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The Delaware Chancery Court Validates Surrender and Cancellation of CDO Notes as a Means to Improve Overcollateralization Ratio Performance

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Over the past year, several managers of collateralized debt obligation (or similar) vehicles (CDO issuers) have sought to avoid the failure of overcollateralization ratio (O/C ratio) tests that would have resulted in the diversion of cash flows to pay down the most senior debt tranches by causing the surrender of junior debt to the CDO issuer with the intent that it be forgiven. The managers argued — persuasively in our view — that a creditor can unilaterally forgive indebtedness and that, because after surrender such indebtedness is no longer outstanding, it reduces the denominator of the O/C ratio test, resulting in an improvement in the ratio. The holders of senior tranches of debt have disparaged the technique, arguing that (a) in the absence of a specific authorization, a creditor cannot forgive indebtedness and surrendered indebtedness does not cease to be outstanding, (b) it would be a breach of the covenant of fair dealing to permit a party to avoid the purpose of the O/C ratio test by permitting the CDO to treat surrendered indebtedness as no longer being outstanding, and (c) it is a breach of fiduciary duty by the investment manager to facilitate such transactions.

It was perhaps inevitable that this controversy would be litigated. On May 14, 2010, in *Concord Real Estate CDO 2006-1, Ltd et al. v. Bank of*

America, N.A., C.A. No. 5219-VCL (May 14, 2010), the Delaware Chancery Court ruled that, in the absence of an express prohibition, a creditor's surrender of notes to a CDO issuer results in cancellation of the underlying notes and that such notes cease to be "outstanding" for purposes of O/C ratio tests. The decision affords managers of CDO issuers a meaningful alternative to "building par" to maintain or improve O/C ratio compliance and to (i) preserve distributions to subordinated noteholders and (ii) make other periodic payments, including subordinated management fees.

In Concord, Concord Trust, an affiliate of the CDO sponsor, held the Class G and Class H notes (Subject Notes) as well as the entire "equity" tranche consisting of Preferred Shares (Preferred Shares) issued by Concord Real Estate CDO 2006-1 (Concord CDO). Anticipating that the Concord CDO would soon fail its O/C ratio tests, after which cash flows would be diverted from the regular payment priority to the early redemption of the most senior tranche until the O/C ratio tests were satisfied, Concord Trust surrendered all of the Subject Notes, without consideration, to the CDO co-issuers (Co-Issuers) with the intent that the indebtedness be forgiven. The Co-Issuers delivered the Subject Notes to the CDO trustee (Trustee), in its capacity as notes registrar, with instructions to cancel the Subject Notes.

As a result of forgiveness of the Subject Notes, the Co-Issuers argued that the aggregate outstanding amount of notes issued (*i.e.*, the denominator in the O/C ratio tests) was reduced and the O/C ratio tests satisfied. If the O/C ratio tests are satisfied, the Trustee would be obligated to continue regularly scheduled distributions. The Trustee refused to cancel the Subject Notes on grounds that it was not authorized under the indenture (Concord Indenture).

In its resolution of the dispute, the court first noted that the Concord Indenture neither expressly permitted nor expressly prohibited unilateral surrender and cancellation of notes. Because the Concord Indenture was governed by New York law, the court observed that it is well-settled under New York law that "where an obligee delivers up the obligation which he holds against another party, with the intent and for the purpose of discharging the debt…such surrender operates in law as a release and discharge of the liability thereon; nor is any consideration required to support such a transaction when it has been full executed" (Delivery Rule).

Consistent with the Delivery Rule, the court concluded that, absent a contrary provision in the Concord Indenture, Concord Trust had the right to surrender the Subject Notes to the Co-Issuers for cancellation with the intent of extinguishing the Co-Issuers' corresponding liability, and that such act validly discharged the debt represented by the Subject Notes as of the date Concord Trust surrendered them to the Co-Issuers.

The court's decision in *Concord* establishes and reaffirms several important principles having significant implications for CDO managers and their affiliates, particularly those that own the entire "equity" tranche of a CDO's

notes. Specifically, absent contractual prohibitions against canceling notes surrendered by a noteholder with the intent that the liability represented by such notes be extinguished:

- Noteholders in a CDO have a right to surrender their notes to the CDO issuer for cancellation as a matter of law. The CDO's indenture need not expressly permit this type of surrender and cancellation in order for it to be valid.
- A CDO trustee does not have any authority to prevent the cancellation of notes surrendered by a noteholder in a manner consistent with the Delivery Rule. In *Concord*, the Concord Indenture authorized the Concord Trustee to cancel notes under specific circumstances—none of which were implicated by the delivery of the Subject Notes for cancellation. But the Concord Trustee, in its capacity as trustee, was not authorized to prevent the cancellation of the Subject Notes. The court held that the Concord Trustee, in its capacity as notes registrar, was an agent of the Co-Issuers and, as such, was obligated to follow the instructions of the Co-Issuers to cancel the Subject Notes once they were delivered.
- The cancellation of notes surrendered by a noteholder as a means to maintain or improve O/C ratio test performance is consistent with the reasonable contractual expectations of senior noteholders under a CDO indenture. As the court explained in *Concord*, when purchasing their notes, senior noteholders bargained only for the payment of principal and interest when due and the mandatory redemption of the senior notes if the CDO failed its O/C ratio tests. Methods of compliance with or improvement of the Concord CDO's O/C ratio tests were not limited by the contractual provisions of the Concord Indenture; therefore, the Co-Issuers were free to employ any method permitted by applicable law, including through cancellation of surrendered notes or otherwise, and holders of senior notes could not reasonably expect otherwise.
- Importantly, the decision is consistent with the well-established principle under the Investment Advisers Act of 1940 and applicable common law that a CDO manager's fiduciary obligations run to a CDO's "equity" holders and not to its creditors. Obligations to creditors are contractual in nature, and are governed by the terms of the related indenture or other operative transaction documents.

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