

## Moody's Re-examines Trustees' Role in ABS and RMBS

### AUTHOR

Claire M. Robinson  
Senior Vice President  
(212) 553-1436  
*Claire.Robinson@moodys.com*

### CONTACTS:

Ed Bankole  
Managing Director  
(212) 553-3620  
*Ed.Bankole@moodys.com*

Jay Eisbruck  
Senior Vice President  
(212) 553-4377  
*Jay.Eisbruck@moodys.com*

Pramila Gupta  
Managing Director  
(212) 553-4489  
*Pramila.Gupta@moodys.com*

Michael B. Kanef  
Managing Director  
(212) 553-1964  
*Michael.Kanef@moodys.com*

Jay Siegel  
Managing Director  
(212) 553-4927  
*Jay.Siegel@moodys.com*

Linda A. Stesney  
Managing Director  
(212) 553-3691  
*Linda.Stesney@moodys.com*

### Investor Liaison

Marie Erickson  
All Asset Backed and  
Residential Mortgage  
Backed Securities  
(212) 553-4796  
*Marie.Erickson@moodys.com*

### WEBSITE:

[www.moodys.com](http://www.moodys.com)

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### OPINION

The default of the National Century Financial Enterprise (NCFE) healthcare receivable-backed transactions has raised questions about the nature of the trustee's role in asset-backed (ABS) and residential mortgage-backed securities (RMBS)<sup>1</sup>. Although perhaps the most notorious, the NCFE transactions are not the only deals to have raised issues concerning the role of the trustee. Issues regarding successor servicers' fees, payment of servicing transition expenses and the degree of trustee oversight in the application of transaction cash flows have cropped up in other troubled transactions, including Heilig-Meyers, NextCard, Autobond and the Consecro manufactured housing transactions.

Moody's considers the role of the trustee, along with many other factors, in its rating process for ABS and RMBS. A central concept of these securities is to separate, insofar as possible, the credit quality of the asset originator from the credit quality of the securities issued in a securitization. This is accomplished by segregating the assets and their associated cash flows from the seller's owned assets. The trustee plays a key role in this process, particularly in cases where the credit quality of the seller/servicer is significantly lower than that of the structured securities issued.

In most transactions, the trustee's role involves holding transaction cash flows in segregated accounts, notifying investors and rating agencies of covenant breaches and events of default, and managing servicing transfers if the original servicer is no longer able to function as servicer.

<sup>1</sup> See upcoming Moody's report for a discussion of the role of CDO trustees. The trustees and servicers in commercial mortgage-backed transactions and the functions they perform have not given rise to the concerns addressed in this report.



Recently, some trustees have characterized their role in ABS and RMBS transactions as an essentially administrative one. They have argued that their conduct is subject to the "prudent person" standard of care only after a transaction has defaulted. In the majority of cases, and especially in transactions involving unrated or noninvestment-grade-rated seller/servicers, this was not Moody's understanding of the trustee's role when these transactions were initially rated. Less creditworthy seller/servicers are more likely to experience financial distress, which in turn, may lead to inappropriate servicing or misuse of transaction cash flows. If there is no oversight on the part of the trustee, the risk of misapplication of cash collections by the servicer is greatly increased.

In addition, in many transactions, it was Moody's understanding that the trustee would oversee transfers to successor servicers without causing investors to bear servicing costs beyond those specified in the documents. However, based on recent trustee behavior, it is likely that investors will bear the brunt of higher-than-anticipated servicing expenses in the event that a successor servicer is appointed or alternative servicing arrangements are adopted. (Certificateholders of the Conseco manufactured housing transactions are paying higher servicing fees that were mandated by Conseco's trustee in bankruptcy.)

In the future, transactions where the trustee's role is confined to essentially administrative functions are likely to be subject to higher credit enhancement or lower ratings unless structural protections are present that mitigate the risks associated with the trustee's reduced role. These structural protections would include financial guarantee insurance, contractual back-up servicing, and auditing procedures. Moody's review of future transactions will include increased attention to the trustee's oversight functions with regard to segregated trust accounts and the tracking of covenant breaches. In addition Moody's will consider the trustee's interpretation of their role as evidenced by past performance on behalf of investors.

Over the next several months Moody's will be re-examining asset-backed and mortgage-backed transactions where the trustee is more likely to be called upon to perform functions beyond those viewed as essentially administrative. Moody's review will focus on transactions with unrated or noninvestment-grade-rated servicers. In its analysis Moody's will consider the type of securitized asset, its credit performance relative to current credit enhancement levels, the adequacy of the servicing fee relative to servicing costs, arrangements for backup servicing, the level of trustee oversight of segregated trust accounts, and input from the trustee. Transactions that Moody's deems to be potentially weak in terms of trustee function may be placed on review for possible downgrade subject to further analysis.

## **TRUSTEE PERFORMANCE AT TIMES FAILS TO MEET EXPECTATIONS**

Over the past several years, as more ABS and RMBS experienced economic stress and default, the performance of trustees has been tested. In a number of instances, trustees' performance has fallen short of expectations. Our review of problematic transactions revealed that the weaknesses in trustee performance centered on the following issues:

- Monitoring the application of transaction cash flows
- Taking action when evidence of impropriety is presented
- Assuming backup servicing duties at the fee stipulated in the transaction documents
- Taking note of covenant breaches

Some trustees have argued that their responsibilities are limited to strictly administrative functions as detailed in the transaction documents and that they have no "fiduciary" duty prior to an event of default. However, this was not Moody's understanding in the past, based on transaction documentation and conversations with trustees and underwriters. The issues raised by the NCFE healthcare receivable transactions have prompted Moody's to re-evaluate the trustee's role in specific ABS and RMBS transactions. Moody's will focus its analysis particularly on transactions where the trustee's role was considered a significant investor safeguard at the time the deal was rated.

## **THE ROLE OF THE TRUSTEE IN MOODY'S RATING ANALYSIS**

The importance of the trustee's role in Moody's rating process is mostly a function of the credit strength of the seller/servicer. As long as the seller/servicer is financially strong, the role of the trustee is not as critical a component of Moody's analysis. Other factors such as the type and quality of the receivables and the quality of the servicing carry much more weight. In general, a financially strong servicer is less likely to consciously misallocate transaction cash flows. Intentional misuse of transaction cash is typically caused by the servicer's financial dis-

stress, so financially strong servicers are much less likely to defraud investors. If cash flows are inadvertently misapplied, a financially strong servicer has the wherewithal to indemnify the transaction for its errors. A financially strong servicer is much less likely to commit an event of default that would lead to a servicer termination event. As long as no servicer termination event takes place, the issue of servicing transition and successor servicer's fees is moot.

In transactions involving weaker seller/servicers, the trustee's role is much more important to the rating analysis. Control of transaction cash flows is of paramount importance. The purpose of using segregated trust accounts is to limit the servicer's access to cash collections. Weaker servicers are more likely to default, so the backup servicing role of the trustee is material to the transaction. The selection of a new servicer if the original servicer is unavailable and the cost of a replacement servicer are especially important considerations when the assets are of subprime credit quality, or have other unusual characteristics.

## **MANAGEMENT OF SEGREGATED TRUST ACCOUNTS**

### **The Servicer Collects Payments, Calculates Distributions**

In a securitization, the securitized assets are no longer the property of their originator. The assets are typically transferred to a special purpose vehicle, which is legally separate from the originator. However, the originator is often also the servicer, and in that capacity is responsible for collecting the payments made by obligors on behalf of investors. Collections on the securitized assets are deposited to a segregated trust account that is held by the transaction's trustee. Unrated or noninvestment-grade-rated servicers often make daily deposits to the trust accounts because collections held by the servicer would become property of the servicer's bankruptcy estate if the servicer were to become insolvent. In some transactions, obligors mail payments to a lockbox account from which collections are transferred to transaction trust accounts. Sometimes, a noninvestment-grade-rated servicer elects to deposit collections monthly, but obtains a letter of credit, which may be drawn upon if a month's worth of collections were lost in the servicer's bankruptcy.

Highly rated servicers need not make daily deposits to the segregated trust accounts because a 30-day exposure to a Prime-1-rated entity is consistent with even a **Aaa** rating on the transaction itself. For example, in a transaction that pays interest monthly, a **Prime-1**-rated servicer may make a single monthly deposit of asset collections that will be used to pay investors' interest on the payment date.

Besides collecting payments on the securitized assets, the servicer is responsible for tracking the performance of the receivables and, in many cases, calculating the distribution of transaction cash flows. For example, in an auto loan securitization, the servicer calculates the amount of interest and principal to be distributed to holders of the various tranches of debt issued by the trust. The servicer reports repossessions, delinquencies and losses on the receivables and calculates ratios relating to any performance triggers that were included in the transaction. The servicer also directs transaction cash flows to any reserve accounts that might be held by the trustee as credit enhancement for investors. The servicer is responsible for notifying the trustee if any performance triggers have been breached.

The degree of complexity involved in calculating distributions of asset collections varies greatly. A term transaction, such as a mortgage pass-through, may consist of many tranches, some of which may have special properties, such as interest-only securities or principal-only securities. Monthly collections of principal and interest on the securitized mortgage loans must be correctly allocated among all the tranches of securities issued. However, in many transactions (particularly RMBS, CMBS and CDO), the trustee is responsible for calculating the allocation of transaction cash flows, which removes many concerns regarding this part of the process. Revolving transactions, such as those involving trade receivables, are often complicated because the receivables turn over very quickly. Some transactions involve weekly or even daily settlements, where collections on receivables are used to purchase newly originated receivables from the seller/servicer. Purchases of receivables are generally subject to compliance with various ratios relating to the performance of the receivables and the sufficiency of receivables relative to advances outstanding.

### **The Trustee Maintains Trust Accounts**

The trustee's role in the management of segregated trust accounts consists of distributing the cash in the segregated accounts to the proper parties. Typically, some of the monthly cash flow is allocated to make principal and interest payments, some of it may be held in one or more reserve accounts, and some of it may be paid out

to the servicer in the form of servicing fees and "excess spread"-the cash left over after making all required distributions. The monthly servicer's certificate spells out the distributions that are to be made that month. In many mortgage transactions, the trustee calculates the distribution amounts. In some transactions, the trustee recalculates the distribution amounts based on figures supplied by the servicer. The purpose of recalculation is to make sure that the distribution amounts are correct and that the ratios used to determine whether a performance trigger has been breached are calculated correctly. The trustee is not in a position to verify certain of the numbers reported by the servicer. For example, the amount of delinquent receivables and the amount of receivables charged off in a given month are figures that are taken from the servicer's own computer systems. While these numbers could be verified by an auditor, they are not verifiable by the trustee.

The key issue regarding the management of segregated trust accounts is the extent to which the trustee may rely on the instructions of the servicer for the distribution of funds. Some trustees have argued that they have no responsibility for the calculation of distributions and that they rely solely upon the direction of the servicer. While it is true that transaction documents may not in each case specifically call for the trustee to recalculate the distributions every month, Moody's believes that the trustee is responsible for exercising some oversight with respect to distributions. If a servicer has unfettered access to the segregated trust accounts, investors are gaining little benefit from the segregation of asset collections. If the servicer can direct the use of cash in the accounts with few constraints, investors are left vulnerable to misdirection of cash by the servicer. In its review of transactions involving unrated and below investment-grade-rated seller/servicers, Moody's will evaluate the level of oversight, if any, that is exercised over the distribution of transaction cash flows.

## **FINANCIAL STATEMENTS, CERTIFICATIONS AND COVENANTS**

The trustee is the recipient of various financial statements and officers' certificates that are scheduled to be delivered by the seller or the servicer in the transaction. The failure to deliver statements or certificates is a breach of a covenant. The trustee is required to report such breaches to rating agencies and investors. Generally speaking, trustees establish a "tickler" system that would alert trust personnel if materials that were to be received by a certain date have not arrived.

The provision of statements is a routine covenant, but in securitizations there may be other, more unusual covenants as well. For example, recently the servicer of a pool of airplane leases failed to sell the required number of aircraft by a certain date. The trustee's tickler system should be designed to detect covenant breaches of this type, in addition to provision of financial statements.

The key issue with covenant monitoring is the extent to which trustees are responsible for detecting a covenant breach independently. The servicer is responsible for notifying the trustee of its own breaches and default. However, to rely solely on self-reporting is inadequate in many structured transactions. The servicer in the aircraft transaction mentioned previously did not report that it had not sold the requisite aircraft and the breach went undetected for six months. To the extent possible, seller/servicer covenants should be structured so that they can be included in the trustee's tickler system. In this way, the failure to perform a required action will be noted and reported by the trustee.

## **NOTIFICATION OF BREACHES AND EVENTS OF DEFAULT**

The trustee is responsible for notifying investors and rating agencies of the occurrence of an event of default or a potential event of default. This is a routine matter in cases where the seller/servicer has reported the breach. In those instances, the trustee simply passes along the notification that it has received from another party to the transaction. However, many instances of potential events of default are less clear-cut. A servicer may be in default, but may not have notified the trustee of that fact. If the trustee receives information from other sources that a possible default may have occurred, to what extent is the trustee bound to investigate the matter and notify investors and rating agencies? For example, if a rating agency analyst notifies a trust officer that the servicer has been improperly re-aging accounts or has failed to charge off accounts in accordance with the transaction documents, is the trustee bound to act upon this information? In practice, Moody's has found some trustees to be unresponsive to information of this type. Moody's believes that the trustee has a duty to investigate credible indications that a servicer is in default and notify rating agencies of any claims of a possible default. Otherwise, the integrity of the transaction depends entirely on the willingness of transaction participants to report their own failures to act in accordance with transaction documentation.

## SUCCESSOR SERVICERS AND SERVICING TRANSFERS

### **Successor Servicer is a Key Component of Securitizations**

Since a key objective of a securitization is to isolate, insofar as possible, the credit quality of the assets from the credit quality of the originator and the servicer, it is necessary to make provisions for the servicer to be replaced if it fails to fulfill its obligations. At issue is who should replace the servicer and what will the successor servicer be paid. The initial servicer in a transaction has agreed to service the assets in a certain way for an agreed-upon fee. Each transaction defines the circumstances that would cause a servicer to be terminated. In most transactions, if a servicer is terminated, the trustee is responsible for finding a suitable successor servicer. If the trustee is unable to find a third-party successor, the trustee is ultimately responsible for servicing the assets as the successor servicer of last resort. Some transactions allow for a successor servicer to be paid a specified higher servicing fee than the original servicer received, but most transactions call for the successor servicer to be paid the same fee as the original servicer. Some transactions are structured to include a designated backup servicer who is paid a fee to stand ready to take up the servicing duties if need be.

In appointing a successor servicer, time is often of the essence. If the original servicer is no longer capable of servicing the assets appropriately, higher delinquencies and defaults are inevitable. The amount of time required to engage a successor servicer and complete the servicing transfer varies greatly from deal to deal. Even in cases where a backup servicer has been designated in advance, problems can occur. In one case, the contractual backup servicer resigned and refused to service the assets. In other cases, backup servicers have been unprepared to take over, even though the transaction documents had called for the backup servicer to periodically review computer tapes delivered by the servicer.

In theory, the selection of a successor servicer would appear to be straightforward, but in practice a number of difficulties may arise. The issue of whether a given successor servicer is qualified to service the asset is a matter of judgement. Some assets require specialized servicing and there may be a limited number of servicers who are qualified to take over. For example, a servicer who normally services prime auto loans is not likely to be an ideal candidate to take over a subprime portfolio. The universe of qualified servicers is even smaller for esoteric assets such as aircraft and music royalties. An inappropriate servicer is likely to service the assets relatively poorly, which will result in higher chargeoffs and less cash collections for investors.

### **Below-Market Servicing Fees Are Rampant**

One of the most contentious issues concerning servicing transfers is the servicing fee. In most transactions the successor servicer is entitled to receive the same fee that the original servicer received. But many companies who securitize assets are motivated to specify a minimal servicing fee. There are a number of reasons for this. The lower the servicing fee, the higher the "excess spread" that is available as credit enhancement for investors. More excess spread means that other forms of credit enhancement such as overcollateralization or subordination can be minimized. When the "gain on sale" method of accounting for securitizations was widespread, companies were motivated to maximize the amount of excess spread in the transaction because it resulted in a greater gain on sale. From the standpoint of Moody's rating analysis, the availability of successor servicing at a predetermined price is important to the determination of how much cash flow from the serviced assets will be available to pay principal and interest.

The tendency of issuers to favor low servicing fees is offset in several ways. Some transactions call for a successor servicer fee that is higher than the original fee. The higher fee is more realistic compensation for a third-party servicer. In some transactions that involve difficult-to-service assets, or assets with a limited universe of potential servicers, a "hot" backup servicer has been employed. The hot backup receives a fee to do preliminary work necessary to transition servicing and to review data tapes from the servicer periodically in order to stand ready to step in as servicer quickly and efficiently. In many transactions, the trustee, as successor servicer of last resort, is obligated to service the assets at the specified servicing fee.

Once a servicer is to be terminated in accordance with the transaction documents, the trustee is charged with finding a successor servicer. In practice, selecting and paying a successor servicer has been a thorny issue. Several factors can affect the cost of replacement servicing. Third-party servicers sometimes charge a fixed fee per loan serviced. Since the transaction documents define the servicing fee as a percentage of aggregate principal balance outstanding, the servicing fee may fall short if, for example, the deal has seasoned to the point

where the average balance of individual loans in the pool is small, but there are still many loans with outstanding balances. Furthermore, a servicer may charge a higher fee to service delinquent loans than loans that are current. If pool performance has deteriorated, a higher-than-anticipated proportion of delinquent loans could result in higher servicing costs than originally anticipated.

### **Trustee Obligated to Engage Successor Servicer**

Trustees and investors sometimes find themselves at odds when a successor servicer must be appointed. A trustee is highly motivated to find a replacement that will service at the contractual rate. Investors want the most skilled servicer available in order to maximize the cash collected on the assets. However, the trustee may be reluctant to pay additional servicing expenses out of its own funds. In some cases, a trustee has proposed a successor servicer who is willing to service at the contractual fee, but investors have been dissatisfied with the servicer's qualifications. In this case, the trustee may argue that if investors wish to hire someone else, then the additional expense associated with that choice should come out of deal cash flows, and is not the trustee's responsibility. If the servicer is in bankruptcy, the bankruptcy trustee may step in and prevent servicing from being transferred, while imposing a higher servicing fee on the transaction. Here too, the extra costs may come out of cash collections that would have been available to investors.

Since in most transactions, the successor servicer or the trustee as successor servicer is obligated to service at the agreed-upon servicing fee, trustees are vulnerable to the risk that the contractual servicing fee is inadequate to provide high-quality servicing. Increasingly, trustees have been unwilling to assume unreimbursed servicing costs. Instead, the increased servicing costs have been paid for out of transaction cash flows that would otherwise have been available to pay investors' principal and interest.

### **Servicing Transition Expenses**

The transfer of servicing to another party entails expenses that are generally not specified in the transaction documents in advance. A servicing transfer may require that loan files be physically moved to another location. There may be set-up costs associated with transferring loan data from the original servicer's computer system to a new system. Some transactions include a maximum dollar amount of transition expenses for which the trustee is entitled to be reimbursed.

Many transactions are silent as to transition expenses. The trustee is entitled to be reimbursed at a senior level out of transaction cash collections for expenditures it makes on behalf of investors. Some trustees have interpreted this language to cover the cost of servicing transition. Others claim that those provisions for reimbursements apply only to extraordinary items, generally outside of normal servicing transition. In most cases, the costs associated with a servicing transfer are not material in the context of the entire transaction. However, in some cases the costs have been extremely high. In what was deemed a controversial move, the trustee in the Heilig-Meyers workout escrowed approximately \$35 million to cover servicing transition expenses. This was a material amount, which some investors found to be excessive. Moody's believes that the expenses associated with servicing transfers have been under-appreciated in the past. Going forward, Moody's will evaluate the likelihood of material transition expenses and will factor those expenses into its analysis of the credit enhancement available to investors.

## **MOODY'S WILL EXAMINE TRANSACTIONS**

Given the recent history of trustee performance in troubled ABS and RMBS, Moody's is re-examining transactions in which the trustee is more likely to be called upon to take an active role. Moody's examination will focus on transactions with unrated or noninvestment-grade-rated seller/servicers in the ABS and RMBS sectors. Moody's analysis will consider the adequacy of the servicing fee, backup servicing arrangements, and potential servicing transition expenses. The nature of the securitized asset, its credit performance relative to credit enhancement levels and the reliability of the seller/servicer will be taken into account. Moody's will seek trustees' input regarding the measures currently in place to protect investors. Transactions that present material concerns in these areas will be either placed on review for possible downgrade pending further analysis or in extreme cases downgraded without review.

As a result of trustees' recent stance, there is likely to be a closer link in the future between changes in the credit quality of a seller/servicer and changes in the ratings of structured transactions, in the absence of mitigating factors. The types of structural protections that mitigate seller/servicer exposure include the trustee's recalculation

tion of transaction cash distributions as a check on the servicer's calculation, periodic audits conducted by independent accounting firms, and contractual backup servicing arrangements.

In its examination of existing transactions Moody's will evaluate the protections available to investors and will determine whether it is necessary to re-evaluate the cash flow investors are likely to receive in a distressed situation. For example, Moody's will seek clarification from trustees about their role and will look for clear language in the transaction documents to describe that role. If the trustee's interpretation of their function or the trustee's function as specified in the transaction documents fails to assure that the servicer's direction of cash collections is supervised, Moody's will consider the ratings impact of that situation. Moody's will examine the existing backup servicing arrangements, if any, and evaluate the likely effectiveness and cost of those arrangements. If the cost of backup servicing is likely to be higher than the servicing fees stipulated in the transaction documents, Moody's will assess the effect that higher fees would have on the cash available to pay investors' interest and principal. For example, if the likely cost of backup servicing on an auto loan securitization is 100 basis points higher than the current servicing fee, Moody's will assess the effect on the security's creditworthiness of 100 basis points less excess spread. Moody's analysis will also incorporate an assessment of the expenses that could be incurred in a servicing transition and will incorporate those expenses in its analysis of the future cash available to investors. Moody's analysis of the potential financial effects of a servicer termination will include a consideration of the likelihood that servicer termination will occur.

### **CONSIDERATION OF TRUSTEE'S ROLE IN FUTURE TRANSACTIONS**

Going forward, Moody's analysis of ABS and RMBS transactions will include a detailed review of each of the components of the trustee's function that could impact the cash available to pay investors' principal and interest. In particular, Moody's will consider whether the servicing fee called for in the transaction is reasonably in line with the fee a successor servicer would likely require. Moody's will also take into account provisions for servicing transition expenses and any backup servicing arrangements in place. In the past, some transactions have capped the amount of transition expenses for which the trustee would be reimbursed at a senior position in the transaction's priority of payments. In the future, Moody's will regard those caps as unlikely to be enforced.

Many sectors of RMBS and ABS will not be widely affected by this approach because these considerations are adequately addressed at present. For example, there is an active market for traditional residential mortgage loan servicing and the servicing fees in most transactions are adequate. In the franchise loan sector, more recent transactions with unrated or noninvestment-grade servicers have had higher servicing fees than previously and contractual backup servicers are more prevalent.

Moody's document review will include an increased level of attention to the trustee's oversight functions with regard to segregated trust accounts and the tracking of covenant breaches. A lack of clarity and specificity in these areas will be viewed negatively in the context of Moody's assessment of the transaction's credit strength. In addition, Moody's will take into consideration the trustee's interpretation of their role as evidenced by past performance on behalf of investors.

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