash flows paid on the bond.[173] The payment structure is independent of any credit event.[174] The swap comes to an end if the entity, which issued the reference asset, defaults[175] before the maturity of the contract. The investor being the economic owner of the asset bears the loss.[176] Furthermore, there is no requirement that the maturity of the swap should coincide with that of the reference asset.[177]

Credit spread options[178] are used to take positions on the future credit quality of a reference entity.[179] Credit spread is the difference in the yield of the underlying bond/loan[180] and the riskless securities[181] of the same characteristics such as

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[169] And, of course, exposed to the associated risk.
[170] Who is protection buyer.
[171] There is no requirement that the reference obligation should be held by the protection buyer.
[172] See, Das, above n 141, p7. Cf Anson et al, above n 165, p1: Credit Derivatives include Credit Linked Notes. Also see, Bomfin above n 18, p 123. Credit linked notes can be thought of both as securities and derivatives. For brief discussion on credit linked notes see above FN 135.
[173] See Das above n 141, p8-9.
[174] Ali & Job above n 155, p6.

[175] Bomfin, above n 18, p83-5. However, a variation may specify the continuation of contract despite default by he reference entity, till maturity of the contract. Moreover, there may be a portfolio of reference assets or a bond index, p90. Also see John-Peter Castagnino, *Derivatives the Key principles: A practical guide to Market, Products, Contracts and Regulations(hereinafter: Castagnino)*, p60-1.

[176] Bomfin, above n 18, 85.
[177] Bomfin, above n 18, 85
[178] Ibid, 91.There are two types of credit spread options, namely, call options and put options on the credit spread.
[179] Bomfin, above n 18, 93.
[180] Reference asset.

maturity. Yield of a security is calculated by dividing the coupon rate with the price of the bond.[182] The increase in yield[183] shows the falling price of the bond[184] which, in turn, shows deteriorating credit quality of the reference entity. With increase in yield the spread increases. In order to insulate against the falling credit quality, shown by the increasing spread, party exposed to credit risk may buy protection.[185]It is important to note that the mechanics of the credit spread options do not involve any credit event.[186] Moreover, unlike other credit derivatives, these options are not linked to the default by the reference entity; rather these are dependent on the performance of reference obligation in relation to a benchmark.[187]

Of all the credit derivatives, Credit default Swaps (hereinafter: the CDS) are the most important.[188] They account for the major portion of the transactions involving credit derivatives. Synthetic securitization technique also mainly uses the CDS.[189]The mechanics of the CDS involves the transfer of credit default risk of reference entity in respect of a reference obligation, such as a bond, loan. It is worth-mentioning that the reference obligation may or may not be held by the protection buyer.[190] In consideration of risk assumption, protection buyer promises to pay, usually, a periodic amount to the protection seller, which in turn promises to pay protection buyer, certain amount on the happening of a credit event.

As credit default swaps is the most commonly used credit derivative, the documentation and other legal issues would be discussed from the perspective of credit default swap.

3.2 *Understanding Working of the ISDA Documents*

Credit default swap is the mainstay of synthetic securitization.[191] Therefore, the legal /documentation issues inherent in the CDS manifest themselves in synthetic securitization transactions[192] as potential risk factors.[193]

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[181] Das, above n 141,18. For example US Treasury bonds. Also see Anson, above n 165 et al, p40-1.
[182] Castagnino, above n 175, 61.
[183] It is due to decrease in the price of the obligation as price is the denominator. The price of an obligation is directly proportional to the credit quality of the reference entity.
[184] Cantagnino, above n 175, 61.
[185] A party may also enter into credit spread option contract for speculating on the credit quality of the reference entity. For example, it may buy option when the spread is high but assuming that the credit quality of the refernce entity would increase; thereupon it can enjoy high spread despite tightening of market spread.
[186] Ali& job above n 155, p6. Bomfin above n 18, p91.
[187] Bomfin above n 18, p91.
[188] For good understanding of the CDS and their types see, Anson et al, above n 165, [ch3] 47-55.
[189] Das, above n 141, 8.
[190] Ibid, p6. Importantly, the parties to the credit derivative may not have any commercial stakes in the party whose credit risk is contracted.
[191] , eg, Edwards, Credit derviatves, above n 157,p 620. Also see Das, p8
[192] Credit derivatives are OTC traded products and therefore individually negotiated. Therefore, the terms/conditions and definitions contained in the ISDA credit derivative documents are usually changed in the synthetic securitization transaction to reflect the negotiated terms. This has been briefly discussed below.

Standard documents,[194] developed and published by International Swaps and Derivatives Association (hereinafter: ISDA), are used for contracting the CDS.[195] The standard documents include the Master Agreement,[196] Schedule, credit support document, credit derivative definitions[197] and confirmation(s).[198] The master agreement contains the contractual framework, such as netting, representations, events of default,[199] termination events.[200] The agreement is supplemented by the schedule. The terms of the standard agreement are usually not interfered with. In order to adjust to a particular transaction, the parties set out negotiated terms in the schedules. [201]

In order to stave off cherry-picking, the master agreement stipulates that the agreement and that all the confirmations will make a single agreement.[202] If either or both of the parties to derivative transaction are concerned about counterparty risks, they may ask for collateral commensurate with its exposure to the counterparty. [203] To this end, ISDA has published two credit support

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[193] For discussion on the risks faced by participants in the credit risk market(esp banks) see European Central bank, 'Credit risk Transfer By European Union Banks; Activities, Risks and Risks Management' May 2004.

[194] For a brief overview of the derivatives documents see, Allen & Overy, An Introduction to the documentation of OTC Derivatives(May 2002) <www.isda.org>

[195] See, Edwards, credit derivatives above n 157, 619. Also see Steven Edwards, 'Legal principles of derivatives' (Jan 2002) *JBL*1, 4(hereinafter: Edwards, legal principles).

[196] The fist master agreement was published by ISDA in 1992; the latest one was published in 2002. This paper makes references to 2002 master agreement, unless specified otherwise. There are two types of Master Agreements: Cross Border agreement and single jurisdiction agreement. See Allen & Overy, aboven 194.

[197] The definitions published in 2003.

[198] See, Castagnino, above n 175, 132.

[199] It is important to mention that the events of defaults are different from the credit event. The triggering of later usually terminates that particular transaction without affecting the other trasactions; however, event of default such as bankruptcy of the protection buyer, brings terminates the master agreement thereby termination all the transactions governed by that master agreement. A distinction between event of default and termination event is also important. The former is considered to be due the fault of counterparty, while the latter is considered happening due to circumstances outside the control of counterparties eg change in laws of jurisdiction, illegality of subject matter etc. The termination event usually puts an end to affected transaction. Also see castagnino above n 175, 135-6.

[200] Ibid.

[201] Ibid, 132

[202] For working of master agreement see Allen & Overy, above n 194. Altoough it is in respect of 2002 Master Agreement, it is quite relevant. Also see Castagnino above n 175,133.

[203] Catagnino above n 175, 142. The collateral used for credit support usually involves, cash, government debt securities and letters of credit. In order to protect the seller against the credit exposure to the buyer, it may be agreed that buyer would make upfront payment equal to the present value(Present value is calculated by applying the agreed discount rate. The mathematical expression is PV(present Value)= Total Value over the term of the contract/(1+r)^n where r is the agreed discount rate and the exponent n is duration of the derivative contract) of the fees to be paid over the period of the transaction. A provision is inserted in the agreement, called claw back clause for the reimbursement of the unamortized portion of the fee if credit event occurs before the maturity date(Das above n 141, 77).

documents: credit support Annex and Credit support deed.[204] The former being part of the schedule and constitutes a single agreement with the maser agreement. It transfers the title of the collateral; on the other hand, the deed is a separate agreement and involves transfer of security interest. [205] Due to difference in nature of the transactions, the two agreements would result in different treatment of the collateral in the event of bankruptcy of the counterparty. The value of the collateral may change during the life of the transaction due to changes, positive or negative, in the extent of the exposure.[206]

The confirmation documents the transaction by setting out the economic terms agreed upon by the parties.[207] The economic terms may be highly complex using mathematical models and expressions. So these terms are to be meticulously drafted to be interpreted (as agreed by the parties) by the judicial authorities. This becomes all the more important, if the courts are not willing to adopt liberal interpretation of the terms and expressions.[208]

The 2003 credit derivative 'definitions' is the most important document.[209] Which particular set of definitions to apply, is set out in the confirmation.[210] The use of standard set of definitions also reduces the transaction cost. Another main advantage of definitions is that only minimal information is expressed in the confirmation.[211] The definitions contain detailed rules which operate to give legal support to the economic terms contained in the confirmation. For example, definitions contain detailed calculation procedures while the confirmation includes only the data required for calculating default payments.[212]

In order to avoid any clash between the standard terms of the agreement and the negotiated terms, the master agreement stipulates that the Confirmations would prevail over the schedule and master agreement.[213] The parties by an

[204]From Jurisdiction point of view, ISDA has published credit support documents subject to Japanese, English and Newyork Law. See, eg, Edwards, Legal Principles above n 195, 5. castagnino, above n 175, 141.

[205] If Governed by English law. If deed is used which creates security interest, charge need to be registered under s 395(1) of the Companies Act 1985, failing which it would be unenforceable. See castagnino above n 175, 141.

[206] Ibid,143: However, it all depends on the credit policy of the parties

[207] Ibid.

[208] *Deutche Bank AG v ANZ Banking Group Ltd*(unreported case discussed below. For details see, Catagnino above n 175.

[209] The first set of credit derivative definitions, issued by the ISDA, is the 1999 Credit Derivative definitions. However, later on, these were revised and expanded to dispel certain confusions such as qualifying guarantees, voting shares, notice of publicly available information. Edwards, credit derivatives, above n 157, 637

[210] Castagnino, above n 175,144. There are three different sets of derivative definitions: Financial Derivatives, Commodity Derivatives and Credit Derivatives.

[211] Ibid

[212] ibid.

[213] Edwards, Legal Principles above n 195, 5

agreement may fix the priority of application of the documents in the event of clash.[214]

3.2.1 *Important concepts in 2003 Definitions and legal implications*
As already mentioned above, majority of the transactions involving credit derivatives use ISDA master agreements. Of its constituent documents, the 'definitions' is the most important one. It is, therefore, important to understand the important terms and the concepts used in the definitions.

Firstly, it is the reference entity whose credit is traded through the use of CDS. The 2003 'definitions' is applicable to both sovereign and non-sovereign entities and need to be clearly identified in the case of CDS.[215] The definitions could be used to refer to more than one reference entity.[216]

The concepts of reference entity[217] and reference obligation operate together in order to make the agreement meaningful. Reference entity is one whose risk needs to be hedged. The concept of reference obligation is used to determine the extent of credit exposure.[218] The 2003 'definitions' determines the scope of the reference obligation. It covers direct obligations of the reference entity, qualifying affiliate guarantees and all guarantees.[219] Reference obligations are defined by categories and characteristics.[220] It is important to note that only one category is mentioned while characteristic may be more than one.[221]

Credit event[222] is the most important concept which triggers the termination of CDS and protection payment.[223] There are three commonly used credit events,

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[214] Ibid..Confirmation, schedules, definitions which would prevail over the master agreement ,
[215] Das, above n 141, 73. The sovereign entity may act through multiple entities so sovereign entity may need to be clearly identified .
[216] The standard, 2003 definition refer to only single reference entity. Portflio/basket default swaps use number of reference entities usually with a single CDS. See, Bomfin, [ch9], [ch10].
[217] It is reference obligor, Das above n 141, 73
[218] Ibid, 74.
[219] Ibid. The first one covers the obligations of the reference entity itself. The second one covers the guarantees by the reference entity as to the obligation of subsidiaries(Subsidiaries in which refernce entity has more than 50% of the voting shares). The third type refers to the third parties guarantees given by the reference entity.
[220]The categories of obligations include reference obligations only, borrowed money, bond/loan, Payment. The characteristics include Not subordinated, Specified currency, Listed, Not sovereign lender, not domestic currency, not domestic law, not domestic issuance. Not subordinated means that the obligation does not rank junior to other obligations of the reference entity; specified currency refers to obligations due in currencies of certain countries/blocks mentioned therein; No sovereign means the obligation is not owed to a sovereign or any supranational entity.
[221] Das, above n 141, 75-6. Specific reference obligation is used in case of cash settlement or where it is required to determine materiality. It must be an asset, such as bond, issued or guaranteed by the reference entity. On the other hand, physical settlement may require any security which could be delivered.[221] For cash settlement purposes, it is important to fix the initial price of the asset at the time of entering into transaction.
[222] It is important to note the difference between credit event, event of default and termination events. The triggering of the former terminates the transaction (that particular CDS) while the other

namely, Bankruptcy, failure to pay and restructuring. [224] Failure to pay is triggered due to non-payment by the reference entity above the minimum threshold of US$1 million.[225]The concept of bankruptcy is different in different jurisdictions. It is therefore, defined according to the place of incorporation of reference entity. Restructuring has been subject of controversy in the credit derivative definitions due to the width of the concept.[226] It is because restructuring may not materially effect the reference obligation.

To enforce payment in the event of any credit event, protection buyer must issue/serve credit event notice. If agreed it may be served by either the protection buyer or seller. This may give rise to conflict of interest between the two parties due to the timing aspect.[227] The seller, in order to restrict its loss or in order to trigger offsetting hedge,[228] may want early settlement; while the buyer may wish to delay it as he may sustain losses in excess of contingent payment.[229]The notice is issued on the basis of publicly available notice.[230] The reason for this requirement is that none of the parties to the swap, especially, the buyer, may have contractual relationship with the reference obligation. It is required that the information must be supported by two different sources such as

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transactions governed by the master agreement may continue. On the other hand, event of default, mentioned in the master agreement terminates master agreement, thereby terminating all the transactions governed by the master agreement. Termination event also mentioned in the master agreement, gives the affected party right to terminated one or more swaps but not necessarily all the transactions. See Edwards, Credit derivative, 619-20. For discussion on events of default see, Edwards, legal principles of derivatives, JBL, Jan 2002, 1, 13-4. Events of default include, failure to pay, Breach of agreement, Credit support default, Misrepresentation with material consequences, Default under specified transaction, cross default, Bankruptcy, merger without assumption. Termination events include Illegality, Force Majuere, Tax Event, Tax vent upon merger and credit event upon merger. Event For explanation see Fitchratings, Counter party risk in Structured finance transactions: Swap Criteria, www.fitchratings.com

[223] The concepts relevant to credit event are transaction date and termination date. Transaction dates include trade date, effective date and termination date. The first is the date on which terms of transaction are finalized; the effective date is the day on which the terms of transaction become effective: it is usually the following business day; The third refers to the day on which the transaction comes to an end. This may either be the last date of the transaction or the date on which a credit event happens. The maturity of the transaction may be extended by expressly mentioning in the confirmation. Similarly grace period may be included when credit event happens close to the termination date.

[224] In case of non-sovereign entities. In case of sovereign entities, the events commonly used are: failure to pay, oblgation default accelerator, repudiation or moratorium and restructuring. Bankruptcy event is rare. Also see Fitch ratings , 'Fitch examines Effect of 2003Credit Derivatives Definitions' p2. <www.fitchratings.com>

[225] This minimum amount may be changed by agreement between the parties. It may provide for grace period.

[226] Discussed below.

[227] Das above n 141, 83.

[228] Back to back transaction involved in *Deutche Group Bank v ANZ Banking Ltd.,* are an example of offsetting hedge. Briefly discussed below.

[229] Das above n 141, 83.

[230] This requirement may be modified in synthetic securitization, especially involving confidentiality issues. Discussed below.

judicial proceedings, internationally recognized news source(Bloomberg), [231] party of an associate acting as trustee, clearing agent etc for the obligation.[232]

The 'definitions' also incorporate the concept of deliverable obligations for physical settlement.[233] These are similar to the reference obligations as defined by system of characteristics and categories.[234] However, these are different in that they have some additional categories[235] and characteristics.[236] Moreover, the definitions clarify that convertible bonds and zero coupon bonds are not contingent.[237] If the characteristic of deliverable obligation is assignable loan, there must not be any anti-assignment clause in the agreement between the buyer and the reference entity; it must be capable of *novation* without consent. It may be 'consent required' loan where the consent of the reference entity or obligor is required. However, the buyer can deliver substitute loan/obligation if the consent of the borrower could not be elicited.[238] Importantly, it is required that the buyer must transfer title, presumably legal or equitable, free of any charge, set-off which the obligor or reference entity may have against the lender/buyer.[239] Further legal problems which may obstruct settlement include bankruptcy of the reference entity.[240] Firstly, the bankruptcy and winding-up process may take long time before the rights of the creditors and the extent of their claims may be established. Secondly, the legal settlement may affect the rights of the creditors or give rise claims of set-off.[241] Thirdly, the claim of the buyer/creditor may not be legally assignable.[242]

3.2.2 *ISDA Definitions/documents and Synthetic Securitization*
It is important to note that the ISDA 2003 credit derivative definitions do not envision synthetic securitization;[243] therefore, the contractual terms are usually

[231]Proof of a Credit Event typically derives from Public Sources) such as Bloomberg Service, Wall Street Journal, New York Times or such other recognised financial news source specified in the Confirmation, but there is no need for Public Sources if the Publicly Available Information emanates from, inter alia, a Reference Entity or is contained in an insolvency petition. See Edwards, credit derivatives above n 157, foot note 69, 626.
[232] Das, above n 141, Footnote 157, p86.
[233] These are eligible obligations which could be delivered to the protection seller in the event of physical settlement. Das, above n 141, 91.
[234]Ibid.
[235] Ibid. Reference obligation only, Bond, Loan, bond or Loan, Borowed Money or Payment. However the most commonly used are bond or loan(including consent required loan, Das, above n 141, 93,
[236]Not subordinated, not contingent, assignable loans etc, maximum maturity, not bearer, accelerated or matured. Not subordinated, specified currency, maximum maturity normally used for non-sovereign entities. Das, above n 141, 91-3.
[237] Ibid, 92
[238] ibid.
[239] Claims relating to legality or validity of obligation are excluded. See ibid, 93.
[240] ibid, 94.
[241] ibid.
[242] Ibid.
[243] Edwards, Credit Derivatives, above n 157, 644. The definitions consider pool of assets comprising bond or loan while in the synthetic securitization variety of reference obligations could be used such as asset backed securities, CDOs, Credit derivatives. See, eg, Ali 7 Job above n 155, p61.

modified in case of synthetic securitization.[244] It is because the definitions only consider those obligations which comprise bonds or loans. On the other hand, synthetic securitization transaction may reference obligations such as, credit derivatives, asset backed securities. Moreover, the parties to synthetic securitization modify the terms in keeping with the credit risk transferred; however, the parties should ensure that the credit events and the alterations would not affect the capital relief, especially when it is the driving farce for undertaking synthetic transaction. Importantly, regulatory authorities regard bankruptcy and failure to pay sine quo non to capital relief.[245] For instance, the failure to pay credit event, in case of asset backed securities, may be triggered not simply on account of failure on the part of the reference entity but also failure on the part of the issuer, guarantor or insurer.[246] Similarly, parties may negotiate the grace period, which may either be totally eliminated, or may be extended.[247] Minimum threshold amount, which needs to be exceeded in order to trigger default, may also be changed.[248] A credit event may be added by including the losses suffered by the holder of reference obligation which may or may not be the buyer of protection (originator).[249] Settlement mechanics may also be modified under synthetic securitization. The cash settlement provision may contain a claw-back clause[250] or contingent payment y the SPV may be greed to be net of the loss incurred and the recovery. The other modifications may be in respect of cut-off date, appointment of calculation agent, [251] confidentiality agreement between the parties,[252] agreement that in the event of credit event, the buyer will act in good faith as per the directions of the seller especially in respect of the voting rights attached to reference obligations,[253] termination of agreement at the option of buyer under specific circumstances.[254]

3.3 *Legal Issues surrounding Credit events*

As already mentioned above credit event by itself does not trigger settlement.[255] Rather it has to be followed by publicly available information and notice of credit event. Historically, the concept of credit event has been under stress,

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[244] Edwards, credit Derivatives, above n 157, 644.
[245] See, Ali & Job, above n 155, 61.
[246] Edwards, Credit Derivatives above n 157, p645
[247] Ali & job, above n 155, p62.
[248] The standard minimum amount is US $1 million.
[249] Edwards, credit derivatives, above n 157, 645
[250] Ibid. For example when there is only deferral of principal or interest.
[251] See Ali & job above n 155, p64.
[252] Edwards, Credit Derivatives above n 157. 645.
[253] Ibid
[254] Ibid.
[255] Settlement mechanism may be either cash or physical. In the former, if no fixed payment has been agreed upon, the seller pays money equal to the fall in the value(it needs to be determined at the time of entering into contract of the reference asset(eg loan issued or guaranteed by refernce entity) due to a credit event. In physical settlement, the buyer transfers reference obligation to the seller in return for notional face value or any other agreed amount. If the buyer fails to deliver the reference obligation within the settlement period, the buyer has the right to buy the same from the market and pay difference between the face value and the market value to the buyer.

giving rise to legal issues which the ISDA has sought to address through revision of documents and issuance of supplements.[256]

Failure to Pay

Failure to pay credit event is triggered in case of inability of the reference entity to make payment in respect of reference obligation. [257] For example, the protection seller, in *Duetche bank v ANZ*, argued in the court that it was merely a "technical credit event" and not a "substantial credit event", therefore, it does not show uncreditworthiness. The court refused to accept this argument. This decision also highlights the narrow construction of the terms of the agreement.

Issue of Successor Entity

The reorganization of reference entities such as mergers, demergers, creates the problem of identity of reference entity. [258] It came to fore first time with reorganization of the AT & T.[259]However, it was the demerger of English company, named National Power, which lead to the revision of the credit derivative definitions (successor supplement).[260] The test of "all or substantially all of the obligations", which was the source of confusion, has been supplanted with a new one; the new test is based on ascertaining the specified quantum of the original obligations undertaken by the new entities.[261] It also envisages a scenario wherein successor may be more than one reference entity.[262] However, the successor problem seems far from solved. Importantly, the test considers only the bonds and loans of the original reference entity.[263]. Moreover, the complexity of demergers and the intention to follow efficient way for achieving purpose has the potential of creating problems. It is evidenced by the issue of Six Continents (6c). [264]As the debt of the original entity, which survived demerger, was reduced significantly, there was little possibility of its default, rendering the CDS worthless from buyers' perspective.[265] Although the issue was ultimately amicably solved, it shows it being a potential source of problems. The second problem with the new

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[256] See Paul Ali & Job above n 155, p15.

[257] After allowing for the minimum threshold which is US$1milion and grace period, if applicable. See Edwards,credit derivatives above n 157, 624. Deutsche bank v ANZ Banking Group(May 28 1999) is an unreported case. See Edwards, Credit Derivatives, above n 157, Foot note 56(the first 56). For brief analysis see, Castagnino, above n 175.

[258] That is to say, which entity would be taken as reference entity for the successful working of the credit derivative transaction?

[259] See, Das above n 141, 110.

[260] Ali & Jan above n 155, p 17.

[261] It deals with various scenarios based on the %age of the obligation assumed by the new entities.

[262] If no clear successor exists all the entities having assumed obligations between 25% and 75% of the obligtions and the original CDS would be split evenly among the successor entities. Das, above n 141,110.

[263] Ibid, 111.

[264] See, Mark Brown, "Six Continents Demerger Drives Uncertainty" July 2003, Euromoney, 16-7.Six Continents was demerged in complex way, with the 6c, original reference entity becoming the subsidiary of International Continental Hotels Group, one of the two entities created as result of demerger.

[265] Ibid. Demerger coud also result in a contract inimical to the interests of the sellers if he orginal entity assumes more debt.

definition is the short time period (14 days) to prove the happening of succession event.[266]

Restructuring Event

Restructuring event, in simple words, is triggered upon restructuring of reference obligation. Apparently simple to understand, it has proved to be a contentious issue in the derivative market,[267] resulting in the revision of the definition. Importantly, this event cannot be avoided from the perspective of capital relief.[268] This issue came to the fore with the *Conseco* debt restructuring which resulted in higher interest rates, and extension of maturity. It also highlighted issues of moral hazard and the cheapest to deliver obligation.[269] The supplement and the 2003 definitions have sought to address the issues. The definitions contain self-dealing[270] and restructuring maturity limitation[271] provisions. However, the revision has created fissures in the market.[272] It has also resulted in price[273] and rating differentials.[274]

Parties to the CDS must be ad idem in respect of reference entity. Any confusion as to the identification may become a legal issue. The dispute between *UBS and Deutche bank* highlighted this issue.[275] The protection buyer considered *Armstrong World industries(AWI)* as reference entity while protection seller

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[266] See, Edwards, credit derivatives above n 157, 636.

[267] It is more contentious in case of seovereign debt re-structuring-rescheduling. See, eg, John Ferry, "Argentine Sovereign debt Spartks Biter Credit Default Row" Risk 10.

[268] See, Das, above n 141, 103, US and the French regulatory authorities refused t grant capital relief in CDS without Restructuring credit event. Also see Basel 2 which also requires the inclusion of credit event for total capital relief. See Das, p108. Also see Morris Jenny, "Revisiting the Restructuring Issue(May 2001) Euromoney 16. This also shows clash of interests between protection sellers and the buyers(banks). The former usually wishes to eliminate it.

[269] Obligation otherwise matches the characteristics of the reference obligation. Also see Xerox case. Das, above n 141, Footnotes 181, p102 and 185, p103.

[270] The restructuring credit event can only be triggered provided there are 4 unassociated holders and 2/3rd majority agrees to restructure the loan/obligation. See Das, above n 141,p104. also see Ali & Job above n 155, p16.

[271] This provison limits the maturity period of the obligation which could be delivered in case of physical settlement in order to avoid cheapest to deliver issue. The 2003 definitions provide two alternatives, namely, Restructuring maturity Limitation and Fully Transferable Obligation and Modified restructuring Maturity Limitation and Conditionally transferable Obligation

[272] After the 2003 definitions there are 4 alternatives: (1) NR which means no restructuring event; (2) R means Restructuring credit event which contains self dealing provision and unrestricted deliverable obligation(subject t maximum maturity) and unrestricted transferability; (3) Modified restructuring which contains self dealing provision deliverable obligation with maturity 30 months or the latest final maturity date of any restructured bond provided it is not earlier than the maturity of the CDS or later than 30 months from that date and obligation must be fully transferable;(4) Modified Modified restructuring containing self-dealing provision, deliverable obligation maturity 60 months from restructuring date for restructured obligation or 30 months from restructuring date for other provided it is not earlier than the maturity of the CDS and conditionally transferable. See Das, Exhibit 1.20, p 109. The Asian market mainly uses R as most of the corporate debt in the form of loans, US MR and European R or MMR as most of the obligations are consent required loans which are not fully transferable.

[273] Das above n 141, p106.

[274] ibid, 108

[275] Ibid 99, foot note 177. The dispute was amicably settled.

considered *Armstrong Holdings* as reference entity.[276] The dispute arose when Armstrong World Industries filed for bankruptcy. The UBS treated the filing of voluntary bankruptcy by *AWI* as bankruptcy credit event which the protection seller refused to accept it.

Contingent Obligations

Ascertaining whether obligation is contingent or not, has also been problematic. It is because such obligations are usually excluded form the reference obligations and deliverable obligation under the CDS. The issue came to fore in the *Railtrack case* which was put under administrator which constituted restructuring event. The buyers wanted to deliver convertible bonds while the seller was unwilling to accept on the plea that these were contingent.[277] Although the ISDA supplement clarified that convertible bonds were not contingent obligations, the seller (*CSFB*) refused to accept. The issue was ultimately decided by the UK High Court deciding that convertible bonds were not contingent.[278] However, the issue may arise in respect of any new financial product which may make it difficult to apply the test invoked by the court.

3.4 *Ultravires Transactions*

For a credit derivative transaction to be valid and enforceable, the protection buyer and seller must be capable of entering into the contract. The restrictions on capacity may be set-out in the constituent documents;[279] or there may be statutory restrictions.[280] If any of the parties contracts beyond its powers, the transaction may be void *ab initio*. That is, the relevant law deems as if no contract has ever been made. This may be much more damaging in that any money paid under such a contract may not be recovered under normal

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[276] Edwards, Credit Derivatives above n 157, fn 12, 655

[277] Also see Edwards, credit derivatives above n 157, 634-5 .

[278] See, Bream Rebecca and Tait Nikki, 'Nomura Wins Landmark Ruling against CSFB', *Financial Times* (UK), 14 February 2003, 31. Also see, Edwards, Credit Derivatives above n 157, 635, the court concluded that the obligation is noncontingent if conversion is vested with the holder of bond or its trustee. :…[The court]fails to recognise that an option, which is an integral element of a convertible bond, **is indeed contingent** as it can only be exercised once prior conditions have become effective. In an attempt to construe the commercial purpose of Not Contingent as a Deliverable Obligation Characteristic, the court held that the contingency inherent to the character of an option is nevertheless not contingent for the purpose of **credit derivatives.** There may also be valid commercial reasons for a bondholder to exercise the option in a convertible bond and make a temporary loss if that party can thereafter exercise a physically-settled share put option with a third party in order to make an ultimate profit. This decision emphasises the difficulties encountered when interpreting credit derivative contracts.

[279] See, Castagnino above n 175, p103.

[280] In this regard it is important to mention UK case of *Hazelv Hammersmith & Fulham London Borough Council*.[280] It involved a derivative transaction between the council and financial institutions. The auditor of the council filed appeal on the ground that the derivative transactions entered into by the council were outside its powers set out in the Local Government Act of 1972. The case was adjudicated upon by the High court,[280] Court of appeal[280] and finally by the Judicial Committee of the House of Lords which declared the transactions ultra-vires.[280] For further Judicial developments, especially as to the recovery of money and doctrine of restitution see cases, *Westdeutche Landes Bank Grizontrale v Islington London Borough council*[1996] AC 669(Islington), *Kleinworth Benson Ltd. V Lincoln City Council and others* [1998] 4 All ER 513 (Lincoln). For description of these case see, Castagnino above n 175, p103-109.

judicial/legal remedies.[281] Different jurisdictions apply this rule almost in a similar fashion;[282] some jurisdictions apply this only to non-private entities or entities with limited powers while in other it may be extended to private entities.[283] Therefore, the parties to a credit derivative contract must exercise due diligence.

3.5 *Issue of Confidentiality and Publicly Available Information*

Issue of Confidentiality has relevance to balance sheet synthetic securitization. There may be an agreement between the reference entity and the protection buyer(lender) holding the reference obligation which may prohibit disclosure as to the nature of the agreements, name of the reference entity and other details which may determine the occurrence of credit event.[284] In order to avoid breach of confidentiality provisions, an independent third party is usually appointed to verify the occurrence of the event.[285] This is done by modifying the requirement set out in the credit derivative definitions, of publicly available information. Similarly there may be an issue as to the disclosure of information to different investors; it is because an investor having a large exposure to the CLNS, especially high rated notes) may want to get more information as compared to the one with small exposure. Depending on the jurisdiction, a possible solution is to issue different classes of notes with that much of information which is expected to satisfy the investor.[286] It is important to note that legal risk increases if the notes target retail investors. In such a case, the retail investor must be furnished sufficient level of information which clearly explains the nature of the transaction.[287]

3.6 *Recharacterization as insurance contract*

As already mentioned above, the CDS, which transfers credit risk in synthetic securitization, is used to protect the buyer against any credit default by the reference entity. The periodic payment by the buyer to the seller is akin to insurance premium; and the contingent payment by the seller to the buyer, made on the occurrence of a credit event, is akin to indemnification payment. Because of this close similarity there is a debate on the subject of rechracterization of the CDS/synthetic transaction as an insurance contract. The analysis usually looks at two things: first, whether the synthetic transactions are insurance contracts; second, if the answer is affirmative, what are the regulatory/legal implications for the protection seller and legal implications for the protection buyer.

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[281] Castagnino above n 175, p103.
[282] See Ali & job above n 155, p12.
[283] See, Ali & job above n 155, p13.
[284] Ibid, 69
[285] Ibid. Another way is to get the consent of the borrower. The relevant information is only disclosed to rating agencies, trustees and the SPV. Ibid, 70.
[286] ibid, p70. There may be moral hazard issue where the reference entity also holds the reference obligation . It can be limited if buyer holds a part of the risky tranches.
[287] ibid, p71-2

In order to sort out the issue it is important to analyze the constituent elements of the two transactions.[288] In order to be an insurance contract, the common law normally requires: (1) consideration in return for assumption of risk by the other party (like any other contract); (2) Uncertain event; (3) insurable interest held by beneficiary; (4) insured party must sustain loss as a result of happening of an uncertain event. Juxtaposing these constituent elements of insurance contract against the synthetic, it gets into sharp relief, that normally protection payment is contingent on the happening of a credit default event, not the actual loss suffered by the protection buyer; in-effect, protection buyer may not even suffer any loss whatsoever. Even more important is the distinction that in synthetic transaction protection buyer need not hold any reference obligation; thirdly, there may not be any direct or indirect contractual relationship between the protection buyer and reference entity. That is to say, the buyer may buy protection for hedging purposes or for mere speculation.[289] Unlike insurance contract, under the CDS protection buyer may enter into two separate risk transfer contracts with two separate parties with the same reference obligation. Therefore, protection buyer may end up getting payment from each party if any default event happens.[290]

Another distinguishing feature is that the Insurance contracts impose duty of utmost good faith, legally referred to as *uberrima fides*, on the parties to the contract; while the CDS contract does not require any such condition.[291] In fact, the driving force for entering into the CDS may be different analysis and information available to the two parties. However, it is important to note that if protection buyer holds an interest in the reference obligation [292] and the payment is linked to both happening of credit event and incurring of loss,[293] the synthetic transaction would be closer to an insurance contract.[294]It has been, therefore, suggested that the parties incorporate a clause in the contract, especially when buyer holds interest in the obligation,[295] making it clear that the payment would be made irrespective of the of loss.[296]

Recharacterization as insurance has legal implications for both the buyer and seller of the CDS. In the event of recharacterization, the contract may be

[288]In order to dispel confusion ISDA sought legal opinion from a leading lawyer(Robin Pott Q.C. See Edwards, Credit Drivatives above n 157), Footnote 90, 648.) who argued that the CDS is not insurance contract due to differing nature of the two types of contracts(Also See, p 647)
[289] Edwards, Credit Deratives, above n 157,p 648.
[290]The credit event may be the same in both transactions.
[291] See Ali & Job, above n 155, p26.
[292] Even in this scenario interest must be held from the date of entering into the transaction/contract. On the other hand if the reference obligation is acquired subsequently, there is remote chance of its being recharacterized.
[293] The calculation of settlement price based on the value of the asset in the books of the buyer, See, Ali & Job above n 155, p27
[294] Edwads, Credit Derivatives, above n 155, p 648.
[295] Balance sheet synthetic securitization. However, even in balance sheet synthetic securitization protection buyer may acquire reference obligation after entering into transaction. This true especially a bank is considering lending money to a party in future.
[296] See, Edwards, Credit Derivatives above n 157, p649, also see footnote 6 and 7 of p 648.

declared void which in turn may have 4 concomitant consequences: (1) the buyer of protection would not be able to enforce on the happening of a credit event;(2) it may not be able to get protection payment;(3) if entered into with the intention of getting capital relief, it would not be able to claim it for want of legality/enforceability; subsequent re-characterization may result in violation of relevant regulations of a jurisdiction;(4) it may not be able to claim the return of protection fees paid to the seller(the SPV). The seller would also be not in a position to enforce contract for demanding any protection payment. The enforcement of any security interest, granted by the buyer to reduce counterparty risk, may not be possible. More importantly, if the relevant jurisdiction forbids unauthorized entities from carrying on insurance business, the seller may commit statutory breach; therefore, it may be guilty of criminal act.[297]

4. Conclusion

Both conventional securitization and synthetic securitization have their own legal risks and issues. However, the former is relatively come of age in that the case laws, both the US and the UK, give some useful parameters for minimizing the legal risks. It is possible to have true sale treatment despite the presence of reasonable recourse; the lender can retain the residual interest over and above the part assigned to the SPV; similarly, the chances of bankruptcy of the SPV can be minimized by setting out restrictions in the constituent/transaction documents or by corporate governance, provided the restrictions are allowed by the relevant jurisdiction. There are useful parameters for avoiding substantive consolidation. It can be avoided by abiding by separateness covenants.

Synthetic securitization is a relatively new technique. Most of the conceptual issues have yet to be tested in the courts. ISDA documents and revision thereof, seem to have minimized but not eliminated the legal risks. It is noteworthy that documents are modified in synthetic securitization in order to reflect the extent of the credit risk transferred. It may present legal risk. Moreover, the clarifications issued by the ISDA are not binding on the parties. The definitions of credit events still present some problems. The main issue of recharacterization as insurance contract poses problems for both the buyer and the seller. There is a legal opinion that there is no similarity between the two; however, it is not tested in any court. It may become a real risk if the reference obligation is held by protection buyer and the calculation of payment is based on actual loss incurred by protection buyer.

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