

Insight

on Financial Restructuring & Insolvency

Danger and opportunity

The effect of the credit squeeze on hedge funds and Structured Investment Vehicles (SIVs)

Credit crunch; margin calls; hedge fund bailouts; redemption requests and liquidations – these are the worrying stories which have filled the financial headlines in recent months.

Few of us would have predicted that difficulties in the US sub prime mortgage market would cause such a significant reverberation around the financial markets. Loss of investor confidence seems to have caused a lack of liquidity. Institutions are wary of lending to each other as it is not clear who is holding the most “toxic” US sub-prime mortgage investments. Participants in credit markets, particularly those exposed to any form of asset backed securities, have been most affected. Whilst the credit squeeze has thrown up a large number of issues, this article focuses on some of the legal issues facing hedge funds and structured investment vehicles (SIVs). As is perhaps inevitable behind the gloomy headlines, the credit squeeze presents opportunities for distressed debt investors.

The liquidity crunch and certain hedge funds

It is now well known that many mortgage lenders in the US have, over the past few years, made significant loans to households with poor credit histories. Many of these loans have (and will continue) to go into default across the US. In recent months, the world’s capital markets began to take note of these problems as various lenders (such as

Countrywide Financial Corporation and New Century Financial Corporation) either needed significant third party liquidity injections or collapsed into bankruptcy.

One downside of the increasing sophistication of global structured finance is that the problems of the US sub prime market spread beyond those domestic lenders directly exposed to the market. Like any other securitisation, collateralised debt obligations, known as CDOs, are bonds secured on a pool of income producing instruments (in the case of CDOs, such instruments might include secured loans, high yield securities and other bonds). CDOs disperse the risk of default of these instruments beyond the original counterparties (in other words, the lenders or bond issuers) to other market participants. The rights to the income of those debt instruments are sliced into a number of tranches. Insurance companies and pension funds often buy the least risky, most highly rated tranches, which are the last to suffer loss in the event of default of the underlying assets. Hedge funds, by contrast, have tended to purchase the highest yielding, but most risky, so-called “equity” tranches. As the price of the CDOs and asset backed securities (whether backed by sub-prime



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The team has particular strengths in advising on complex debt restructurings following big-ticket leveraged buyouts and is currently advising on a number of highly-leveraged deals in keeping with the increasing trend for this type of work.

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loans or not) plummeted, a number of hedge funds came under intense pressure. Many equity investors sought to redeem their investments when the problems became apparent. Certain funds, such as two funds managed by Bear Stearns Asset Management (the "Bear Funds") were unable to meet their creditors' margin calls and they were forced to file for insolvency in the Cayman Islands. As a demonstration of the global nature of the crisis another fund, managed in Australia, the Basis Yield Alpha Fund ("BYA") also recently filed for provisional liquidation in Cayman.

Hedge fund funding – an achilles heel?

It is apparent that some funds have levered themselves in a way which has made them vulnerable to market volatility. Hedge funds use brokers (mainly international investment banks) to provide them with financing, execution and custodian services. Up until recently this has been a mutually enriching relationship (and still continues to be for the vast majority of funds and brokers).

Brokers tend to lend based on the value of the net assets of the fund and hedge funds are charged a certain interest rate based on maintaining a certain value – the net asset value (NAV) of the fund. Brokers are often able, at very short notice, to increase margin requirements (or in the case of repos described below, increase their 'haircut' requirements). Recent experience has shown that many nervous brokers will understandably choose to tighten their lending criteria in periods of volatility. Once the fund has failed to honour its margin call (as happened in the case of the Bear Funds and BYA) brokers were able to seize collateral and sell it on the market.

Security enforcement

The little known Financial Collateral Arrangements (No. 2) Regulations 2003 (the 'Regulation') which applies to the UK and which is in force across the European Union, in similar form, has made life easier for brokers looking to seize a fund's collateral where it is in default. The Regulation exempts certain financial collateral arrangements (likely to include a

brokerage agreement) from being subject to the automatic stay which applies in the context of any insolvency. The Regulation may apply where parties (who may be non English) have entered into English law qualifying arrangements. Brokers are permitted to appropriate collateral when a fund is in default (regardless of whether it is in insolvency or not) without a court process.

The US Bankruptcy Code includes provisions which have substantially similar effect to the Regulation. Certain financial contracts are protected by the "safe harbour provisions". These mean that a party to a qualifying financial transaction may exercise its rights to terminate the transaction, foreclose or liquidate the collateral securing the transaction without regard to bankruptcy of the counterparty to the transaction.

Repos

Many hedge funds are extensive users of so called repurchase arrangements (repos). Under a classic repo, a hedge fund will sell certain securities to its prime broker and, at a specified later date, will purchase those securities back at an agreed future rate. The purchase price is usually less than the market price of the securities and this difference or "haircut" provides a cushion if the value of the securities falls during the term of the repo. The danger for the hedge fund is that if it fails to re-purchase the security, its counter-party keeps the underlying asset which formed the subject of the repo. The repurchase arrangement means that the legal ownership of the underlying asset has been transferred to the broker and so there does not need to be any complicated security enforcement if the fund fails to repurchase under the repo.

Litigation?

It is perhaps inevitable that some of the actions taken by brokers to seize collateral will, when the immediate crisis has abated, be scrutinised by funds (and, if relevant, their liquidators) very carefully. Many brokerage agreements are drafted under English law and it is possible that there will be allegations that

when the time came to enforce security the requirement to 'obtain the best price reasonable obtainable' was not met. Both sides to these agreements would be wise to review their records and take advice in the coming months. It is also to be expected that some disgruntled investors will seek to take action against hedge funds for mis-selling or negligence claims.

Chapter 15

Recent events have cast a spotlight on the operation of Chapter 15 of the US Bankruptcy Code which allows the US Courts power to give help to foreign liquidators or debtors in foreign insolvency proceedings.

In order to avoid a legal 'free for all' and ensure an orderly distribution of assets to investors, certain funds have not only filed for provisional liquidation in Cayman but they have also sought protection under Chapter 15. Chapter 15 provides relief from individual aggressive enforcement action for an insolvent debtor in the US. In addition, any US creditor or creditor who has a strong US nexus would be reluctant to take enforcement action even outside of the US for fear of being in contempt of court. As it is never easy to identify the 'home jurisdiction' of an asset like a CDO, this latter aspect is very attractive for distressed debtors who are often anxious to avoid costly and time consuming secondary insolvency proceedings in every jurisdiction in which its assets are based.

In the case of the Bear Funds, a judge recently denied the request for Chapter 15 recognition. His reasoning was that the funds had insufficient nexus with Cayman for the liquidation there to be either main or non main proceeding (a necessary precursor for Chapter 15 relief) even though the funds were incorporated in Cayman. The factual pattern of the Bear Funds may not be replicated by all funds seeking similar relief, and although the judge left open the possibility that funds could file for Chapter 7 or Chapter 11 relief in the US (i.e. a full scale US liquidation or rescue process) the judgment (which is the subject of an appeal) has meant that there is now considerable uncertainty whether

the US Courts will assist foreign registered funds in distressed circumstances unless they choose to give overall control to those courts in a Chapter 11 filing.

SIVS

Hedge funds are not the only investors of asset backed securities which have become troubled in recent weeks.

One well publicised structured investment vehicle which was severely affected by the credit crunch has been Cheyne Finance – receivers were appointed over its assets in August. SIVs and SIV-lites (the latter are less diverse in their investments and have a fixed maturity) often have in the past benefited from the difference between cheaper priced short term commercial paper and higher yielding longer term instruments such as CDOs. The most simple are often funded by two classes of notes; higher yielding first loss notes, at the low end of the investment grade spectrum which fund between about 5 per cent and 15 per cent of the portfolio, and a larger portion senior of low-yielding, AAA-rated paper which can be short-term asset-backed commercial paper, or notes with a life of up to three months.

SIVs are often required to 'mark to market' the value of their underlying investments on a regular basis. Recent events have shown up some key weaknesses in the SIV structure.

Firstly, the short-term asset-backed commercial paper market effectively seized up in September. Secondly, many SIVs are forced to sell assets to maintain their leverage within pre-set levels when the net asset value of the portfolios declined. In some SIVs, enforcement requires immediate liquidation of the portfolio, whereas in other SIVs assets are required to be liquidated only as liabilities fall due.

Of course, the danger is that there have been very few bidders for the SIVs' underlying assets (such as CDOs) and the automatic sales mechanism has meant that fire sales of assets were required to take place in an illiquid market leading to significant losses on those assets.

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Conclusions

Complexity of security enforcement, and the related associated risks are often one of the key elements which drives creditors to the negotiation table to hammer out a restructuring with a distressed borrower.

The regulatory backdrop means that the ease of security enforcement (and the leverage which brokers gain from this) may mean that discussions to restructure a hedge fund's debt will never commence. The irony is that many hedge funds have lost significant money not because the underlying CDOs failed to perform (after all many CDOs have little or no exposure to US sub prime mortgages) but rather because, as the market for CDOs went into meltdown, margin calls from brokers forced funds to sell their CDOs at fire-sale prices.

Much the same can be said for SIVs; fire sales are required at the very time that the market for CDOs and other asset backed securities is at its worst.

As the sales process is hard wired into the documentary structure there is no obvious way in many cases of avoiding the forced sale process. Accordingly, rescuing funds and SIVs once the relevant NAV triggers have been breached is very hard and any rescue attempt must start immediately at the first hint of trouble, even then, it is hard if you need unanimous consent from all claims of investors.

For distressed investors the recent turmoil at some funds and SIVs will present interesting opportunities for strategic investment or for injecting longer term liquidity. If the CDO market recovers, no doubt many funds and SIVs will carry on much as before, but it is hard not to conclude that fund managers and SIV arrangers should seek to learn the lessons of the past few weeks when structuring the next round of vehicles, when and if that comes.

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