Should the Recent Credit Market Events Affect the Debt-vs.-Equity Characterization of MBS, ABS, CLO, and CDO Notes and, as a Consequence, Their ERISA Eligibility?

Barbara D. Klippert
Since the credit market disruptions that began in 2007, it has not been uncommon to see mortgage-backed, asset-backed, and CLO or CDO securities downgraded or purchased at both origination and in the secondary market at higher discounts and/or with higher promised rates of interest than in the past. Should these factors change the traditional approach taken in determining whether securities designated as notes should be considered debt or equity when acquired by pension and profit sharing plans subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA), and/or the Internal Revenue Code of 1986, as amended (the Code), or entities deemed to hold their assets (collectively, Plans)?

Plans and public pension plans in the U.S., which currently hold approximately $14 trillion in assets, provide a significant direct or indirect market for these notes. In general, subject to an investing Plan or its fiduciary satisfying the conditions of certain exemptions that do not generally affect its marketability, if a note is considered to be debt for ERISA purposes it may be freely transferred to the Plan. In contrast, if a note is considered equity for ERISA purposes, its transferability is either prohibited or severely restricted. For example, should a note rated BBB upon issuance, but sold at a 20% discount (increasing its effective yield), be treated as equity for ERISA purposes because this arguably is an equity-like return? What about an investment-grade note that was considered debt upon issuance and is later downgraded to BB? Does this note become equity?

If the answer is “yes,” these notes cannot be sold to or in some cases held by Plans. Thus, the debt-equity distinction is of great importance to sponsors and underwriters in the initial market, non-Plan sellers in the secondary market, and Plans purchasers in both. This article concludes that while the issue is being debated, on balance the current market conditions should not change the traditional debt-equity ERISA analysis and a note that received debt treatment for ERISA purposes previously would receive the same treatment now. However, even if a note is determined to be a debt, whether it should be purchased by a Plan should in the final analysis be based upon its investment suitability as determined by the Plan's fiduciary in accordance with the applicable ERISA prudent investment standards.

SOME BACKGROUND

Under ERISA, if a Plan purchases a note issued by an issuing entity that is deemed debt for ERISA purposes, ERISA problems can still occur because the underwriters of the notes or any entity that owns any significant equity interest in the issuer or any
of their affiliates (a party in interest) is presumed to have pre-existing relationships to the Plan in some other capacity, (such as acting as a broker, a record keeper, a trustee, an investment manager, or the employer of the Plan). As a result, when a Plan purchases a note it is deemed to be engaging in a prohibited transaction with the underwriter and the equityholder, and significant excise taxes can be imposed on these parties. The Plan sponsor or other fiduciary making the decision to invest in the notes can also be subject to excise tax penalties for allowing the transactions to occur and can be personally liable for resulting losses. A court may order that the acquisition of the notes be unwound, and any parties involved in the securitization transaction could be required to return their fees. However, all is not lost, because most institutional Plan investors can make a deemed representation that they have a prohibited transaction administratively or statutory exemption available to cover the purchase and holding of the notes. This allows most notes to be sold to Plans with little adverse affect on their marketability.

In contrast, if the note is considered to be an equity security as opposed to a debt security, U.S. Department of Labor regulations (the Plan Asset Regulations) provide that, in addition to the acquisition of the note being a possible prohibited transaction per above, the Plan is deemed to acquire a proportionate share of the assets of the issuer. As a consequence, any activities conducted by the issuer in 1) acquiring its initial assets, 2) selling or dealing with any defaulted assets, or 3) entering any notional principal contracts, credit support contracts, or servicing agreements will be treated for ERISA purposes as if the Plan investing in the issuer entered into these transactions directly with the counterparties (such as the depositor of the collateral or a swap counterparty). This will trigger all of the prohibited transaction issues discussed above. In addition, any entity deemed to have any investment discretion over the assets of the issuer will also be considered an ERISA fiduciary and will be subject to the penalties and have liability for any losses described above. The prudent investment standards of ERISA will also apply to the issuer, which is not the expectation of non-Plan investors. Obviously, in most situations there are very negative consequences to being considered equity for ERISA purposes in a securitization transaction. As a result, in most securitizations that issue notes, if a security is deemed to be equity, it either cannot be transferred to a Plan or it can only be transferred to Plans to a limited extent pursuant to a Plan Asset Regulation exception that requires monitoring.

The Plan Asset Regulations provide that a security will not be considered an equity investment in an issuer if it is indebtedness under local law and has no substantial equity features. There is no definition of “substantial equity feature” in the Regulations, and there is almost no helpful guidance under any state or foreign local law as to what is indebtedness versus equity. There is discussion in the preambles to both the proposed and final Plan Asset Regulations as to the definition of an equity interest that may be described as follows. The determination of whether something is equity is to be based upon a facts-and-circumstances analysis to be made on a case-by-case basis.

A significant equity feature is clearly present where the purchase of the security is intended to allow management of Plan assets through investment in an alternative vehicle that is not subject to the ERISA fiduciary and prohibited transaction rules. This would be the case when the Plan has significant opportunity to participate in the earnings, i.e., the profits of the issuer. The preambles mention that the Treasury Regulations that were issued (although withdrawn) under Section 385 of the Code on whether corporate stock is debt or equity may also be relevant in determining the characteristic of an instrument. For this reason, it is traditional for any ERISA analysis first to consider whether tax counsel will render an opinion that the security will be considered debt for U.S. federal income tax purposes (“will be debt-for-tax”). The determination of a note’s debt-equity characterization for ERISA purposes is made continuously. If due to changing market conditions the equity features become significant, a debt security could be recharacterized as equity. This could also occur, for example, where a security was issued with a warrant, contingent payment, or conversion feature that was exercised.

**DEBT–EQUITY ANALYSIS IN PRACTICE WITHOUT REGARD TO THE 2007 CREDIT EVENTS**

Assuming a note receives a “will be debt-for-tax” opinion and is investment grade, ERISA practitioners will typically consider the following additional factors in characterizing it as debt or equity and determining whether there are any substantial equity features.
If a security is to be considered debt for ERISA purposes, it should be in the form of a note issued under an indenture, it should have a fixed obligation to repay principal, and the term of the note should not be excessively long. A security is more likely to be classified as debt, absent other equity features, if it bears interest at a fixed rate. It may pay a variable rate of interest, provided that the rate is not geared to the profit returns of the issuing entity. All payments due to noteholders should be senior to any distributions on the equity, and there should be sufficient equity subordinate to the note.

A note is more likely to be classified as equity if holders share in the profits of the issuer, and/or holders have the most risk of loss because their interests are subordinated to other debt holders as to payments and losses, and/or holders have insufficient equity supporting that class of notes. A note will probably not be classified as debt if it has substantial conversion features, warrant rights, or contingent payment features. Also, if the total principal amount of the note equals, or nearly equals, the principal balance of the pool assets, noteholders may not have a reasonable expectation of being repaid at the outset of the transaction. If the note does not have at least an investment-grade rating, some ERISA counselors take the position that the note may not be treated as debt for ERISA purposes, even though it receives a “should be debt-for-tax” opinion. Others will treat the note as debt depending on the circumstances, as discussed previously.

DEBT–EQUITY ANALYSIS SINCE THE 2007 CREDIT EVENTS IN INITIAL OFFERINGS

Should a discount or a high stated coupon affect the traditional ERISA debt-versus-equity analysis because the high effective yield provides the noteholder with an “equity like” return?

While the tax treatment of a note is not determinative (as indicated above), the absence of a “will be debt-for-tax” opinion will usually make it difficult for ERISA counsel to come to the conclusion that a note should be treated as debt for ERISA purposes. Therefore, consideration of the tax analysis on this point is useful. If the effective yield on a note from any source is more than 600 basis points over a rate similar to LIBOR, by analogy to certain provisions under Section 163 of the Code regarding high-yield discount debt obligations, tax lawyers will give the note increased scrutiny to determine its characterization as debt or equity for tax purposes. Other factors considered will be 1) the rating, 2) whether there is sufficient subordination supporting the note, 3) whether the note has a fixed principal obligation, 4) whether the pool of assets backing the note is revolving, 5) how much excess spread (interest) is available, and 6) the absence of equity-like features. The tax analysis, unlike the ERISA analysis, does not require the relevant equity features to be “substantial” for a note to be equity. (Note for tax purposes that the revolving nature of the assets of a pool is a helpful factor in finding a security to be debt. In contrast, in an ERISA analysis, the opposite is true. If the pool is static, or as in the case in a synthetic transaction where there is no collateral manager, there is less motivation for the issuer to have been set up to avoid the ERISA prohibited transaction or fiduciary investment standards.)

Assuming that the high effective yield does not prevent the note from receiving a “will be debt” for tax purposes, are there reasons to recharacterize the note as equity for ERISA purposes because of a high effective yield? In the 1980s, interest rates on bonds were as high as 17%; this did not make them equity. Admittedly, today the cost of borrowing funds is generally low, but yields payable and discounts given on ABS/MBS and CLOs are high. On the other hand, these high discounts and higher yields are given even on AAA rated notes, which one would assume are still debt, so this factor alone should not be determinative of the debt—equity characterization. Some investors are demanding discounts and higher returns to compensate them for their perceived higher risk of loss, whether from the particular issuer or from securitizations in general. Yet risk of not being repaid principal and or interest is inherent in every debt instrument; this does not distinguish it from an equity interest. An equity interest’s entitlement to profits distinguishes it from a debt interest, not the risk of loss. For example, if a bondholder is not repaid, he does not become an equityholder in a bankruptcy proceeding.

Another important question is whether a purchase price discount represents profits from the issuer as contemplated as an equity feature under the Plan Asset Regulations. ABS/MBS or CLO notes are being purchased at a discount over the entire spectrum of the market, even for AAA rated notes. No one would say that AAA rated notes should be considered equity or that the higher resulting returns paid to senior notes represent a profit return. The discounts may also be
likened to buying undervalued stocks or bonds. The fact that the market has undervalued a security or an investor has bought a security at a bargain is not thought to be determinative of its characterization as debt or equity. It is generally acknowledged that due to the uncertainties in the securitization markets, ABS/MBS and CLOs are difficult to value and investors are demanding and receiving purchase discounts. This is occurring even where the particular issuer has high-quality assets and borrowers and the notes have a very high likelihood of paying off in accordance with their terms. In an analogous situation, the fact that junk bonds trade at high yields or discounts, or that General Motors bonds were just downgraded and will trade accordingly, does not cause those bonds to become equity.

In any case, without regard to whether the discount or resulting yield is attributed to issuers' profits or market factors or the merits of that distinction, if the analysis is completed and the note receives an investment-grade rating and a “will be debt-for-tax” opinion and has the debt features discussed above and has no other substantial equity features, there would appear to be no reason to treat it as equity for ERISA purposes, even if it was sold at a high discount rate or with a higher interest rate than we have been used to seeing. In contrast, if the discount or interest rate is so high that a “will be debt-for-tax” opinion is not forthcoming, then at that point the risk of loss due to inadequate subordination below the note or some other factor would be an obvious equity feature for tax purposes and a substantial equity feature for ERISA purposes. The latter situation would not be an appropriate one for treating the note as debt under Plan Asset Regulations.

DEBT–EQUITY ANALYSIS SINCE THE 2007 CREDIT EVENTS AFTER THE INITIAL OFFERING

Should a note that was treated as debt for both tax and ERISA purposes when originally issued but then is downgraded to a BB rating or one that was sold at a discount in the secondary market be recharacterized as equity for ERISA purposes?

Let us consider downgrades first. For ERISA purposes, the debt-versus-equity test is continuous for the term of the note. The argument articulated for treating notes that were considered debt when issued but are later downgraded is that if such a note is analyzed at the time of downgrade it would not be treated as debt for tax and/or ERISA purposes. In contrast to ERISA, the debt-versus-equity tax analysis is made only at initial issuance and applies for the term of the note. This undercuts the argument that if a note is downgraded it should be recharacterized as equity for ERISA purposes, because it would not receive a “will be debt-for-tax” opinion. There is no tax opinion of any kind to be had at that point in time.

The real question is: What substantial equity feature(s) has the note developed or “grown” since the initial offering to cause it to be recharacterized as equity as a result of the downgrade, whether or not caused by “market conditions” (using the parlance of the Plan Asset Regulations)? Some “ERISA Considerations” disclosures in offering documents state that if the issuer experiences losses, the notes may be recharacterized as equity. It is difficult to understand why this would be the case, in the absence of the note otherwise having developed a new substantial equity feature. As discussed above, the possibility of a noteholder incurring losses does not distinguish debt from equity securities.

In the case we are considering, at issuance the note would have been at least investment grade and designated as debt for both tax and ERISA purposes, it is later downgraded to a rating no lower than BB, but is still treated as debt for tax purposes. For those dealing in hypotheticals, had the note been issued at that time of its downgrade, it most probably would have been given at least a “should be” debt-for-tax opinion. In these facts there would be retained equity, possibly another subordinated note class(es), and/or some other form of credit support below the class in question. As a result, in the absence of the note having some other substantial equity feature, such as a conversion feature that has been triggered, there would appear to be no reason to have it recharacterized as equity for ERISA purposes. From a policy point of view it is also a beneficial result for Plans that own notes that have been downgraded to a level below investment grade and want to hold to maturity. It allows the Plans to receive their promised interest and principal without having to sell at a severe loss (given the limited market for these particular type of securities at this time) even though there will be a loss in market value on an annual-valuation basis. In a situation where the note has a lower rating or no rating and no retained equity or other support below the class of notes in question, the result may be different, but that is not the situation at issue.
If a note is sold at a discount in the secondary market, the discussion regarding discounts at initial issuance would be equally applicable and therefore would mitigate the possibility of discounts being deemed to be a substantial equity feature. The initial issuance discussion on this question made a distinction between discounts attributable to profits from the issuer's assets as opposed to market factors. Without regard to that distinction, the discount in secondary market transactions strictly represents the bargain made between the seller and the buyer. It is not funded in any respect from the profits of the issuer. As a result, a secondary market discount should certainly not be considered a significant equity feature that would cause a note to be recharacterized as equity for ERISA purposes.

CONCLUSION

Purchase price discounts, payment of higher coupons, and downgrades should not, on balance, cause notes considered debt for ERISA purposes to be recharacterized as equity. However, it is very important for investment managers or other fiduciaries of Plans (and other plans subject to laws subject to laws similar to ERISA) to consider that the debt or equity characterization of a note is not determinative of whether it should be purchased by such Plans or other plans. ABS, MBS, CLOs, and CDOs are complicated financial instruments that need to be carefully analyzed especially in this turbulent market. The overriding consideration applicable to any investment must always be whether the investment is prudent and meets the fiduciary investment standards under ERISA or other applicable law.

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