Article Title: ARCHIVE | Legal Criteria: Criteria Regarding Legal Opinions in the Context of CDOs Data: (Editor's note: These criteria are no longer valid.) It has been Standard & Poor's general practice to require that legal opinions be delivered in the context of securitization transactions. The opinions requested pertain to those aspects of a relevant transaction's legal structure that Standard & Poor's deems complex and important enough to require comfort from outside counsel to be sought. Which aspects fall into that category will depend on the transaction structure, the country, and asset class. However, even though the ultimate decision as to the legal opinions Standard & Poor's requires to see must remain a case-by-case decision, over time certain rules of thumb have been settled. This enables market participants to enter into most transactions with a legitimate expectation as to the opinions they must seek from outside counsel. The CDO market, and particularly the non-U.S. CDO market, is still a relative newcomer to the securitization scene. As such, Standard & Poor's feels that it may be useful to the market to set down those items of legal due diligence that it feels need to be covered and the manner in which Standard & Poor's feels is most appropriate to see them covered. These guidelines are not rules insofar as, in the case of any specific transactions, it may be appropriate to require additional comfort in respect of novel or especially difficult points. They apply to all types of CDOs that involve the legal transfer, by way of sale or participation or otherwise, of the underlying debt to a special-purpose entity (SPE). This paper does not deal, therefore, with synthetic transactions where the assets are not transferred to the issuer. The rules of thumb are summarized in the reference table set out in the appendix at the end of this paper. CDOs generally fall into two categories, which for the sake of simplicity are called "balance-sheet" CDOs and "arbitrage" CDOs. Balance-sheet CDOs are effected by financial institutions that wish to divest themselves of part of their banking assets. Usually these will be assets that the institution has generated itself through its lending activities or that were purchased some time previously with the intention that the institution will hold them. Usually these transactions are carried out to release regulatory or economic capital and/or reprofile the financial institution's balance sheet. The assets disposed of would not usually be booked in the relevant institution's trading book. Arbitrage CDOs are set up for the purpose of taking advantage of imperfections in the market's pricing of financial assets. From the legal point of view, their key feature in Standard & Poor's eyes is that the securitized assets are purchased in the open market from a variety of market sellers who are unconnected with the rated transaction. As a rule of thumb, Standard & Poor's will treat the transaction as an arbitrage CDO where: The assets are purchased directly by the securitization vehicle from third-party market participants; or The assets are purchased from a financial institution that has itself purchased them from a third-party market participant in the previous three months and where the assets were always booked in that institution's trading book. The distinction is important because certain risks relating to the sale of the assets and particularly preference risks in the insolvency of the seller are likely to be much less acute in an arbitrage CDO than in a balance-sheet transaction. This is because, as a practical matter, a sale at open market value using the normal procedures and sale documentation of the international capital markets is considerably less likely to be challenged by the liquidator of an insolvent seller. The Laws Governing CDOS Turning now to the legal aspects of CDOs there are potentially seven legal systems in play: The law of the seller of the assets — i.e., the country whose law will govern any potential insolvency of the seller. Under principles of international law, whether a sale is to be treated as a preference and/or the asset purported to be sold is treated as still remaining in the estate of the insolvent seller is to be determined under the law governing that seller's insolvency. That is, in the vast majority of cases, the law of the country in which that company is incorporated. The law of the contract transferring the assets — i.e., the law chosen by the parties to govern the sale or participation agreement. This law is at the option of the parties but is usually the law of England or the law of the State of New York. This is the law that determines whether the document signed by the parties and purporting to effect a sale actually achieves the anticipated result. The law of the underlying debts — i.e., the law chosen by the original lender or lenders and the original borrower (or issuer) to govern the asset being sold or participated. It is this law that determines whether the debt is valid, but also whether it is capable of being sold or participated in the manner contemplated by the transaction. Under the law of most jurisdictions, if a debt governed by the law of jurisdiction A cannot be assigned, for example, under the rules of jurisdiction A then the courts of jurisdiction B will hold that a purported assignment under their own law will fail, even if, had B's law governed the debt, the assignment would have been valid. The law of the underlying debtor — i.e., the law of the jurisdiction in which the underlying debtor is incorporated and in which it has the majority of its assets. Irrespective of whether the underlying debt has been sold to a securitization vehicle, any enforcement of the debt against a defaulting debtor would need to get the cooperation of the courts of that debtor's home jurisdiction. The reason is that, under general rules governing national sovereignty, even if a creditor gets a judgment in its own jurisdiction against a debtor in another jurisdiction (for example, because both the creditor and the debtor agreed to a "choice of forum" clause in the loan agreement, which mandated the creditor's own courts as the proper forum to hear a dispute), that creditor cannot enforce against the assets of the debtor located in the debtor's home jurisdiction without the explicit agreement of the debtor's home courts. Anything else would violate the national sovereignty of the debtor's country. This raises issues such as, would the debtor's home court recognize the SPE as the creditor — in other words, would the local courts recognize the validity of the sale or participation from the originator to the issuer? The law of the issuer — i.e., the law of the jurisdiction of incorporation of the issuer. This is the law that will determine whether the issuer is capable of owning the assets, of issuing the rated notes, and whether it is likely to suffer adverse tax charges as a result of owning the assets. The law of the transaction documents — i.e., the law chosen by the market participants to govern the various issuance documents in the CDO transaction including the rated notes and other ancillary contracts, such as liquidity facilities and hedging agreements (other than the document transferring the underlying assets which is dealt with above). The law of third-party providers — i.e., the law of incorporation of providers of various facilities to the issuer. This will include asset managers, trustees, liquidity facility providers, and hedge counterparties. First, it should be noted that in many transactions, these laws will overlap. It would be very unusual for the law of the transaction documents not to be the same as the law governing the transfer agreement and probably that of many of the underlying debts. The other possibility, though, is that in an international CDO it is perfectly plausible for the underlying debtors to be governed by the laws of a multiplicity of countries. In respect of the laws set out in the fifth, sixth, and seventh points above, CDOs are no different from any other securitization and Standard & Poor's would expect to see the same opinions as are common for all structured finance transactions. In respect of the other legal systems mentioned in the first four points, Standard & Poor's would in turn expect to see the following. Law of the Seller The concern would be that, in the insolvency of the seller/originator the sale would either be struck down or reversed under the relevant law's preference rules. Here, because of the greater comfort to be derived in the case of arbitrage CDOs, Standard & Poor's will not require a "true sale" opinion in such transactions. In the case of balance-sheet CDOs, however, Standard & Poor's will expect to see a full true sale opinion in respect of the seller. In conformity with Standard & Poor's published criteria, the opinion would have to set out that the transfer of the assets to the SPE would be considered a true sale, would not be recharacterized as a loan by the originator to the vehicle, and would not be set aside in the originator's insolvency. In addition, in jurisdictions with strong "substantive consolidation" rules, such as the U.S., a nonsubstantive consolidation opinion may be required, depending on the structure. For sellers within the EU, the determination of the relevant law governing the seller's putative insolvency will need to take into account the EU insolvency regulation — Council Regulation (EC) No. 1346/2000. For transactions that are partially arbitrage CDOs and partially balance-sheet CDOs, Standard & Poor's would expect to see a full true sale opinion in respect of any seller whose assets were sold to the vehicle as a balance-sheet transaction. Law of the Contract Transferring the Assets For arbitrage CDOs where the sale of the assets has taken place under standard types of documents in general use in the international capital markets, Standard & Poor's is satisfied that it is extremely unlikely that the markets are using inappropriate legal forms. Accordingly, Standard & Poor's would not expect to see any legal opinions confirming direct sales from third parties unconnected to the transaction. In arbitrage CDOs where a financial institution has warehoused the assets so that there is only one seller and that seller is also closely connected with the securitization transaction, it is not improbable that the form of documentation used to transfer the assets has been drafted specifically for the rated transaction. In those circumstances, Standard & Poor's will wish to see either (i) an opinion from counsel qualified in the jurisdiction of the law governing the sale to the effect that the transfer agreement effects a sale; or (ii) a representation by the seller that the sale has taken place on the same standard documentation and according to the same procedures that such seller uses for sales and/or purchases to unconnected participants in the capital markets; or (iii) a representation by the seller that, under the laws of the jurisdiction governing the contract of sale, the transfer agreement effects a sale. In all balance-sheet CDOs, Standard & Poor's will wish to see an opinion from counsel qualified in the jurisdiction of the law governing the sale to the effect that the transfer agreement effects a sale. Law of the Underlying Debt The main concern here would be that the law of the underlying debt prohibits the transfer of that debt either absolutely or in the manner set out in the transaction documents. As mentioned above, in such circumstances, the courts, wherever situated, are likely to find that the purported sale of the assets to the SPE had failed. Standard & Poor's views this risk as one that should be eliminated through proper due diligence by the arrangers and the originators. In many CDOs involving the sale of well-known capital market instruments (such as Eurobonds), the arrangers and/or originators will be large financial institutions that have a substantial business trading such instruments in the normal course of their operations. Standard & Poor's expects that these institutions will have done all the due diligence necessary to ascertain the tradability of these instruments many years previously and therefore considers it to be unnecessarily onerous to require the same work to be done again and again for each transaction. Standard & Poor's considers that it is up to such market participants to ensure that the transfer method selected is appropriate to the assets sold. In cases of unusual instruments, though, Standard & Poor's may require legal opinions from counsel qualified in the jurisdiction of the debt to ensure that there are no issues that may negatively affect the rated notes. Law of the Underlying Debtor The essence of an asset-backed transaction is that, in the insolvency of the originator, the issuer of the asset-backed notes is able to derive the economic benefit of the transferred assets. In the case of debts, this includes the capacity to enforce the payment of the debt by the underlying debtor. Both as a matter of legal theory and a matter of practice, this will always require the assistance of the courts in which that debtor has substantial assets located, normally the debtor's jurisdiction of incorporation. As mentioned above, the concern would be that, under the law of the debtor's jurisdiction, a sale of that debtor's payment obligation would bind the debtor only if certain specific steps had been taken (e.g., written notification of that debtor). In the absence of such steps, the local court would simply not recognize the SPE as being the lawful creditor. It is, however, extremely unlikely that, if the court does not recognize the SPE as the owner of the debt, the court would then conclude that the debt has disappeared altogether. The near universal conclusion of a failure to transfer the asset under the debtor's home jurisdiction is that the original owner (i.e., the originator) still remains, in the eyes of that country's courts, the legal owner and, accordingly, the entity entitled to enforce the debt. Unfortunately, if that originator is insolvent, the SPE will no longer be able to rely on a contractual undertaking by the originator to pursue the defaulting debtors on behalf of the vehicle. This has led Standard & Poor's to the following conclusions: the requirements before Standard & Poor's gives credit to debts transferred through a CDO will vary depending on whether there is an agent or trustee acting on behalf of a group of creditors, the issuer has the benefit of a power of attorney, there is a meaningful economic incentive for the originator's liquidator to enforce the debt, or none of the above. Agent or Trustee In the case of many instruments, an agent is mandated to act on behalf of a group of lenders. This will be the "facility agent" on syndicated loans or the "note trustee" on secured bonds. In these circumstances, the debtor's jurisdiction needs only to recognize the agent's or trustee's rights to enforce the debt on behalf of the lenders. This is a matter for due diligence at the time of the entering into force of the underlying debt. From the point of view of the SPE, it is necessary that the agent or trustee recognizes only it and not the originator as a "lender" under the facility or as a "noteholder" under the terms and conditions of the notes. Legally, this should be dealt with under the law of the underlying loan, as set out in the previous section. Accordingly, Standard & Poor's will assume that appropriate due diligence was conducted at the time of the entry into the underlying debt instrument to ensure the rights of the relevant agent or trustee and, if it receives the comfort referred to above in relation to the law of the underlying debt, it will not request any additional legal comfort relating to the jurisdiction of incorporation of the debtors. Power of Attorney In certain circumstances, the issuer may have the benefit of power of attorney granted by the originator. Pursuant to such power, the issuer would legally be entitled to enforce the originator's rights against the creditors. If the transaction relies on the effectiveness of such power, Standard & Poor's would expect to receive a legal opinion from counsel qualified in the jurisdiction whose law governs such power and, if different, the law of the seller to the effect that the power is valid, would survive the insolvency of the seller, and would be recognized by the courts in the jurisdiction of the relevant underlying debtor. Based on such opinions, Standard & Poor's would not normally require any additional comfort relating to the jurisdiction of incorporation of the debtors. Incentives In circumstances where there is no agent acting on behalf of all the lenders and where the jurisdiction of the debtor fails to recognize the transfer of the debt to the SPE, the vehicle would need to rely on the originator to enforce the debt on its behalf. Once the originator is insolvent, however, it is almost invariably the case that such contractual obligations to enforce on the vehicle's behalf will no longer bind the originator. Unless the rating on the originator is a dependent rating for the transaction, this will be a problem. Nevertheless, there may be transactions where the originator retains a meaningful economic interest in the transferred assets. For example, the assets may be transferred under a master trust type structure where the originator retains an undivided interest in a percentage of each transferred loan. To the extent that Standard & Poor's can identify a meaningful economic interest being retained by the originator such that the liquidator of the originator will have an incentive to pursue the defaulting debtors, no additional legal opinion from the debtors' jurisdiction will be necessary. If reliance is placed on such incentive, however, Standard & Poor's will wish to see a paragraph in the true sale opinion (if required) provided from counsel in the seller's jurisdiction indicating that, if the liquidator or other insolvency officer of the seller did enforce the debts in its own name, any collections recovered would, to the extent of the SPE's interest in the debts, be handed over to the SPE and could not be retained by the liquidator or other officer as part of the insolvency estate of the seller. No Incentives and no Agent In circumstances in which there is no incentive for a liquidator or insolvency officer of the seller to recover from defaulting debtors and no agent to do so on behalf of the SPE, Standard & Poor's will require some comfort that the vehicle is able to recover the debts itself. If there are additional steps that must be taken before the vehicle is able to do so, these steps will need to be understood and Standard & Poor's will wish to see what provisions have been made to ensure that these steps are taken in a timely manner. To obtain comfort that the vehicle can enforce the debts in the debtor's home jurisdiction, Standard & Poor's will wish to see a legal memorandum written by counsel qualified in the debtor's jurisdiction of incorporation. This memorandum, though, is not a legal opinion. A legal opinion is a statement about the transaction at hand. It requires the counsel to read all the relevant transaction documents and do any additional searches in local registries and other sources necessary to reach the relevant legal conclusion about the transaction. The legal memorandum referred to in this paragraph is a memorandum describing the general law as to assignments of the type contemplated in the transaction. The memorandum will need to set out whether and on what conditions the SPE would be entitled to enforce the transferred debt. Counsel, though, will not be require to opine on the specific transaction and whether that transaction complies with the rules for a valid assignment in the relevant jurisdiction. In addition, it is not the intention of Standard & Poor's to request such memoranda each time a transaction is effected. Whenever Standard & Poor's receives a memorandum in respect of a given jurisdiction, it will determine whether the jurisdiction is such that credit can be given to debts owed by debtors incorporated in that jurisdiction. If certain steps are necessary in that jurisdiction to perfect the sale to the vehicle, these steps will be noted and appropriate measures will need to be incorporated in transaction documents. If assets transferred in CDOs have debtors in a jurisdiction that Standard & Poor's has previously deemed acceptable for the type of asset transferred, then no additional opinion or memorandum will be required for such assets. Since the law changes and all transfer mechanisms may not be treated equally in any particular jurisdiction, Standard & Poor's urges market participants to check, at the outset of their transaction, whether any particular jurisdiction has been deemed acceptable by Standard & Poor's in respect of the type of transaction they wish to conduct. Additional Steps In circumstances in which there is no incentive for a liquidator or insolvency officer of the originator to enforce, no agent or trustee to do so on behalf of the SPE, and no effective power of attorney it is possible that legal analysis reveals that certain steps need to be taken in the debtor's home jurisdiction to make the transfer of the assets binding upon it. Often these steps involve the giving of notice of the transfer to the debtor. Provided these steps may be taken legally after the transfer, Standard & Poor's does not deem it necessary for such steps to be taken immediately on the closing of the transaction to obtain the highest rating categories if either (i) legal advice indicates that these steps can be taken at any time by the vehicle itself or the trustee for the rated notes — notwithstanding, for example, the insolvency of the seller; or (ii) if these steps can be taken only by a third party (e.g., the seller), such third party being rated at least 'BBB' and the transaction documents provide that, on a lowering of the rating on such party below 'BBB' or withdrawn, such party will be obligated to effect the relevant steps immediately and in any case within 30 days. Please note that this "trigger" at 'BBB' is only consistent with high rating levels if the relevant additional steps can be taken swiftly and at little meaningful cost. If the taking of such steps does incur a cost, Standard & Poor's will need to be satisfied that a source of cash has been identified that will be available to meet such costs. This may require some form of cash reserve. Withholding Tax Should any withholding tax fall to be paid on the underlying loans following the assignment of these loans to the SPE, such tax will need to be factored into the relevant transaction's cash flows to prevent a shortfall in the cash received by the vehicle and needed to pay the rated notes. To obtain comfort that this is not necessary, Standard & Poor's will wish to see: A representation from the arranger, originator, or collateral manager that the relevant loans/bonds contain an effective gross-up clause entitling the vehicle to obtain sufficient funds to account for any tax and retain the same cash amount as it contracted to receive; or A memorandum for tax counsel in the relevant debtor's country stating that debt of the type sold to the vehicle does not attract withholding tax. No legal opinion will be requested, though; or A demonstration that, even net of applicable withholding tax, the cash flows generated by the assets are sufficient to allow payment in full on the rated notes under the various stress scenarios applicable to the transaction. Appendix Rules of Thumb Concerning Opinions Required ARBITRAGE CDO BALANCE-SHEET CDO A. WITH TRUSTEE/AGENT* B. WITH VALID POWER OF ATTORNEY** C: WITH ECONOMIC INCENTIVE ON SELLER TO ENFORCE*** WITHOUT A, B, OR C Law of seller ("true sale") X YY YY YY YY Law of transfer agreement X YY YY YY YY Law of asset X X X X X Law of debtor Same as for balance-sheet CDO X X X Y Law of issuer YY YY YY YY YY Law of transaction documents YY YY YY YY YY Law of third party providers O O O O O Key: YY - Opinions needed. Y - Legal memorandum. X – Opinions not needed. O – Opinion to be delivered if required (the usual rules). *There is a trustee or agent acting for the creditors of the assets. **There is a valid power of attorney surviving insolvency and giving the issuer power to enforce the asset. ***There is an incentive post-insolvency for the seller to enforce the asset for the issuer. Please note that this table is for guidance only and that Standard & Poor's reserves the right to request legal opinions whenever it considers that any aspects of the proposed transaction require further or deeper legal comfort to be provided. E-Mail Addresses

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