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AN OVERVIEW OF CDO TRANSACTIONS

CDOs are complex financial transactions in which portfolios of financial assets are securitized and sold in tranches of debt and equity securities to investors. The authors describe the typical transaction, discuss its variants, and note how CDO structures have contributed to the subprime market crisis.

By Ed O'Connell, John White, and Bruce Luna *

In 2007, collateralized debt obligation ("CDO") transactions managed to receive more bad press than Britney and Jamie Lynn Spears combined. But unlike the entertainment industry, there is such a thing as bad press in the financial world. One only needs to review a few of the CDO headlines from 2007 to get a sense of just how bad the year was for CDOs.[1] CDO transactions have been portrayed as villains in the current financial crisis, responsible for the current problems of many of the nation's banks as well as today's credit crunch. This follows the steady growth of the issuance of CDO securities for over a decade.[2] The upshot: total issuance of new CDO transactions in 2008 is expected to fall significantly from 2007.[3]

What are CDOs, and why are people saying such terrible things about them? CDOs are complex financial transactions and, until recently, were understood by few but the banks, collateral managers, rating agencies, and

[1] David Evans, "*The Poison in Your Pension: Banks are selling the riskiest CDO portions, known as toxic waste, to public pensions and state trust funds*," Bloomberg Markets Magazine (November 2007): 64.

David Henley and Matthew Goldstein, "*The Bear Flu: How It Spread; A novel financing scheme used by Bear's hedge funds became a template for subprime disaster*," BusinessWeek (December 31, 2007): 30.

Paul J Davies, "*$6.5bn of CDOs Face Ratings Downgrades*," The Financial Times (January 4, 2008).

Christopher Whalen, "*CDO Mess Reveals a Problem in Basel II*," American Banker (August 24, 2007): 11.

footnote continued from previous column…

Ben Hallman and Aruna Viswanatha, "*Brother, Can You Spare a Tranche?*," The American Lawyer (October 2007): 19.

[2] Sheri P. Chromow and Timothy G. Little, "*CDOs Impact the Debt Markets*," New York Law Journal (September 19, 2005).

[3] Jody Shenn, "*CDO Sales May Tumble 65% in 2008 on Subprime Slide*," http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a587rmfxO_KI (December 4, 2007).

∗ED O'CONNELL is a Partner in the New York City office of Jones Day. JOHN WHITE is Of Counsel and Bruce Luna is an Associate in the firm's Atlanta office. Their e-mail addresses are, respectively, ejoconnell@jonesday.com, jrwhite@jonesday.com and bluna@jonesday.com.

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lawyers intimately involved in the structuring, documentation, and issuance of CDO securities. Due to recent events, a lot more people are now talking about CDOs. On the theory that a little knowledge can be a dangerous thing, we have written this article to provide the reader with a description of typical CDO structures, explain some of the commonly used terms, and discuss the effect of CDOs on the current subprime mortgage crisis.

OVERVIEW

CDOs Generally

A CDO is a securitization of a portfolio of financial assets such as corporate bonds, loans, residential mortgage-backed securities, commercial mortgage-backed securities, asset-backed securities, or other financial assets or combinations of the foregoing. In a typical transaction, a special-purpose vehicle ("SPV"), typically an entity organized in the Cayman Islands or another tax-advantaged jurisdiction, is created to purchase the portfolio of financial assets, and the SPV finances its purchase of those assets by selling to investors multiple classes of debt securities (usually in the form of notes) and a class of equity securities (usually in the form of preferred shares but sometimes in the form of income notes).

As is the case with most securitization transactions, the SPV is structured as a limited-purpose, bankruptcy-remote entity. This means that purchasers of the securities issued by the SPV are taking the risks of ownership of the underlying assets (for example, the loans, in the case of a CDO backed by syndicated loans), but not the additional credit risk of an operating company (the entity that originated the loans). The organizational documents of the SPV and the other transaction documents will limit the SPV's activities to those essential for the CDO transaction and prohibit the SPV from incurring additional debt. The SPV must conduct itself as a separate entity so that its assets are not consolidated with those of any other transaction party. In a balance sheet transaction (described more fully below under "Balance Sheet vs. Arbitrage vs. Financing"), where the newly created SPV purchases assets from the transaction sponsor, the transfer of the assets must be documented as a "true sale" for bankruptcy purposes so that it is clear the assets would not be at risk if the sponsor became insolvent. For offshore SPVs, local counsel must be consulted to ensure the equivalent protections are in place under the laws of the SPV's jurisdiction.

The notes issued by the SPV (other than any income notes) will be assigned ratings by one or more rating agencies, which will be used by the underwriter for the transaction to help market the notes.

Many CDOs differ from typical securitizations in that they provide for the reinvestment of principal collections on the financial assets (referred to as "principal proceeds") during a specified period (usually three to five years) known as a "reinvestment" or "substitution" period. In addition, unlike most securitizations, CDOs are often permitted to sell assets that default, or are likely to default, or appreciate in value. Some CDOs also permit sales solely at the discretion of the portfolio manager up to a specified percentage of the aggregate principal balance of the portfolio.[4] A CDO may enter into interest rate swaps or other types of hedge agreements to manage mismatches between interest rates or timing of payments between the CDO notes and the underlying assets.

The financial assets purchased by the SPV are pledged under an indenture to secure the CDO notes and certain other financial obligations of the SPV. Unless the payments in respect of the CDO securities are insured or there is some other form of credit enhancement built into the transaction, these assets provide the only source of funds to make payments in respect of the CDO securities. Generally, interest payments ("interest proceeds") and principal proceeds in respect of the underlying assets are used to make interest and principal payments, respectively, in respect of the securities issued by the SPV in accordance with a payment priority (often referred to as a "waterfall") specified in the CDO indenture. *See* the Appendix to

[4] *See* "Static vs. Managed" below.

this article for a description of a typical CDO priority of payments.

In our example of a CDO transaction structure, there are three classes of debt securities (Classes A, B and C Notes) and one class of equity securities denominated as preferred shares. In general, amounts owed in respect of a more senior class of CDO securities are required to be paid before amounts owed in respect of the more junior classes. Holders of the preferred shares receive no distributions of interest proceeds until all note interest has been paid in full.[5] This subordination of classes of securities (often referred to as "tranching") is what allows classes of notes secured by the same pool of assets to achieve different ratings.

Principal proceeds also will be distributed on each transaction payment date in a similar order of priority. As mentioned above and as described further below under "Static vs. Managed," if the transaction is a managed CDO, principal proceeds will be used by the SPV to purchase additional financial assets during the reinvestment period for the CDO transaction before they are used to repay principal of the notes. Holders of the equity securities generally receive no distributions of principal proceeds until the notes and all other financial obligations of the SPV have been paid in full.[6]

The transaction documents for CDOs typically contain coverage tests which serve to "delever" the CDO transaction (*i.e.*, pay down the principal of notes) if the assets are not performing as expected. These coverage tests typically consist of an interest coverage test and an overcollateralization or par value coverage test. In an interest coverage test, the amount of interest proceeds received during a specified period is compared to the expenses of the CDO to be paid with interest proceeds. In an overcollateralization test, the aggregate par amount of the underlying financial assets is compared to the outstanding principal amount of the CDO notes.[7] If these ratios fall below specified levels, interest proceeds (and if these are insufficient, principal proceeds) are diverted to pay down the notes sequentially in order of seniority until the tests are passed or the notes are paid in full. This means that amounts which were scheduled to be paid below the senior notes (including interest on subordinated notes and distributions to equityholders) will be shut off until the test is satisfied or all senior classes are repaid.[8] Different classes of notes may have coverage tests that trigger at different levels. The more highly rated the class, the more interest proceeds or collateral will be required.

Tax Considerations

The economics of the typical CDO transaction mandate that the CDO be structured so that the SPV will be subject to no (or only a limited amount of) entity-level income taxation. In most CDOs, two steps must be taken to achieve this result. First, as noted above, in most CDO transactions the SPV is organized in an offshore jurisdiction which does not impose entity-level taxation. Alternatively, the SPV may be organized in a jurisdiction, such as the Netherlands or Ireland, which imposes a predictable low level of taxation for a qualifying SPV. Second, the activities of the SPV must be limited so it is not considered to be engaged in a trade or business for purposes of the Internal Revenue Code and thus subject to taxation in the United States.[9]

Another common tax issue in structuring the CDO transaction is whether the securities issued by the SPV will be treated as debt or equity for U.S. federal income tax purposes. The mere fact that securities are denominated as notes and bear the typical attributes of debt (*i.e.*, a fixed rate of interest and principal due upon maturity) does not mean such securities will be treated as debt under the Internal Revenue Code. Generally, the most senior classes of notes will qualify as debt due to their ratings and the amounts of subordination protecting them. It is often less clear whether subordinated classes of notes (particularly if they are rated below investment grade) should be considered debt or equity. It is important to some investors to purchase only classes of notes that will be considered debt rather than equity. U.S. investors in equity securities, including certain securities that are issued in the form of notes but are considered equity for tax purposes, face phantom income

[5] *See* the Appendix to this article.

[6] *Id.*

[7] For purposes of an overcollateralization test, the aggregate par amount of assets is discounted for certain collateral which is assumed to be impaired because it is in default or downgraded or was purchased at a deep discount. As discussed in more detail under "The Impact of CDOs in the Current Environment," these haircuts can create serious issues for CDOs.

[8] *See* the Appendix to this article.

[9] In a balance sheet transaction (described in more depth below under "Balance Sheet vs. Arbitrage vs. Financing"), the sponsor owns the financial assets, which it desires to securitize in order to remove the assets from its balance sheet. In certain transactions, one or both of these steps are avoided (for example, if the SPV is a wholly owned subsidiary of a U.S. real estate investment trust as is common in certain commercial real estate CDO transactions).

issues when the actual cash distributions on their securities are less than their allocation of the SPV's income for U.S. federal income tax purposes.

Securities Laws

Typically, the securities issued by the SPV are offered globally. To avoid registration of a CDO transaction under the Securities Act of 1933, which would be cost prohibitive and delay the timing of the offering, an exemption from registration of the securities must be available to the SPV and the related underwriter. CDO transactions often are structured as a "Rule 144A/Regulation S" offering, meaning that the securities are offered (x) within the U.S. only to one or more "qualified institutional buyers" in an offering meeting the requirements of Rule 144A and (y) outside of the U.S. to one or more non-U.S. persons in an offering meeting the requirements of Regulation S.[10]

In addition, the SPV will meet the definition of an "investment company" under the Investment Company Act of 1940. As compliance with the Investment Company Act's reporting requirements and limitations on transactions with affiliates would be prohibitive, the CDO transaction must be structured so that there is an exception or exclusion from registration as an "investment company" under the Investment Company Act. The most commonly used exception in CDO transactions is Section 3(c)(7) of the Investment Company Act, which excepts from registration any company all of whose outstanding securities are held by "qualified purchasers" (within the meaning of the Investment Company Act).[11] Importantly, if the SPV is organized outside of the U.S., non-U.S. investors can be ignored when determining compliance with Section 3(c)(7).[12]

[10] "Qualified institutional buyers" generally are sophisticated investors with a certain net worth and/or financial expertise that are deemed not to need the protection of registration under the Securities Act. Regulation S provides guidelines which create a safe harbor for determining whether an offering is made outside the United States.

[11] A "qualified purchaser" is defined similarly to a "qualified institutional buyer."

[12] The specific requirements for exemptions from registration of a transaction under the Securities Act and exclusions or exceptions from registration as an "investment company" under the Investment Company Act are beyond the scope of this article. Qualified securities law counsel must be consulted when structuring the offering of the SPV's securities.

BALANCE SHEET VS. ARBITRAGE VS. FINANCING

A CDO transaction often is classified as a "balance sheet," "arbitrage," or "financing" transaction, depending on its primary motivation. In a so-called balance sheet transaction, an originator or owner of financial assets, often a bank or another financial institution, removes the assets from its balance sheet (thus reducing capital requirements) by transferring the risk of ownership of such assets to the SPV. This may be accomplished by selling the financial assets to the SPV in a transaction characterized as a true sale as described above. Alternatively, the risks of ownership of the financial assets may be transferred from the owner to the SPV synthetically through the use of one or more credit-default swaps or total-return swaps linked to the financial assets.[13] *See* "Cash vs. Synthetic" below. If the owner of the financial assets is a bank, the regulatory capital rules established by the banking regulator in the home country of the bank sponsoring a balance sheet CDO transaction may affect the structure of the transaction.

In an arbitrage CDO transaction, the primary motivation is that the entity sponsoring the transaction believes that the return on the financial assets to be purchased by the CDO in the open market will be greater than the financing costs associated with the securities issued by the SPV. Typically, the sponsor will benefit economically through its ownership of all or a portion of the SPV's equity securities and through its receipt of fee income during the life of the transaction if the sponsor also acts as the collateral manager.

A financing CDO transaction is similar to a balance sheet transaction in that the assets are owned by the entity sponsoring the transaction before being sold to the SPV. The primary motivation for entering into a financing transaction, however, is not to remove those assets from the sponsor's balance sheet but simply to finance the sponsor's ownership of those assets by accessing the capital markets through a CDO transaction. Many recent commercial real estate ("CRE") CDO transactions are financing transactions. The sponsor in each of those transactions is a U.S. real estate investment trust ("REIT") and the offshore SPV is a subsidiary of the sponsor REIT. After the CDO

[13] Credit-default swaps are discussed more fully herein under "Cash vs. Synthetic." Under a typical total return swap, one party usually receives all yield on a specified pool of assets and any appreciation in the value of those assets in exchange for payment of the other party's financing costs and any depreciation in the assets.

transaction closes, the assets remain on the sponsor's consolidated balance sheet.[14]

CASH VS. SYNTHETIC

CDOs also may be characterized as either cash or synthetic, depending upon how the SPV gains exposure to the financial assets.

In a cash CDO transaction, the net proceeds of the securities issued by the SPV are used to purchase the underlying financial assets. The portfolio of assets purchased by the SPV is held by the related trustee on behalf of the noteholders and the other parties secured by the pledge of the underlying assets to the trustee under the related indenture. In a managed transaction, principal proceeds in respect of the underlying assets (as well as sale proceeds resulting from any permitted dispositions of underlying assets) may be reinvested in additional underlying assets during a reinvestment period. *See* "Static vs. Managed" below.

In a synthetic transaction, the SPV does not purchase financial assets directly but invests in them "synthetically" through derivative products. That is, the SPV enters into a number of credit-default swaps with a counterparty relating to a particular "reference" asset or corporate "reference" entity. Under a typical credit-default swap, the SPV sells credit protection on the reference asset or reference obligation to the counterparty. In exchange, the counterparty pays a periodic premium to the SPV. The amount of this premium is based either on current market rates or is calculated so that it is sufficient to pay the SPV's operating expenses and interest on its securities. Under the swaps, if certain defined credit events occur with respect to a reference entity or obligation,[15] the SPV must either purchase a specified obligation from the counterparty at par or pay to the counterparty the difference between the par amount and current market value of the related obligation. Thus, the SPV has assumed the risk of loss on the entity or obligation without actually purchasing any obligation. A single counterparty, sometimes the sponsor, may enter into all of the credit-default swaps with the SPV, or multiple dealers may be involved. Reference obligations can include asset-backed securities ("ABS"). Credit-default swaps for ABS typically are documented in a form referred to as "pay-as-you-go" because, although the form contains credit events analogous to those for corporate transactions, it also provides that the buyer of protection may receive payments for writedowns or interest and principal shortfalls on the reference obligation without terminating the entire transaction.

The net proceeds of the securities issued by the SPV typically are invested in relatively low-risk investments. The SPV uses the income on these investments together with the periodic premium on the credit-default swaps to pay interest on the notes it has issued. The SPV will make payments due under the credit-default swaps from cash flows or by liquidating one or more of these investments it purchased with the net proceeds of issuance. Proceeds remaining at the maturity of the transaction are used to make principal payments on the notes.

Many synthetic CDO transactions also contain an unfunded class which is subject to the risk of the credit-default swaps after losses have eaten through the principal amount of the securities issued by the SPV. This class represents additional leverage for the transaction (*i.e.*, it allows the SPV to receive the cash flow on a larger pool of assets but also subjects the CDO notes to losses on those assets). This class is often referred to as "super senior" because its risk of loss is above that of the risk to the triple-A rated notes of the CDO. The counterparty may retain this unfunded class or transfer the risks associated with it to an insurer.[16]

HYBRID

Hybrid CDO transactions are combined cash and synthetic transactions, which may start out with a mix of cash and synthetic assets. After closing, the portfolio manager may rebalance the CDO's portfolio between cash and synthetic assets at any time. Available cash may be used either to purchase assets or, if assets are acquired synthetically, to fund a reserve account in case the CDO is required to make payments under the related credit-default swaps. A hybrid transaction often will require some type of liquidity facility to handle

[14] One additional requirement in these types of CRE CDO transactions is that all of the equity of the SPV must be held by the REIT sponsor. Generally, this would include the equity securities issued by the SPV as well as any class of notes rated below investment grade.

[15] Credit events typically include such events as bankruptcy and failure to pay on specified obligations and may include restructuring of an entity or a moratorium on payments in the case of a sovereign.

[16] For ease of understanding, we have restricted the discussion of synthetic transactions to those using credit-default swaps, although synthetic transactions may also use total return swaps as noted above under "Balance Sheet vs. Arbitrage vs. Financing."

mismatches in timing between payments on the underlying assets and payments due under credit-default swaps, as well as some type of interest-rate protection on the reserve account for the synthetic assets because of its potential size and the danger of negative carry.[17] This protection often will take the form of a guaranteed investment contract or total return swap.

STATIC VS. MANAGED

In a static CDO transaction, the portfolio of underlying assets (or reference obligations or reference entities, in the case of a synthetic CDO transaction) is selected at the beginning of the transaction and remains fixed for the entire term. However, in some cases, the transaction documents may permit the SPV to sell certain of the underlying assets that become defaulted or are in danger of becoming defaulted.

In a managed CDO transaction, subject to specific investment guidelines established at the outset, assets may be added to and/or removed from the portfolio of underlying assets during the reinvestment period. In a typical managed CDO transaction, a collateral manager is retained by the SPV to select the initial portfolio of underlying assets, sell underlying assets from time to time as permitted by the transaction documents, and to purchase new assets with principal proceeds and the sale proceeds resulting from permitted dispositions of underlying assets. The manager receives a fee for performing these services, which often includes an incentive component if the deal performs well.

In a managed CDO transaction, it is anticipated that the collateral manager will use its expertise to produce a lower level of defaults or credit events, and to generate more income to service the debt of the SPV as well as provide a better rate of return for the equity investors. However, investors may prefer a static CDO transaction because they can analyze at the outset the exact portfolio of underlying assets to which they will be exposed for the life of the transaction.

CASH FLOW VS. MARKET VALUE

CDO transactions also may be classified as cash-flow or market-value, with most being cash-flow. In a cash-flow transaction, the market value of the portfolio collateral is generally unimportant because the assets are either held to maturity or sold to provide funds to purchase new collateral. Cash flow transactions typically make use of the overcollateralization tests and interest coverage tests discussed above.

Market value CDO transactions are less common. As with other forms of CDO transactions, securities are issued by an SPV and the proceeds are invested in a portfolio of underlying assets. The collateral manager has considerable flexibility to trade the assets. The portfolio is periodically marked-to-market (typically daily or weekly), and each category of investments is assigned an advance rate by the rating agencies. If the value of the portfolio calculated by using the advance rates falls below a specified percentage of the principal amount of the outstanding CDO notes, assets must be sold until the collateral is back in sync with the advance rates. As an alternative to selling assets, the holders of the SPV's equity securities may contribute funds to purchase assets in a sufficient amount to satisfy the test. Market value CDO transactions generally require that the entire portfolio of underlying assets be liquidated if the portfolio value test is not satisfied within a specified time period. Market value CDO transactions are often thought of as highly structured hedge funds.

THE IMPACT OF CDOS IN THE CURRENT ENVIRONMENT

Having described CDOs in some detail, we would now like to explain how they relate to the current subprime crisis.

Our discussion begins with the origination of subprime mortgages. Subprime mortgages are mortgages made to borrowers who would not ordinarily qualify for a mortgage based on weak credit history or weak documentation on their ability to repay. Banks and mortgage companies were willing to make these loans, and borrowers to take them, because most expected that the increase in housing prices would continue and make it possible for the related borrowers to refinance their loans under normal terms in a relatively short period of time.

These subprime mortgage loans, like most residential mortgage loans, were securitized, and many of the resulting residential mortgage-backed securities ("RMBS") were purchased by CDOs.

As subprime mortgages began to default, it became apparent that the methodologies used by the rating agencies in rating RMBS did not take into account the

[17] That is, amounts on deposit in the reserve account will be earning significantly less than the interest rates on the CDO notes.

looser subprime underwriting criteria.[18] The agencies then revisited RMBS they had rated and drastically reduced the ratings they had assigned to RMBS backed by subprime mortgages. Consequently, the market value of RMBS (and CDOs holding RMBS) dropped significantly.

These downgrades and drops in market value had serious consequences. First, many banks had kept a significant amount of notes issued by CDOs they had sponsored on their balance sheets. As the market values of these securities dropped, the banks experienced significant losses.[19]

As discussed above, the documentation for many CDOs contains "overcollateralization" or "par value" triggers, which divert cash flows to pay down notes in order of seniority if they are breached. RMBS securities held by a CDO that are rated below investment grade are haircut at various levels (depending on their ratings). Consequently, as the ratings are lowered, many CDOs will begin to "delever," cutting off interest payments to lower-rated notes and distributions to equity, making these securities practically worthless. In addition, many of the CDOs that closed in recent years provide that an "event of default" will occur under the transaction indenture if the overcollateralization level falls below a specified target. Holders of the most senior notes will then have the option of liquidating the CDO's holdings. In such event, sales of large blocks of securities into the markets will further depress the market values of underlying collateral and, consequently, the securities issued in connection with other CDOs.[20] In hybrid CDOs, or CDOs with large amounts of synthetic assets, the credit-default swap counterparty will be entitled to receive termination payments from the SPV under the credit-default documentation, which will reduce the amounts available to make payments to the noteholders. Some insurance companies, pension funds, and other institutional investors also may be forced to sell bonds that have been downgraded, because they are allowed to hold only top-rated securities.

Many industry critics feel that CDOs have had the effect of magnifying the subprime crises. Not only did CDOs purchase RMBS backed by subprime mortgage loans, but CDOs also purchased other CDO securities that had exposure to RMBS securities secured by subprime loans. In addition, because CDOs often sourced assets synthetically, exposure to these RMBS securities could exceed the actual amount of the securities outstanding.

WHAT'S NEXT

The outlook for the CDO market is uncertain. Many believe we have not yet seen the worst of the subprime mortgage crisis. Most industry experts agree that CDO issuance in the near future will be sparse. Over the next several months, it will be interesting to see if new structures can be created to mitigate current risks and how other types of CDOs, such as CDOs backed by trust preferred securities and CDOs secured by corporate loans, will fare. ■

[18] Joseph R. Mason and Joshua Rosner, "*Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage-Backed Securities and Collateralized Debt Obligation Market Disruptions*," Hudson Institute Working Paper (May 14, 2007): 23; Jonathan S. Sack and Steven M. Juris, "*Rating Agencies: Civil Liability Past and Future*," New York Law Journal (November 5, 2007).

[19] *A Citi Situation*, The Economist (January 17, 2008).

[20] Steven Pearlstein, "*Over an Insurance Barrel*," Washington Post (January 25, 2008): D1; Jody Shenn, "*S&P Says State Street CDO Liquidates; Ratings Slashed*," http://www.bloomberg.com/apps/news?pid=20601087&sid=a4iXG6w_Hft0&refer=home (November 8, 2007).

Appendix – Basic Priority of Payments

Interest Proceeds	**Principal Proceeds**
1. Taxes and senior fees and expenses	1. Amounts payable pursuant to clauses 1-5 under "Interest Proceeds" to the extent not paid thereunder;
2. Hedge counterparty payments (other than such payments which are subordinated as described below);	2. Interest on the Class C Notes (but only if the Class C Notes are non-pikable or they are then the most senior class of notes outstanding, and only to the extent not paid with interest proceeds);
3. If the CDO is a "managed" CDO transaction, to the periodic fee due to the collateral manager;	3. If the transaction provides for a reinvestment period, purchase of additional financial assets (until the end of such period);
4. Interest on the Class A Notes;	4. Principal of the Class A Notes;
5. Interest on the Class B Notes;	5. Principal of the Class B Notes;
6. Interest on the Class C Notes;	6. Principal of the Class C Notes;
7. Unpaid subordinate fees and expenses;	7. Unpaid subordinate fees and expenses (to the extent not paid with interest proceeds);
8. Subordinate hedge counterparty payments (*i.e.*, payments due to the counterparty where it is the defaulting or sole affected party); and	8. Subordinate hedge counterparty payments (to the extent not paid with interest proceeds); and
9. Remaining amounts to holders of the preferred shares.	9. Remaining amounts to holders of the preferred shares.