This article was published by Standard & Poor's Ratings Services (James F. Penrose, Esq. and Dina J. Moskowitz, Esq.) on September 19, 2002. Copyright © Standard & Poor's, a division of The McGraw-Hill Companies. All Rights Reserved.

U.S. Legal Criteria for "Recycled" Special-Purpose Entities

Reduced to its essentials, securitization enables a lower-rated company to obtain financing at interest rates normally associated with higher-rated borrowers by transferring a pool of the company's cash-generating assets to an entity that is unlikely to become insolvent. Such an entity is commonly nicknamed an "SPE", but the term does not impart its full significance-many entities can be "special purpose" but the key for a securitization is that the entity be "bankruptcy remote" as well.

The transfer of assets often takes the form of a sale, with the purchase price being raised contemporaneously by the SPE issuing notes (debt), certificates (equity), or both. The proceeds from the sale of the securities are paid to the transferor. The transfer also may take the form of a capital contribution by the transferor, as the SPE often is a wholly owned subsidiary of the transferor. The transferor's funding costs go down as a result of transferring its assets to an SPE because the transferor's risk of bankruptcy need not be taken into account (in the simplest form of transaction) in analyzing the creditworthiness of the debt issued by the SPE. Rather, the analysis of the SPE's credit can be based primarily on the size of the debt service payments relative to the cash flow generated by the assets.

But what does it mean to be "bankruptcy remote"? The following are the traditional characteristics of a bankruptcy remote SPE:

- Restrictions on objects, powers, and purposes;
- Limitations on ability to incur indebtedness;
- Restrictions or prohibitions on merger, consolidation, dissolution, liquidation, winding up, asset sale, transfers of equity interests, and amendments to the organizational documents relating to "separateness";
- Incorporation of separateness covenants restricting dealings with parents or affiliates;
- "Non-petition" language (i.e., a covenant not to file the SPE into involuntary bankruptcy);
- Security interests over assets; and
- An independent director (or functional equivalent) whose consent is required for the filing of a voluntary bankruptcy petition.

These characteristics are further explained in various Standard & Poor's publications (most recently in Structured Finance Legal Criteria available at RatingsDirect.com). In sum, however, their function is to minimize the likelihood that the SPE will file itself into (voluntary) bankruptcy, or will be filed by third parties into (involuntary) bankruptcy. Thus, in analyzing the ability of the SPE to make its debt service payments, the bankruptcy of the SPE need not be taken into account.

Rationale for the Newly Created SPE

The advantage of a newly created vehicle for each new transaction is that investors have the assurance that it has no prior history of dealings or disguised liabilities that could affect cash flow. If the vehicle is created just prior to its use in the securitization, it is unlikely that there would be claims that might have to be satisfied at some later date. If the SPE is not newly created for the securitization, an unrated, pre-existing liability of the entity may result in a lawsuit against it which might have to be satisfied out of its assets, and which could give the plaintiff the incentive to put the entity into an involuntary bankruptcy.

For example, with respect to real estate transactions, such pre-existing liabilities could include, among other things, prior contractual obligations, environmental liability, and various other liabilities related to personal injury claims, "dram shop" liability, and employment liability. Of course, none of the SPE's assets should remain unpledged, as unpledged assets provide an increased incentive for a lawsuit or bankruptcy filing.

For every principle, though, there are exceptions. One such exception lies in Standard & Poor's recognition that an SPE may, if appropriately structured, serve as the issuer for more than one transaction. (See "Criteria for Multi-Use SPEs" at RatingsDirect.com.) Such a multi-use SPE mitigates the potential of a holder of a lower-rated or unrated issuance attempting to place the SPE into bankruptcy by requiring the SPE's debtholders to agree in the transaction documents that they have no rights to collateral held by the SPE in respect of other series, and that if they were deemed by a bankruptcy court to have any rights in such collateral, they would be subordinate to the other debtholders. As an enforceable "subordination agreement" under the Bankruptcy Code, the effect of these provisions is that, upon a default of a particular tranche, holders of the lower-rated defaulted debt would have little to gain by forcing the issuer into bankruptcy.

Another exception is the subject of this article. Currently, securitizations encompass considerably more than pools of liquidating assets. In recent years securitizations have featured a large variety of assets ranging from automobile fleets to "single asset" real estate transactions. On occasion, particularly for first-time entrants into structured finance, it may be impractical or impossible to transfer assets to a newly created SPE. For instance, transactions that have been documented and closed without a Standard & Poor's rating and which require bondholder consent to alter material terms (such as the identity of the obligor on the bonds) may subsequently be submitted for rating. In other instances, the problem arises in real estate loans where the transfer of the mortgaged property to a new SPE may provoke unfavorable mortgage, recording, transfer, or capital gains tax consequences. In still other instances, creation of a new SPE by a regulated entity may require regulatory approval that may not be speedily forthcoming. In such cases, Standard & Poor's has been asked about the possibility of "transforming" the existing operating entity into an SPE. As is usually the case, the answer is, "maybe."

The "Recycled" SPE

As discussed above, the concern with using an existing entity for a new asset-backed transaction is that the entity may have previously incurred material liabilities that could ultimately trigger an involuntary bankruptcy filing.

In transactions where, for reasons described above, it may be onerous to transfer the asset(s) to a newly formed SPE, the transaction sponsor may, in addition to adopting the SPE criteria (including provision of a substantive nonconsolidation opinion), consider removing or mitigating potential liabilities from the existing entity. The now-recycled entity may potentially be treated more advantageously than a non-SPE for rating purposes, though it is likely that some rating penalty may attach to the transaction, particularly at the higher rating levels, unless all risks (regardless of whether known as of the closing date) are specifically mitigated by a creditworthy source. Depending on the rating sought (and in addition to other documents or information that might be required for the rating), such a "recycling" would generally involve:

- A certification by an officer of the company,
- An audit,
- Proof of compliance with environmental standards, and
- Applicable legal comfort.

The officer's certificate should be delivered by an executive officer competent to address each of the matters therein. The certificate should state that the entity:
1. Is and always has been duly formed, validly existing, and in good standing in the state of its incorporation and in all other jurisdictions where it is qualified to do business;

2. Has no judgments or liens of any nature against it except for tax liens not yet due;

3. Is in compliance with all laws, regulations, and orders applicable to it and has received all permits

necessary for it to operate;

4. Is not aware of any pending or threatened litigation;

5. Is not involved in any dispute with any taxing authority;

6. Has paid all taxes;

7. [For real estate transactions] Has never owned any property other than the property that is the subject of the current transaction and has never engaged in any business except the ownership and operation of such property;

8. Is not now, nor has ever been, party to any lawsuit, arbitration, summons, or legal proceeding (if it has been a party, the entity should supply evidence of liability insurance acceptable to Standard & Poor's);

9. Has provided Standard & Poor's with complete financial statements that reflect a fair and accurate view of the entity's financial condition;

10. Has passed a Phase One environmental audit for all of its properties;

11. Has (with respect to the nonconsolidation opinion referred to below) materially complied with the separateness covenants referred to in such opinion since its formation (or any material noncompliance is properly addressed and analyzed in the nonconsolidation opinion); and

12. Has no material contingent or actual obligations not related to the mortgaged property.

The audit aspect of the recycling involves the provision to Standard & Poor's of an accounting audit of the entity. The audit should confirm the substance of the representations and warranties in the Officer's Certificate dealing with the entity's financial statements. The legal comfort involves providing Standard & Poor's the following:

- An acceptable legal opinion confirming the relevant representations and warranties (typically 1 to 5 above) set forth in the Officer's Certificate, and
- An acceptable nonconsolidation opinion containing no assumptions with respect to the entity's prior conduct unless (a) the transaction documentation contains representations to the effect that, since its inception, the entity has never violated Standard & Poor's SPE criteria, and (b) the opinion provider states that it has undertaken appropriate investigations as to prior conduct (including, without limitation, review of lien searches, loan documents from prior loans, and certificates) in support of such assumptions.

If the entity holds real property, Standard & Poor's may request a copy of the Phase One environmental audit referred to in the Officer's Certificate.

Ideally, the result of the recycling is a clean bill of "liability" health for the entity. On occasion, however, issuers or sponsors of the existing entity have not been able to give clean certifications. In such instances, the relevant liabilities have been mitigated by acceptable credit enhancement.

While a newly created SPE is, of course, the ideal, Standard & Poor's recognizes that circumstances occasionally conspire to make this impracticable. In such cases, Standard & Poor's will consider the effect that recycling may have on the desired rating. The resulting recycled SPE, by being held to analogous criteria as a newly created SPE, may consequently support a higher rating than might otherwise be possible.