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Securitization Provides Means To Protect Assets

BY MARK S. INDELICATO

SINCE THE mid-1980s, securitizations have increased at a rapid rate for banks and finance companies and have become an attractive alternative source of financing for corporate America. Securitizations appeal to a broad range of companies, large and small, in many different industries. Loan warehousing transactions are often a prelude to asset securitization, a form of "structured financing."

Structured financing refers to a method of financing pursuant to which the originating company transfers assets that generate a steady stream of income to a separate entity in order to isolate these assets from the potential financial decline of the originating company, particularly the potential that the originating company could become the subject of a proceeding under the provisions of the Bankruptcy Code.[1]

This separate entity, often affiliated with the originator, generally known as a special purpose entity (SPE), then issues securities, either debt or equity, backed by these assets and uses the proceeds generated from the issuance of these securities to pay the originator for the assets that have been transferred by the originator to the SPE, thereby providing the originator with capital for its business needs. The SPE then uses the income stream generated by these assets to make payments to the holders of the asset-backed security issued by the SPE. In certain circumstances, companies are now seeking to securitize non-liquid assets, such as inventory, but such securitizations can be problematic.[2]

In addition to the originator of the assets and the SPE, structured financing transactions typically include many, if not all, of the following additional entities: credit enhancers (i.e., financial guarantors); the servicer (the party that collects on the assets transferred to the SPE, directs cash flow allocation, and may otherwise act as agent for the bondholders); a liquidity provider (letter of credit bank); a trustee or collateral agent; a securities underwriter or placement agent; and a rating agency.

Credit ratings express an opinion about both absolute credit risk of payment default or expected loss to a securityholder and relative credit risk through other rating categories. In order to achieve a rating that reflects a lower level of credit risk than that of the originator, structured transactions may involve some form of credit enhancement. Conventional forms of external credit enhancement include letters of credit, surety bonds, subordinated loans from third parties, and guarantees. Internal credit enhancement can include over-collateralization and capital contributions to the equity of the SPE.

The credit rating given to the SPE security from Moody's or Standard & Poor's will generally be higher than the credit rating that would have been received by the originator, because the securities issued by the SPE are generally either over-collateralized or subject to one of the other credit enhancement devices intended to ensure that timely payment is made on the underlying obligation.

Asset securitization enables the originator to go directly to the credit market for its working capital needs instead of seeking traditional financing; direct access to the credit markets reduces the originator's cost of funds and thereby increases its net operating income. It allows considerable flexibility by using either discrete or revolving asset pools, allocating asset cash flow to match bond payments, and accelerating cash flow from assets, thereby allowing a more efficient redeployment of those assets.

A primary consideration in asset securitization is to ensure, to the greatest extent possible, that the SPE and its assets will not be affected by the financial deterioration or bankruptcy of the originator. It is the premise of structured financing to separate, as a legal matter, the credit quality of the assets being securitized from the credit risk of the originator. The SPE is created to be "bankruptcy remote."

True Sale

In structuring the transaction, it is important to ensure that the transfer from the originator to the SPE will be treated as a true sale as opposed to a secured loan if the transaction is later scrutinized by a bankruptcy court. To accomplish such an absolute sale, the transferor should convey both the benefits and burdens of ownership to the SPE. If the transfer of the assets to the SPE is treated as a true sale the originator will have no interest in the assets of the SPE and the SPE will be permitted to continue collecting the income generated from these assets unaffected by the bankruptcy of the originator.[3]

If, however, the transaction is deemed to be a loan instead of a sale, the assets will constitute property of the originator's bankruptcy estate pursuant to the provisions of §541 of the Bankruptcy Code.[4] The SPE will then be stayed[5] from its efforts to collect the income stream generated from the transferred assets[6] or may be subject to a motion by the originator seeking to either sell the transferred assets or utilize the income stream generated from the transferred assets[7] by providing the SPE with adequate protection of its interest in the transferred assets.

Bankruptcy courts are reluctant to immediately curtail a debtor's access to the funding needed to operate its business. In addition, if the SPE's interest is not perfected, the SPE may be subject to attack by the originator's bankruptcy trustee[8] to avoid the SPE's interest as a

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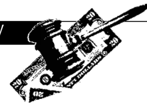


preference and recover payments already received by the SPE from the income stream of the transferred assets.[9]

Even if the transfer of assets from the originator to the SPE is determined to be a true sale, the assets of the SPE could still become subject to the bankruptcy proceeding of the originator if, upon proper motion, the bankruptcy court were to approve the "substantive consolidation" of the estate of the nondebtor, solvent SPE with that of the originator to create one common fund to satisfy creditors of both the originator and the SPE.

Safety of Entity

A recent decision in the *LTV Steel Co.* bankruptcy case has caused some controversy regarding the safety and remoteness of an SPE in structured transactions. LTV Steel Co. and several of its affiliates filed for bankruptcy with the U.S. Bankruptcy Court for the Northern District of Ohio on Dec. 12, 2000. Simultaneously with its petition, LTV filed a motion to use the cash generated in its two separate securitizations with two separate banks, one securitized by accounts receivable and one by inventory.

LTV argued first, that it would have to close its doors and cease operations, and second, that the transfer of assets created disguised financings and not a "true sale." This cash was needed because LTV had securitized virtually all of its liquid working capital assets and did not have sufficient cash flow to continue to operate. Despite bank opposition to the use of the cash, the court granted a temporary order permitting the use of the cash and set a future date for determination of the true sale/disguised financing issue with respect to the securitization. Ultimately, the dispute was resolved when both banks provided debtor-in-possession (DIP) financing to LTV that took out the securitization debt. The court reached no conclusion on the merits of the case. Instead, it issued a summary finding that a true sale had occurred.

DIP financing has been a key factor in past securitizations allowing for quick exit upon a bankruptcy filing by the originator. In this case, DIP financing was not provided because the accounts receivable financer, Abbey National Treasury Services (Abbey), did not want to share its collateral on a pari passu basis with the inventory financer.[10]

Whether the *LTV Steel Co.* case has precedential value remains to be seen. What it does is demonstrate how structured financings are susceptible to entanglement in the originator's bankruptcy. As discussed earlier, bankruptcy courts have the power to balance the equities in their determination of whether a true sale or secured loan has occurred.

It appears that *LTV Steel Co.* is unique and distinguishable from most structured financings. Whether it is distinguishable due to the use of manufactured products or the use of inventory in general as an asset, the *LTV Steel Co.* case should not pose a problem to lenders in the structured finance industry.[11]

The Special Purpose Entity should be structured to ensure not only that it is not subject to the bankruptcy proceeding of the originator, but also that it will not be subject to a bankruptcy proceeding of its own for reasons other than the creditworthiness of the transferred assets.

Proposed Legislation

Proposed §912 of the Bankruptcy Reform Act of 2001 has caused some concern in the bankruptcy community. Section 912 would remove the ability of the bankruptcy judge to recharacterize 'sales' as secured transactions, even where the transaction would not be considered a sale under state law. Bankruptcy judges would no longer be able to determine whether an asset-backed securitization is a disguised financing transaction or a true sale, essentially wiping out any possibility of the *LTV Steel Co.* decision becoming precedent. Detractors argue, that in instances such as the *LTV Steel Co.* case where many jobs were on the line, the provision could prove to be disastrous.

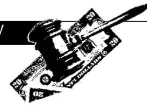
Creating Entity

Establishment of a bankruptcy remote entity may be accomplished by the inherent structure of the particular SPE because not all entities are eligible for bankruptcy protection.[12] If a party is not eligible for the protections of the Bankruptcy Code but either files a petition or has an involuntary petition filed against it, the case must be dismissed because the bankruptcy court will lack jurisdiction.[13]

An SPE may be a corporation, or a grantor trust which has a finite existence and fixed purpose.[14] The different tax treatment afforded to a trust, as well as its inability to seek bankruptcy protection, may be the impetus for creating an SPE as a trust instead of a corporation. If the SPE is to be a trust, however, the trust must be established so as to ensure that it will not be deemed a "business trust"[15] by the bankruptcy courts. Unlike grantor trusts, business trusts may be subject to a filing under the provision of the Bankruptcy Code because as a business trust it would be considered a corporation.[16]

A new form of SPE which has been increasingly utilized is the limited liability company (LLC).[17] Compared with the corporate SPE, the LLC offers its owners full control of management without exposure to personal liability for the LLC's obligations. There is a concern regarding single-member LLCs and their degree of bankruptcy risk. The risk is the potential dissolution of the LLC upon the sole member's individual bankruptcy, depending upon whether the court determines that the LLC is a partnership or corporation for bankruptcy purposes.

If the court deems the LLC a partnership for bankruptcy purposes, the LLC may dissolve upon the bankruptcy of its member and have its assets distributed. Corporations, on the other hand, do not dissolve upon the bankruptcy of its last remaining shareholder. Under Delaware



law, the consensus has been that the LLC agreement is deemed analogous to a certificate of incorporation, and that LLC status is respected as a separate legal entity.[18]

The SPE should be structured to ensure not only that it is not subject to the bankruptcy proceeding of the originator, but also that it will not be subject to a bankruptcy proceeding of its own for reasons other than the creditworthiness of the transferred assets. In order to insulate the SPE from attack the SPE must:

- observe corporate formalities;
- be able easily to distinguish its assets and liabilities from those of the originator;
- have a separate corporate existence that is disclosed to third parties;
- have adequate capital to conduct its business operations; and
- be subject to limitations on its investments, indebtedness, business and ownership.

The stock of the SPE could be owned by the originator, a third party or even a charitable organization depending on the business structure of the transaction. Adequate capitalization will be helpful in defeating any bankruptcy court motion to substantively consolidate the assets of the SPE with those of the originator in the originator's bankruptcy proceeding. It will also reduce the risk that the SPE will be subject to its own bankruptcy proceeding.

Provisions in the articles of incorporation of an SPE that is affiliated with the originator may also help ensure that the SPE is independent and bankruptcy remote, if they:

- limit the number of officers and directors of the originator that can be officers and directors of the SPE;
- require at least one member (preferably two) of the SPE's board of directors to be independent of the originator; and
- require the unanimous consent of the board of directors to file a voluntary proceeding under the Bankruptcy Code.

The inclusion of these provisions in the SPE's articles of incorporation will make it harder for a solvent SPE to file a bankruptcy petition. These provisions, however, are not the same as an express, absolute waiver by the SPE of its right to seek bankruptcy protection; any such provision would be void as against public policy.[19] The SPE could, however, agree not to file a voluntary bankruptcy proceeding if it is solvent. These provisions may be acceptable because the voluntary waiver by a solvent entity of its ability to file a voluntary bankruptcy proceeding when solvent may not constitute a violation of public policy. These provisions will not, however, prevent an involuntary bankruptcy petition from being filed against the SPE.[20]

The underlying purchase agreement between the originator and the SPE should contain the following covenants, representations and warranties which not only will foster the goals of making the SPE bankruptcy remote, but also will diminish the possibility that the SPE will be substantively consolidated in the bankruptcy proceeding of the originator:

- All intercompany transactions between the SPE and the originator will be arm's-length transactions.
- The SPE will observe all corporate formalities and hold itself out to creditors as a separate distinct legal entity.
- The SPE will maintain proper books and records setting forth its assets and liabilities.
- The SPE will not, unless required and then only for such time as is necessary, commingle its assets with those of the originator.[21]

Another structural option to help minimize the effects of a bankruptcy by the SPE is an agreement by the SPE to grant lenders or purchasers immediate relief from the provisions of the automatic stay[22] upon the filing of a bankruptcy proceeding.

In order to further minimize the risk that the SPE will be subject to its own bankruptcy proceeding, the SPE may seek an agreement from its existing creditors (which should be few in number) that they will refrain from filing an involuntary petition against the SPE.

(1) Unless otherwise stated, all section references are to the Bankruptcy Reform Act of 1978, as amended, codified at 11 U.S.C. §101 et seq. (the Bankruptcy Code).

(2) See *In re LTV Steel Co.*, 2001 Bankr. Lexis 131 (Feb. 5, 2001).

(3) But see *Octagon Gas Systems, Inc. v. Rimmer*, 995 F.2d 948 (10th Cir. 1993) (The Tenth Circuit found that even in the event of true sale of accounts, the accounts would constitute assets of the bankrupt seller's estate.) This case has been widely criticized as a misreading of the law.

(4) 11 U.S.C. §541(a) (1984).

(5) 11 U.S.C. §362(a)(3) and (5).

(6) 11 U.S.C. §363(a)(1984)

(7) If the transferred assets are deemed to be part of the originator's bankruptcy proceeding the proceeds of those assets will constitute "cash collateral" pursuant to 11 U.S.C. §363(a). The originator is prohibited from using cash collateral absent a bankruptcy court order.

(8) See generally 11 U.S.C. §§1104 and 1108.

(9) See 11 U.S.C. §547.

(10) Abbey's Brief in Support of its Appeal of the Memorandum Opinion and Order Entered by the Bankruptcy Court on Feb. 5, 2001 (Feb. 15, 2001) (Appeal to U.S. District Court, N.D. Ohio, E. Div.).

(11) In the Enron bankruptcy, however, J.P. Morgan Chase & Co. commenced an adversary proceeding to protect its interest in several complex securitizations of Enron's account receivables. The adversary proceeding seeks a determination that these assets are not included in Enron's bankruptcy estate. At the time of the suit, Enron had failed to surrender the assets or give Chase any information regarding the securitization even after Chase demanded that it do so. Is this another anomaly or a harbinger of things to come?

(12) See generally 11 U.S.C. §109 (1984).

(13) See *In re Independent Clearing House, Co.*, 77 B.R. 843, 850 (D. Utah 1987).

(14) The entity may be so structured as to permit its treatment as a partnership for tax purposes.

(15) See, e.g., *In re The Ophir Trust*, 112 B.R. 956 (Bankr. E.D. Wis. 1990).

(16) See Kravitts, *Securitization of Financial Assets*, §502[c][2], at 5-24, N.N. 44, 45 (Supp. 1992).

(17) See generally, The Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York, "New Developments in Structured Finance," 50 *Bus. Law.* 95, 146-158 (2000) (discussing fully LLC as a new form of SPE to achieve bankruptcy protection).

(18) See 1 Larry E. Ribstein & Robert R. Keatings, *Limited Liability Companies* §14.04, at 14-18 (2000).

(19) Congress' "strong legislative desire that deserving debtors be allowed to get a fresh start" renders void as against public policy "an advance agreement to waive the benefits" of federal bankruptcy law. *Fallick v. Kehr*, 369 F.2d 899 (2nd Cir. 1969);

(20) See *In re Kingston Square Associates*, 214 B.R. 713, 725-26 (Bankr. S.D.N.Y. 1997).

(21) In order to ensure that the SPE retains its interest in the proceeds of the transferred assets, at a minimum, the servicing agreement (as well as the purchasing agreement) should provide: (1) that the allocation of all collections must occur within ten days (or less) of receipt by the originator, and (2) that collections received by the originator are to be segregated and held in trust for the benefit of the SPE until paid by the originator (servicer) to the SPE.

(22) See, e.g., *In re Citadel Properties, Inc.*, 86 B.R. 275 (Bankr. M.D. Fla. 1988); *In re Orange Park South Partnership*, 79 B.R. 79 (Bankr. M.D. Fla. 1987); see also *In re Club Tower L.P.*, 138 B.R. 307 (Bankr. N.D. Ga. 1991).

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