

August 21, 2008

Collateralized Debt Obligation Practice

## Rising Defaults and Workouts for CDO Participants: Careful Tax Planning Required

In light of rating agency and other credit market reports of rising corporate downgrade and default rates,<sup>1</sup> as well as the increasing inquiries that we have been receiving regarding collateral workouts and restructurings, all collateralized debt obligation (CDO) participants should take care to avoid activities that could subject the related CDO to US federal income taxation.

As a general matter, CDO indentures and management agreements require the CDO issuer and manager to refrain from activity that would cause the CDO to be treated as "engaged in a trade or business in the United States" (i.e., activity that could subject the CDO to US federal income tax). Defaults and workouts frequently raise difficult questions in this regard. For example, the receipt of certain securities that are treated as equity for US federal income tax purposes may be problematic. In addition, the workout activity itself may raise questions about the status of the CDO for US federal income tax purposes. While a CDO's eligibility criteria and acquisition standards or guidelines are usually designed to ensure that a CDO will not be subject to US federal income tax, these provisions might not be drafted to address the particular circumstances of a specific default or workout activity. As a result, further advice from a qualified tax professional may be warranted.

Accordingly, CDO managers should carefully consider whether their foreclosure and other default and workout activities would cause the CDO to be subject to US federal income tax and, when appropriate, should seek advice from a qualified tax professional.

Common mitigants of this tax risk involve the use of so-called "blocker" corporations, either domestic or foreign; however, some planning is usually appropriate, because there is no "one size fits all" answer to this risk and applicable state or local issues may apply.

If you have any questions regarding this Client Alert, do not hesitate to contact the authors, [Paul Forrester](#) at +1 312 701 7366 and [Russell Nance](#) at +1 212 506 2534, or your usual Mayer Brown lawyer.

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1. See, for example, Fitch Rating's "U.S. Corporate Bond Market: A Review of Second-Quarter 2008 Rating and Issuance Activity", August 18, 2008, which reported a total par value of over \$115BN of downgraded U.S. corporate bonds in 2Q08, compared to only \$23.8BN in the comparable period in 2007.

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