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When In Doubt, "Vertical Slice" It?

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In recent months, it has become readily apparent that the credit crisis that began in the summer of 2007 has been particularly unkind to the structured investment vehicle ("SIV") market. SIVs typically operate by purchasing rated long-term assets, and funding the purchases by issuing short term liabilities, customarily in the form of highly-rated commercial paper and medium-term notes. Unlike most CDO vehicles, which focus on cash flows, SIVs are market value driven. Due to an unprecedented strain on the commercial paper market, numerous SIVs have been unable to meet their short-term debt obligations while simultaneously experiencing significant drops in their portfolio market values. As a consequence, participants in the SIV market — a market valued at $400 billion at its peak in July 2007 — have been scrambling to find viable restructuring or refinancing alternatives.

With few exceptions, "vertical slicing" has proven to be a critical component in recent SIV reorganization and restructuring efforts. Assets are said to be vertically sliced when one or more classes of SIV noteholders and in some cases, certain other SIV creditors, are allocated a proportionate share of each asset in the SIV's portfolio, calculated according to their proportionate share of the SIV's liabilities. Since a creditor who receives a vertical slice maintains exposure to every asset in the SIV portfolio, vertical slicing has emerged as a means for SIV managers and sponsors to reduce the potential for litigation, as it effectively eliminates the argument that certain creditors have cherry-picked the highest performing assets.

Vertical Slicing is Used in Variety of Contexts

In recent months, vertical slicing has been implemented in a variety of contexts. For instance, a number of SIVs have employed vertical slicing techniques in order to stave off an enforcement or wind-down event, which would generally trigger a fire sale of all of the SIV's assets in order to pay down its liabilities. Certain of these SIVs, including Whistlejacket, Hudson-Thames, and a number of SIVs sponsored by **Citigroup**, were refinanced by causing the holders of the highest yielding, most junior class of SIV notes (in some cases referred to as the equity) to exchange their notes for a vertical slice of the SIV's assets. In addition to surrendering their outstanding notes, these noteholders often paid the SIV a cash purchase price in order to preserve the pre-exchange leverage ratios of the more senior noteholders.

By trading their interest in the SIV for a vertical slice of assets, equity investors were no longer exposed to the risk of a forced asset liquidation in a largely illiquid market. Furthermore, since the assets were now held on their balance sheets, these investors positioned themselves to potentially realize a more favorable recovery by selling at a later date. In this way, vertical slicing satisfied the desire of certain equity investors to monetize their losses in the current period. This technique also benefited the SIVs themselves, as the vehicles not only avoided or delayed the forced liquidation of their asset portfolios by raising much-needed proceeds to retire short-term senior liabilities, but they also reduced the size of their portfolios and locked in a sale price for a portion of each portfolio asset, thereby mitigating the risk of further market value price deteriorations.

In other cases, vertical slicing has been utilized by SIVs that were already subject to an enforcement or wind-down event. Investor concern about the potential consequences of enforcement, which would have required an immediate liquidation at fire sale prices, is what prompted SIVs such as Cheyne Finance and, most recently, Victoria Finance, to undergo restructurings utilizing vertical slicing.

Overcoming Obstacles: Victoria Finance

The parties involved in the recent restructuring of the Victoria Finance SIV, a process which began in late 2007, were confronted with a host of obstacles, including: (i) the need to accommodate divergent, and often competing, investor objectives in connection with the disposition of portfolio assets, (ii) disputes regarding the proper allocation of cash flows among certain senior creditors, and (iii) the inability to vertically slice certain assets as a result of various sale and transfer restrictions. The remainder of this article will use the Victoria SIV to illustrate how these obstacles can be addressed, and how instrumental vertical slicing can be to the implementation of a restructuring.

Initial Challenges

After Victoria became subject to an enforcement event, the SIV's governing documents called for an immediate sale of all portfolio assets, termination of the associated hedge contracts, and a redemption of all senior and subordinated notes (to the extent of available funds).

Although Victoria's senior creditors uniformly agreed that an asset fire sale should be averted, they had differing views as to the timing and means by which the portfolio assets should be disposed. The challenge thus became to devise a fair method of allocating the portfolio's assets among the participating senior creditors, while providing these creditors with the flexibility to make their own determinations as to the time and manner of disposition of their share of the assets. The first part of this challenge was addressed by assigning each senior creditor a "pro rata share" of the SIV, calculated as the percentage determined by dividing the outstanding amount of the SIV's liabilities to each senior creditor by the aggregate outstanding amount of the SIV's liabilities to all senior creditors. The second part of this challenge, described in further detail below, was addressed by affording participating creditors a variety of options in respect of their vertical slices.

Competing Objectives

Most Victoria senior creditors believed that they could maximize their investment value by controlling the disposition of their share of Victoria's assets. These "electing creditors" opted to be allocated a vertical slice of the SIV portfolio (and a corresponding share of available cash) based on their respective pro rata shares. Each electing creditor was then presented with a variety of options. One option permitted electing creditors to sell their respective vertical slices in one or more "pay-in-kind" ("PIK") sales on certain specified dates. An electing creditor could effect a PIK sale by bidding all or a portion of its senior obligations as the purchase price for its vertical slice. If the amount of senior obligations bid by such electing creditor were to exceed any third party cash bid, the electing creditor would receive its vertical slice from the SIV in an in-kind transfer. A second option afforded electing creditors the opportunity to transfer their senior obligations to a new bankruptcy-remote special purpose entity in exchange for notes issued by the entity. As a noteholder in the newly-formed entity, an electing creditor could, among other things, elect to participate in asset sales similar to PIK sales, or to have its portion of the assets included in a long-term financing, such as a static CDO.

In contrast to the electing creditors, other Victoria senior creditors determined that they would be better served by cashing out of the SIV. These "non-electing" creditors were allocated a cash amount in proportion to their respective pro rata shares (and a corresponding share of available cash) based on an agreed-upon valuation methodology that approximated current asset values.

Cash Flow Controversies

One of the central controversies in the Victoria restructuring arose out of differing interpretations of the appropriate application of available funds to the SIV's senior obligations between the time that an enforcement event was declared and the date that the enforcement manager made its determination that a mandatory redemption was required.

A number of senior creditors took the view that funds should be applied to each senior obligation at the time such obligation became due and payable (i.e., on a "pay-as-you-go" or "PAUG" basis). Other senior creditors disagreed, contending that funds should be applied to all senior obligations pro rata, regardless of whether such obligations were due and payable (i.e., on a "pro rata" basis).Confronted with these conflicting interpretations, Victoria's collateral manager filed an interpleader complaint in the Supreme Court of the State of New York in order to resolve the competing claims.

At the time that the restructuring documentation was finalized, the interpleader had not yet been resolved. As a result, the restructuring documents established a cash reserve in the amount of the disputed claim, thereby isolating the disputed funds from the funds that were to be distributed to creditors in the days immediately following the restructuring.

Slicing Too Closely

During the course of the restructuring, it became apparent that certain electing creditors in particular, those creditors entitled to comparatively smaller pro rata shares of assets would be allocated vertical slices of assets in relatively low principal amounts. Consequently, in some cases such creditors would be restricted from selling their vertical slices, since doing so would be prohibited by certain minimum denomination or increment requirements set forth in the documentation governing the underlying assets.

The Victoria restructuring documentation addressed this problem by limiting the number of PIK sale dates and by establishing custodial arrangements pursuant to which the portions of assets that could not be transferred could be held by a custodian for the benefit of the related electing creditors.

Conclusion

Although the vertical slicing of asset portfolios may not be the panacea for all restructurings in the structured finance market, the technique has proven to be an invaluable tool in the context of SIVs. Looking to the future, it would not be surprising if vertical slicing were to play an important role not only for other troubled SIVs, but also for CDOs and other similar asset-backed structured vehicles. ASR