Shedding Light on the Intersection Between CDO and Derivatives Documentation in the *Solstice* Case

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Derivatives transactions are of course an important staple in the diet of CLOs and other structured finance vehicles. Structured finance vehicles routinely use derivatives as hedges for interest rate and foreign exchange risk, as synthetic investments and as credit enhancement. The documentation for structured finance transactions and for derivatives transactions are notoriously complex, and unexpected results can occur when they inter-operate or even "clash."

Two little-noticed opinions, only one of which has been published, from the Solstice ABS CBO II case demonstrate some of the surprising twists and turns that can arise. In the first,[1] U.S. District Court Judge Batts of the Southern District of New York issued a decision on summary judgment that illustrates how indenture events of default and International Swaps and Derivatives Association (ISDA) additional termination events that are ostensibly designed to work in tandem can take surprisingly divergent paths. Second, U.S. Magistrate Judge Peck issued one of the very few - if not the only - published decisions of its kind in the United States assessing a contested termination value under an ISDA Master Agreement.[2] Although *Solstice II* is in essence a "battle of the experts," the nature of the expert testimony required the court to delve into a great number of contentious interpretive issues concerning the indenture and the correct parameters for determining "loss" under an ISDA Master Agreement. Although the ISDA counterparty filed a Notice of Appeal for both decisions to the Second Circuit, the appeal has since been withdrawn.

I. Factual Background.

Solstice ABS CBO II, Ltd. (Issuer) was formed as part of a collateralized debt obligation transaction to issue four classes of notes (Classes A-1, A-2, B and C) and two classes of equity backed by residential mortgage-backed securities. The Issuer also entered into a "Cashflow Swap Agreement" (Swap) with a financial institution (Provider) under which the Provider agreed to top up any shortfalls of interest available to be paid to the Class A-1, A-2 and B notes in return for an on-going fee and a promise to repay the Provider's advances to the extent the Issuer later generated sufficient funds to do so. The Swap, which was made up of a standard 1992 ISDA Master Agreement and a Confirmation detailing the Swap's financial terms, had certain intricate links to the indenture (Indenture) pursuant to which the notes were issued. Specifically, certain events of default under the Indenture (Indenture Events of Default) had two consequences for the Swap. First, an Indenture Event of Default constituted an "Additional Termination Event" under the Master Agreement that would enable the Provider to declare an early termination of the Swap and determine an amount (Termination Amount) equal, roughly speaking, to the value of the Swap to be paid either to

or by the Provider. Second, an Indenture Event of Default constituted a "Cashflow Swap Cancellation Event" under the Confirmation, which would also result in an early termination of the Swap, but with financial consequences different from those that would apply to a mere Additional Termination Event. In the case of a Cashflow Swap Cancellation Event, the Provider would be relieved of its obligation to make future advances and the parties would simply settle up on the basis of an obligation on the part of the Issuer to repay past advances plus an accounting for fees owing to the Provider.

In late October 2009, the indenture trustee (Trustee) declared an Indenture Event of Default on the basis that the value of the Issuer's assets as of a specific date (Measurement Date) had fallen below 101% of the aggregate face value of the Class A-1 and Class A-2 notes (Overcollateralization Test). The Provider responded on November 4, by declaring an Additional Termination Event and designating November 9 as the "Early Termination Date". The Provider's notice included a calculation of the Termination Amount in the amount of $2.2 million owing *to* the Provider on the basis that a Cashflow Swap Cancellation Event had also occurred and that this amount represented the calculation described in the preceding paragraph.

A number of other events also transpired during this time period. First, November 2 was another Measurement Date and the Issuer again failed the Overcollateralization Test. Second, and crucially, MBIA Insurance, Inc. (MBIA), as the "controlling class" under the Indenture, on November 6 (i.e., after the Provider's declaration of an Additional Termination Event but before the Early Termination Date designated by the Provider) waived the Indenture Event of Default that the Trustee had declared in October and took the position that the Swap accordingly remained in full force and effect. Finally, November 9 was an interest payment date under the Indenture and the Issuer failed to make payment of all interest due to be paid the Class A-1, A-2 and B notes. This failure to pay interest, after a three business day cure period, constituted another Indenture Event of Default.

Because of the radically differing positions of the Provider and MBIA as to the status of the Swap and the amount of any payment that might be due to or from the Provider, the Trustee almost immediately commenced an interpleader on November 12.

II. The Summary Judgment Decision.

U.S. District Judge Batts addressed the parties' threshold contentions in cross-motions for summary judgment in *Solstice I*. Judge Batts first held that the Provider's declaration of an Early Termination Date under the Swap was effective as of November 9, notwithstanding MBIA's waiver of the Indenture Event of Default on November 6. However, because that waiver occurred before the Early Termination Date, it operated to nullify the Cashflow Swap Cancellation Event under the Swap and accordingly the special payment mechanic pertaining to a Cashflow Swap Cancellation Event.

The court reached this apparently incongruous result through a close reading of the Master Agreement and the Confirmation. Under the Master Agreement, if a party effectively delivers a termination notice at a time when an Event of Default or Termination Event is "then continuing," the Early Termination Date will occur on the date so specified regardless of whether the Event of Default or Termination Date ceases to exist in the interim.

This is precisely the situation in *Solstice I*. The Provider responded to the Indenture Event of Default by giving notice, on November 4, of the designation of an Early Termination Date to

occur November 9. The Additional Termination Event was thus "continuing" at the time the Provider gave its notice. Accordingly, the Early Termination Date occurred November 9 irrespective of MBIA's intervening waiver.

The opposite result pertained with respect to the Cashflow Swap Cancellation Event under the Confirmation. Under the Confirmation, a Cashflow Swap Cancellation Event would be operative only for so long as the relevant Indenture Event of Default was "continuing." MBIA's November 6 waiver caused the Indenture Event of Default no longer to be "continuing" and, accordingly, the Cashflow Swap Cancellation Event had ceased to exist by November 9.

The second holding in *Solstice I* is slightly more subtle. The Master Agreement required that the Swap be valued "as of the relevant Early Termination Date," which as previously noted occurred on November 9. The problem for the Provider was that MBIA's intervening waiver of the Indenture Event of Default effectively nullified the Cashflow Swap Cancellation Event despite the fact that MBIA could do nothing to prevent the occurrence of the Early Termination Date. The Swap was accordingly to be valued as if no Cashflow Swap Cancellation Event had occurred. This set the stage for the valuation inquest before Magistrate Judge Peck.

III. Battle of the Experts in *Solstice II*: The Contentions.

Magistrate Judge Peck ultimately found that the Provider owed a sizeable payment to the Issuer on the basis of his review of copious expert testimony. There are several noteworthy features to the various expert opinions in *Solstice II*. First, the Provider's expert testified as to three different valuation "models" whose applicability depended on various legal assumptions. This enabled (or required) the court to assess these legal assumptions in the course of accepting or rejecting the various outcomes. Second, both experts utilized a "discounted cash flow" model that attempted to predict exactly what cash flows would have occurred when, and discounted them to present value.

The Provider's expert, Michael DiYanni (DiYanni) applied certain legal assumptions and analytics to create three different valuation "models." "Model A" assumed that Solstice's payment obligations under the Swap are to be valued as if they had been met when due, regardless of whether there would have been funds availability under the "priority of payments" provisions of the Indenture. "Model B" assumed that a Cashflow Swap Cancellation Event was in effect on the Early Termination Date notwithstanding MBIA's waiver of the original Indenture Event of Default. "Model C" assumed that the "priority of payments" provisions of the Indenture would be operative to defer or cancel Solstice's payment obligations depending upon whether and when funds sufficient to pay senior claimants are projected to exist.

"Model A' and "Model B" resulted in amounts payable to the Provider roughly in line with the Provider's original calculation, but the court rejected them as being not legally warranted. Model C produced amounts payable **by** the Provider and, because MBIA's expert utilized much the same methodology, became one of the contenders in the "battle of the experts".

MBIA's expert, Dr. Peter Niculescu (Niculescu) provided only opinions that, like Model C, assumed the "priority of payments" of the Indenture would be operative. All of Niculescu's opinions resulted in substantial amounts payable by the Provider to Solstice.

IV. Model A: Availability of Funds Not a "Condition Precedent".

Model A assumed that Solstice would perform its obligations when they came due, irrespective as to whether it would have funds available to do so under the priority of payments provisions of the Indenture. DiYanni calculated a value in favor of the Provider equal to $ 2.54 million and testified that Model A was "an appropriate model" and that in his experience, "the calculation of Termination Payments for derivatives transactions is based upon present valuing…a projection of what each party 'should' pay under the agreement, not what each party 'would' actually be able to pay." The Provider argued, in legal terms, that the availability of funds under the priority of payments provision was a "condition precedent" to Solstice's obligation to pay. The Provider further argued that, because the ISDA valuation process[3] assumes the satisfaction of all "conditions precedent" to future payment obligations, it follows that the availability of sufficient funds to pay the Provider, as a "condition precedent" to payment, must be assumed. The court dismissed the argument because the parties had not expressly designated the availability of funds as a "condition precedent" and because the law disfavors conditions precedent and will only treat them as such when they are clearly and unambiguously so designated.

V. Model B: No Superceding Indenture Event of Default.

Model B assumed that, notwithstanding MBIA's waiver of the Indenture Event of Default relating to the Over-Collateralization Test on the October Measurement Date, a Cashflow Swap Cancellation Event was nonetheless in effect on November 9, the Early Termination Date, for two reasons. First, Solstice had breached the Over-Collateralization Test "again" on the November 2 Measurement Date whereas MBIA had only waived the October Measurement Date breach. Second, Solstice's failure to pay all interest to senior noteholders on November 9 represented another Indenture Event of Default. These two events, the argument ran, gave rise to a "new" Cashflow Swap Cancellation Event on or before the November 9 Early Termination Date.

Magistrate Judge Peck rejected both contentions. First, he noted that the Indenture makes frequent reference to the possibility that Indenture Events of Default can "have occurred and be continuing" and second that an Indenture Event of Default will cease to be "continuing" if it is "cured or waived." The court reasoned, accordingly, that because the October Indenture Event of Default "continued" through and beyond November 2, the November 2 breach of the Over-Collateralization Test was not a separate Indenture Event of Default and that there was no need for any additional waivers beyond what MBIA had provided relative to the October Over-Collateralization Test breach on November 6.

With respect to the putative interest payment Indenture Event of Default, the court noted that there was a three-day cure period which had only begun to elapse on November 9 and accordingly that there was neither an Indenture Event of Default nor a Cashflow Swap Cancellation Event in existence by virtue of the failure to pay interest on November 9. Model B was thus excluded from consideration as resting on faulty assumptions.

VI. Model C: Estimated Cash Flow and Outcome.

As already noted, Model C and Niculescu utilized broadly the same methodology – a discounted cash flow analysis applied to projected cashflows and taking the availability of funds under the priority of payments provisions into account – but reached very different results on the basis of different financial assumptions. All results, however, resulted in

sizeable payments owing from the Provider to Solstice. The court ultimately sided with DiYanni's valuations, largely for the simple reason that the Provider was the party who was not the Affected Party and therefore, under the terms of the ISDA Master Agreement, the party that was entitled to determine the termination amount.

VII. Conclusion.

The lessons of *Solstice I* and *II* are legion. Principal among them are how the delicate balance in the documents between the Additional Termination Event and Cashflow Swap Cancellation Event – both of which were triggered by the same Indenture Events of Default and were thus presumably designed to work in tandem – was disrupted by an intervening waiver of the relevant Indenture Event of Default. This disruption caused a $2.2 million payment owing to the Provider to be altered in favor of a sizeable payment owing to the Issuer.

Another lesson is that *Solstice II*'s rejection of the Provider's "Model A" is arguably in tension with the "value clean" line of authority on valuations under 1992 ISDA Master Agreements in the courts of England and Wales.[4] In other words, if Magistrate Judge Peck had been more willing to view the availability of funds provisions under the Indenture as a "condition precedent," he might have been required to value the Swap on the somewhat implausible basis that the Issuer would always have had funds available to it to perform its obligations under the Swap.

Finally, *Solstice I* in its careful reading of the Master Agreement and *Solstice II* in its searching analysis of the legal assumptions underlying the Providers three valuation "models" augment the comparatively small group of decisions of their kind in United States courts. The United States courts have heretofore lagged their counterparts in London on cases concerning the interpretation of ISDA documentation. The fall-out from the credit crisis may help to close that gap.

[1] Bank of N.Y. Mellon Trust Co., N.A. v. Solstice ABS CBO II, Ltd., No. 09 Civ. 9415 (DAB), slip op. (S.D.N.Y. March 28, 2012) ("*Solstice I*"). A copy of this decision is on file with the author.

[2] Bank of N.Y. Mellon Trust Co., N.A. v. Solstice ABS CBO II, Ltd., 910 F. Supp. 2d 629 (S.D.N.Y. 2012) ("*Solstiice II*"). The parties had consented to the entry of final judgment by the magistrate pursuant to 28 U.S.C. § 636(c)(1).

[3] Strictly speaking, the Master Agreement specified that the "Market Quotation" methodology be utilized to determine the Termination Amount but the Provider "purportedly" utilized the Loss methodology. Although a detailed description of these methodologies might in other circumstances be warranted, for present purposes it is sufficient to note that Judge Batts had essentially held in *Solstice I* that satisfaction of all future conditions precedent must be assumed under both methodologies. *Solstice I*, *supra* note 1, at *17. This is consistent with the definition of "Market Quotation," *see* 1992 ISDA Master Agreement (Multicurrency - Cross Border) § 14 (definition of "Market Quotation") and, relative to "Loss," with an authoritative line of cases under the laws of England and Wales. *See Lomas v. JFB Firth Rixson Inc.*, [2102] EWCA Civ 419 (Ct. App. April 3, 2012),

at ¶¶ 133-34 (quoting *Pioneer Freight Futures Co. Ltd. (in liquidation) v. TMT Asia Ltd.*, [2011] EWHC 778 Comm, at ¶ 116).

[4] *See*, *e.g., Lomas v. Rixson Inc.*, *supra*, at ¶129: "This means that the loss of bargain must be valued on an assumption that, but for termination, the transaction would have proceeded to a conclusion, and that all conditions to its full performance by both sides would have been satisfied, however improbable that assumption may be in the real world." Application of the "value clean" principle is accordingly a rather abstract exercise and has been determined, for example, to preclude consideration of the Non-defaulting Party's creditworthiness in determining the valuation of transactions. *See*, *e.g.*, *Austl. and N.Z. Banking Grp. v. Societe Generale* [2000] EWCA Civ 44, ¶¶6; 30-31 (Ct. App. Feb. 17, 2000); *Peregrine Fixed Income Ltd. v. Robinson Dep't Store Pub. Co. Ltd.* [2000] EWHC Commercial 99 (High Court (Commercial) May 18, 2000).