ASPECTS OF SECURITIZATION OF FUTURE CASH FLOWS UNDER ENGLISH AND NEW YORK LAW

MARKE RAINES* AND GABRIELLE WONG**

I. INTRODUCTION

Whereas securitization of receivables usually involves the sale of cash flows generated by a company's existing pool of assets, "future flow" transactions are backed by income to be derived in the future by an operating company (the originator). Given the obvious risk that the operating company (or possibly a customer of the operating company) may become insolvent or otherwise fail to perform and generate the receivables that secure the special purpose vehicle's bond payment obligations, it is worthwhile examining the nature of future receivables and the relevant insolvency law, and comparing them to existing receivables. While such issues can arise under the laws of many different jurisdictions in international securitization transactions[1] (in particular the local jurisdiction of the originator), it may be most useful to examine the positions under English and New York law, which very frequently will be relevant due to the importance of English and New York law in governing international financial transactions.

The usual securitization is of amounts which have not yet fallen due, but which are owing, under an identifiable contract; a simple example being trade receivables arising in connection with the sale of goods delivered under invoices requiring payment 30, 60, or 90 days after delivery. Assuming the seller delivers in accordance with its

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* B.A., Simon Fraser University, LL.B., University of British Columbia, LL.M., University of Cambridge, of Shearman & Sterling, London. The assistance of Fanny Lau, of Shearman & Sterling, London, is gratefully acknowledged.

** J.D., Columbia University of New York, of Shearman & Sterling, London. The assistance of Robert H. Saunders, of Shearman & Sterling, New York, and Robert Garvey, of Shearman & Sterling, London, is gratefully acknowledged.

1. *See* discussion *infra* Part IV ("FUTURE FLOW RECEIVABLES SECURITIZATIONS IN THE U.S. CONTEXT").

contract with the customer, the payment obligation of the customer exists, and is virtually unconditional, when sold by the seller to the securitization special purpose vehicle (SPV). The "churning" nature (i.e., repeated purchases) of such receivable pools and simple economics mean that to make a securitization of such short-term receivables economical, the proceeds of each receivable received by the securitization SPV are applied to repurchase new receivables.[2] In a sense, these further receivables are "future receivables" but they are not purported to be sold, and frequently are not paid for, until they actually arise.

Securitizations of receivables arising under continuing supply contracts are common. For example, a contract for the supply of electricity exists as at the date of sale to the SPV. But the purchase price initially paid by the SPV can be in relation to (i) amounts already invoiced (but not yet due or, in some cases, overdue), (ii) amounts in relation to supplies already made (but not yet invoiced), and (iii) amounts in relation to supplies not yet made. Finally, the "pure" future flow securitization will see the originator receive payment on the closing date in relation to receivables arising under contracts that do not exist at the time of closing but which are expected to come into existence at a future date.

Obviously there are variations on these simple examples, such as revolving credit card pools and other assets, which can use advance payment and trust devices to achieve the desired transaction cash flows for so-called undivided interest structures, but these variations are beyond the scope of this paper. It will suffice to discuss, from the examples given in the introduction, the two "extremes," i.e. the assignment of an amount due under an existing contract (an existing receivable) and the assignment of an amount due under a contract not yet in existence but which is expected to come into existence (a future receivable).

II. ENGLISH LAW

A. Existing Receivables

Assignments under English law may be legal or equitable. Legal assignments ordinarily are not used because they require, among other things, that notice be given to the debtor in order for the as-

2. The receivables are characterized as future receivables because the seller will contract on the securitization closing date to sell them to the SPV at some future time, as they arise.

signment to be effective.[3] Equitable assignments, however, may be effected with or without notice: "All that is necessary is that the creditor shall manifest a clear intention to make an irrevocable transfer of the receivable."[4] An equitable assignment, even without notice to the debtor, generally is effective as against the assignor and its unsecured creditors, subject to qualifications on priorities and other matters that are commonly accepted in opinions delivered in the London securitization market.[5]

It should be noted that an equitable assignment of an equitable interest in a receivable (as opposed to an assignment of the receivable itself) must be in writing to be enforceable.[6] It also should be noted that the only advantage resulting from a legal assignment, as opposed to a notified equitable assignment, is that the assignee may, as a procedural matter, sue the debtor without joining the assignor as a party to the proceedings. Not surprisingly, in English law securitization structures existing receivables usually are transferred by way of equitable assignment.

B. Future Receivables

Strictly speaking, a future receivable cannot be assigned because it does not exist at the time of the purported assignment. However, a purported assignment of a future receivable, if supported by consideration, will be treated as an agreement to assign the receivable. When the receivable comes into existence, equity will treat it as being assigned and that equitable assignment will be good as against the assignor or its unsecured creditors as if it had been made at the time the

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3. Under Section 136 of the Law of Property Act 1925, an assignment: (a) must be absolute; (b) is in writing under the hand of the assignor; (c) is of any debt or other legal thing in action (i.e., all choses in action which are capable of being legally or equitably assigned); (d) does not purport to be by way of charge only; (e) must be notified in writing to the debtor or trustee (and an acknowledge of such notice should be obtained); and (f) is subject to equities even if all Section 136 requirements are satisfied. Law of Property Act, 15 Geo. 5, c. 20, § 136 (1925) (Eng.).

4. R. M. GOODE, LEGAL PROBLEMS OF CREDIT AND SECURITY 111 (2d ed. 1988).

5. In the absence of notice, four factors need to be considered. First, certain incremental rights of set-off continue to accrue. Gov't of Nfld. v. Nfld. Ry. Co., 13 App. Cas. 199, 200 (P.C. 1888). Second, the assignor may give good discharge to the debtor for amounts received by the assignor. Brice v. Bannister 3 Q.B.D. 569, 569 (1878). Third, the debtor and assignor may amend the assigned contract. *Id.* at 571–73. Fourth, a third party taking a subsequent assignment without notice of the prior assignment may, by giving notice ahead of the first assignee, take priority. Dearle v. Hall, 3 Russ. 1, 1, 38 Eng. Rep. 475, 475 (Ch. 1823).

6. Law of Property Act, 15 Geo. 5, c. 20, § 53(1)(c) (1925) (Eng.).

agreement to assign was entered into,[7] subject to qualifications on priorities and other matters.[8] Thus, the "assignment" of future receivables is not particularly problematic in an English law securitization structure.

III. TRUE SALE AND OTHER INSOLVENCY CHALLENGE RISKS

A. Existing Receivables

"True sale" in the context of English law securitization structures for existing receivables is used in two contexts. First, the risk that the purported sale will be recharacterized as a loan secured by a mortgage of the receivables, such that the resulting "security" is void for want of registration. Second, the risk that the sale will be set aside under one of the grounds of challenging antecedent transactions under the Insolvency Act.[9] The ground of challenge of a sale to which most attention is paid in English law securitization is a transaction at an undervalue.[10]

As for recharacterization risk, under the principles set out in *Re George Inglefield, Ltd*., as considered and applied by the Court of Appeal in *Welsh Development Agency v. Export Finance Co., Ltd.* (the *Exfinco* case), a court could find that the transfer constitutes a sale rather than the incurring of a debt and the granting of a mortgage or other security interest.[11] In *Re George Inglefield, Ltd.*, Romer LJ prescribed three indicia that distinguish a sale transaction from a transaction of mortgage or charge:

> First, in a sale transaction, the vendor is not entitled to get back the subject matter of the sale by returning to the purchaser the money that has passed between them. In the case of a mortgage or charge, the mortgagor is entitled (until he has been foreclosed) to get back the subject matter of the mortgage or charge by returning to the mortgagee the money that has passed between them.[12]

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7. Tailby v. Official Receiver, 13 App. Cas. 523, 523 (H.L. 1888).

8. *See* In re Dallas, 2 Ch. 385, 385 (1904). Among other qualifications, notice in order to protect the priority of an assignment of a future debt against competing assignments can only be given when the debt comes into existence.

9. Insolvency Act, 1986, c. 45, § 238 (Eng.) (addressing "[a]djustment of prior transactions").

10. *Id.* § 238.

11. Re George Inglefield, Ltd., 48 T.L.R. 536, 539 (C.A. 1932); Welsh Dev. Agency v. Export Fin. Co., 1992 BCLC 148, 1992 BCC 270 (C.A. 1991) (LEXIS, Engen Library, Cases File).

12. Re George Inglefield, Ltd., *supra* note 11, at 539.

> Second, if a mortgagee realizes the mortgaged property for a sum that is insufficient to repay him, the mortgagee is entitled to recover from the mortgagor any balance, whereas in a sale and purchase contract the purchaser has to bear any loss suffered on a subsequent sale of the asset by him.[13]
>
> Third, if a mortgagee realizes the subject matter of the mortgage for a sum more than sufficient to repay (together with interest and costs), the money that has passed between him and the mortgagor, he has to account to the mortgagor for any surplus. Whereas, in a sale and purchase contract, any profit realized by the purchaser is for the purchaser's account.[14]

The *Exfinco* case is authority for the proposition that a transaction structured by the parties as a sale will be upheld as such for the purposes of the registration of company charges provisions of the U.K. Companies Act unless either (i) the transaction is, in substance, a mortgage arrangement and not a sale, or (ii) the transaction is a sham.[15] With regard to (i) above, if one or more provisions of the relevant document is inconsistent with a sale, then the court will look to the provisions of the document as a whole to determine the substance of the transaction. None of the indicia of a mortgage identified by Romer LJ in *Re George Inglefield, Ltd.* is necessarily inconsistent with a sale: a transaction structured as a sale may be upheld as such notwithstanding the fact that it bears all three of these indicia. Indeed, all of the indicia may be present in a transaction without necessarily raising a material risk of recharacterization of the purported sale as a security arrangement. In particular, the extent of recourse to the seller does not raise a particular cause for concern. With regard to (ii) above, the court will find the transaction to be sham where the documents do not represent the intentions of the parties.

As a practical matter, significant recharacterization risk does not arise frequently in an English law, properly documented securitization of existing receivables. It has, however, arisen in the context of trade receivables securitization transactions. Practical bankers occasionally have wished to let sellers apply the cash proceeds of "sold" receivables in a manner inconsistent with the sale documents; that is, by treating them as their own. To the extent that there are informal arrangements between the seller and purchaser that represent a departure from what is prescribed in the sale documents, the risk arises that the documents will not be found to represent the intentions of

13. *Id.*
14. *Id.*
15. Companies Act, 1985, c. 6, § 395 (Eng.).

the parties. There is also a risk that the court might possibly treat the transaction as a secured funding arrangement importing a charge, which ought to have been (but which would not be, as a matter of securitization practice) registered under the Companies Act.[16]

The other context for "true sale" (challenges on undervalue or other grounds) is rarely considered problematic in the context of English law securitization structures. Undervalue generally is considered in the context of the transaction as a whole, and not only the sale document. This allows deferred consideration and other profit extraction devices to be taken into account. These devices invariably result in the seller, or a member of its group, receiving consideration whose value is not significantly less than the value of the receivable sold by the originator.[17] Other grounds, such as a transaction defrauding creditors, tend to be addressed in transaction opinions for the sake of completeness but do not raise material risks.[18]

B. Future Receivables

In principle, the analysis of the risk of recharacterization set out above ought to apply equally to sales of future receivables; that is, the risk ought to be remote provided the transaction documents purport to constitute a sale and the intention of the parties is reflected in the documents. Similarly, the risk of challenge on the grounds of undervalue and heads under the Insolvency Act should not be more acute in the case of securitizations of future receivables, and the legal opinions given in the London market tend to reflect this.

IV. FUTURE FLOW RECEIVABLES SECURITIZATIONS IN THE U.S. CONTEXT

A. Structuring New York Law Future Flow Receivables Securitizations

Future flow receivables securitization transactions are typically suited to originators that are located in emerging market countries which (i) have low sovereign-debt credit ratings; and (ii) have substantial export revenues or which have other claims denominated in

16. *Id.*

17. There are also further "saving" provisions from an undervalue challenge. Specifically, (i) the seller was not insolvent at the time of or as a result of the sale, (ii) the seller entered into the transaction in good faith and for the purposes of carrying on its business, or (iii) there were reasonable grounds for believing that the transaction would benefit the seller.

18. Insolvency Act, 1986, c. 45, § 423 (Eng.).

stable and freely convertible currencies from high credit obligors located in economically developed countries.[19] A future flow receivables securitization involves the originator selling its rights in such expected future receivables.

Future flow transactions can result in the asset-backed debt securities of the originator being rated more highly than the sovereign debt of the issuer's home country. Achieving such a rating is often a principal objective of these transactions. Before the advent of future flow transactions, this was generally not possible because the credit quality of an asset-backed securities issuer is considered to be limited by sovereign factors in the originator's home country. Properly structured future flow transactions, however, are rated taking into account the credit quality of the foreign receivables and thereby seek to achieve a higher rating than the home country's sovereign debt. They may also seek to achieve a higher rating than the originator's local currency debt, notwithstanding that such transactions are dependent on the continued operation of the originator.

A future flow securitization would typically be structured so that: (i) the originator creates a securitization SPV in the form of a master trust created under New York law and transfers all of its existing and future receivables to the securitization SPV; (ii) the obligors on the receivables make payments on the receivables to an offshore account in the name of the securitization SPV; (iii) the securitization SPV finances the purchase of the receivables by issuing debt securities; and (iv) the cash flow generated by the receivables is used to pay the debt securities and thereby amortize the advance purchase price paid by the securitization SPV.

Because a future flow transaction involves the transfer of receivables that do not exist at the time of transfer it will require that (i) the originator has a strong operational record of originating such receivables, or that (ii) there is a guaranteed source of future receivables.[20] Thus, the credit risk of the securities issued by the securitization SPV will be dependent not just on the credit quality of the receivables, but

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19. Examples of countries in which originators involved in future flow transactions are located are Mexico, Turkey, Peru, Brazil, Jamaica, El Salvador, and South Africa. Gary Kochubka, *Commentary*: *Financial Future Flows Concept Penetrates Deeper Into Emerging Markets*, STANDARD & POOR'S, Mar. 11, 2002, *at* http://www.standardandpoors.com/Forum/RatingsCommentaries/StructuredFinance (last visited Apr. 16, 2002); Jose Ramon Tora, *Commentary*: *Latin American Securitization Markets Evolve Further in 2000*, STANDARD & POOR'S, Jan. 16, 2001, *at* http://www.standardandpoors.com/Forum/MarketAnalysis (last visited Apr. 16, 2002).

20. An example of this is the case of long-term contracts with high credit foreign obligors.

also on the credit worthiness of the originator, as evidenced by its ability to service its local currency debt obligations (the local currency rating).

How much higher an issuance can be rated above the sovereign-debt rating of the originator's country is constrained by the originator's local currency rating. However, since a local currency rating assesses the likelihood of full and timely payment of financial obligations and does not necessarily reflect the probability of continued production, an originator may be able to continue operating after it has defaulted on some of its financial obligations. Therefore, depending on the structure of the transaction and the nature of the originator's business, the securities may achieve a rating slightly higher than the originator's local currency rating.

In order to break the "sovereign ceiling" and to enhance a transaction's credit assessment relative to the originator's local currency rating, a future flow receivables transaction should be structured as described above, and should also take into account the considerations set out below.

B. Types of Assets Appropriate for Future Flow Securitizations

The assets chosen for future flow securitizations are typically receivables denominated in U.S. dollars, or another stable convertible currency in an economically developed country, and owed by obligors in countries that have investment grade sovereign debt ratings. Unless some form of credit enhancement is provided, such as political-risk insurance, domestic receivables are not typically utilized because they are susceptible to the devaluation and repatriation risks of the originator's country.

C. Type of Securitization SPV

Offshore securitization SPVs are used to issue debt securities for future flow receivables securitization transactions. Collections on receivables are paid directly to the securitization SPV, thereby bypassing the originator's home jurisdiction. This insulates the transaction from the originator's home country's political and sovereign risks. Many securitization SPVs take the form of New York law master trusts, which issue trust securities in different classes. Instead of a single-tier structure, some future flow securitizations use an intermediary securitization SPV in a non-U.S. offshore jurisdiction in addition to a New York master trust. The two-tier structure may take the form of an initial assignment by the originator to an offshore vehicle such as a Cayman Islands SPV and then a second-tier sale to a New York master trust.

D. Analysis of Assignments of Existing and Future Receivables under New York Law

Rating agencies will want to see that an assignment of receivables for a future flow transaction is effective and perfected under the laws of all relevant jurisdictions, including the local laws of the originator's and the securitization SPV's jurisdictions. Because of the cross-border nature of most future flow securitizations, it may not be clear which law governs perfection of the transfer. Therefore, it is prudent to perfect an assignment under the law of each relevant jurisdiction, including applicable U.S. jurisdictions for transactions that involve U.S. receivables or otherwise have U.S. law aspects. In New York and each other U.S. state, Article 9 of the Uniform Commercial Code (Article 9) establishes rules that govern the perfection of a receivables assignment. Article 9 was substantially revised in 1998[21] (Revised Article 9) and became effective on July 1, 2001 in most U.S. states, including New York.[22]

Under the earlier version of Article 9, the perfection of an assignment of "general intangibles" or "accounts" (which are the types of collateral that a receivables transfer would fall under) of the emerging market originator required a filing in the state in which the originator had an executive office in the U.S. If the originator did not have an executive office in the U.S., notice to the account debtor was required.[23] Under Revised Article 9, notice to the account debtors is no longer required. However, a financing statement should be filed in the District of Columbia, unless the jurisdiction of the originator's place of business (or, if it has more than one place of business, its chief executive office) has a system for filing, recording or registering non-possessory security interests to determine priority. In that case, the filing may be done in the local jurisdiction.[24] Even in this instance, filings are typically done in the District of Columbia as a matter of prudence.

21. *See* U.C.C. § 9-101, official cmt. 2 (2001) (discussing the background and history of the revisions to Article 9 of the U.C.C.).

22. The New York bill introducing Revised Article 9 (S. 5404-A) was signed into effect by Gov. George Pataki on June 29, 2001 and came into effect on July 1, 2001. *See* 2001 N.Y. Laws ch. 84 § 36.

23. U.C.C. § 9-103(3)(c) (2000).

24. U.C.C. §§ 9-109(a)(3), 9-310, 9-301 (2001).

E. True Sale Insolvency Challenge Risk Under New York Law

A key structural element that affects the rating of future flow securitizations concerns the rights of the securitization SPV in the receivables and in its proceeds.[25] Rating agencies generally require assurance that the assets have been validly transferred to the securitization SPV under applicable local law and that the transfer has been perfected under applicable local law.

In order to mitigate the sovereign risk, the transaction must be treated as a "true sale" under the law of the originator's country. A "true sale" can be achieved in one of two ways: (i) by having the asset sale governed by the originator's home country's law with a legal opinion rendered by local counsel to confirm that the transaction would be treated as a sale, or (ii) by having the asset sale be governed by the law of another jurisdiction (e.g., Cayman Islands). In the latter case, a legal opinion would be required from counsel in that jurisdiction to confirm that the transaction would be treated as a sale, as well as a legal opinion of counsel in the originator's jurisdiction to confirm that the choice of the other jurisdiction's law to govern the sale would be respected.

In a future flow securitization, the asset sale is typically not governed under New York law because of the difficulty in obtaining a "true sale" opinion under New York law. Under New York law, what purports to be a sale of existing receivables by the originator to the securitization SPV may be re-characterized as a loan by the securitization SPV to the originator, the repayment of which is secured by receivables. In the U.S., the "true sale" analysis differs for bankruptcy, tax, and accounting purposes. Under the U.S. Bankruptcy Code (the Bankruptcy Code) if, for bankruptcy purposes, the transaction is re-characterized as a secured loan, the "lender" (securization SPV) must participate in any bankruptcy proceedings of the "borrower" (originator) to enforce the collection and disposition rights as to the receivables.[26] If the transaction is treated as a sale, the "buyer" (securitization SPV) will own the receivables and will be able to collect from or dispose of the receivables generally outside the bankruptcy proceedings. The Bankruptcy Code does not, however, govern the question of whether a receivables transfer constitutes a "true

25. STANDARD AND POOR'S, LEGAL CRITERIA FOR STRUCTURED FINANCE TRANSACTIONS (2002); *Rating Debt Issues Secured by Offshore Receivables*, STANDARD & POOR'S CREDIT WEEK INT'L, Sept. 4, 1995, at 53–54.

26. The receivables would constitute property of the originator's estate. 11 U.S.C. § 541(a)(1) (2000).

sale" or a secured loan. Underlying issues of state law govern such determination. The analysis is fact specific, involving a review of a number of factors, the most important of which is the level and the nature of recourse retained by the originator.

In most future flow securitizations, there typically is recourse back to the originator (which may take the form of a guarantee from the originator), and the degree of recourse available would be incompatible with the level that case law suggests is acceptable to characterize a transaction as a sale. Furthermore, the structures of future flow securitizations generally include terms and conditions, such as high debt service coverage ratios and other covenants intended to monitor the financial status of the originator and its continuing ability to generate receivables, which are analogous to terms and conditions suitable for a secured loan. If a U.S. bankruptcy court with proper jurisdiction ruled that the originator's transfer was not a "true sale," the Code's automatic stay provisions would prevent the securitization SPV from pursuing any recovery steps against the receivables or other property of the originator.[27] Additionally, the receivables generated after the bankruptcy filing would not be subject to any lien resulting from the security agreement entered into by the debtor and the securitization SPV before the commencement of the bankruptcy filing (unless the receivables are "proceeds" of assets acquired prior to the bankruptcy filing and subject to a security agreement).[28]

It is also unclear whether a bankruptcy court in New York would give effect to the choice of another jurisdiction's law to govern a purported asset sale to a New York securitization SPV. Therefore, to isolate the receivables from U.S. bankruptcy risks, some future flow securitizations use the two-tier structure with a New York master trust as well as an intermediary securitization SPV in a non-U.S. offshore jurisdiction to ensure that a "true sale" of receivables from the originator to a non-U.S. entity has occurred and is not subject to the jurisdiction of the U.S. bankruptcy courts. With the "true sale" nature of the initial asset sale secured, the transfer from the intermediary securitization SPV to the New York master trust and all other agreements for the transaction would typically be governed under New York law. New York law provides that parties to a transaction valued at $250,000 or more may select New York law to govern the

27. *Id*. § 362(a).
28. *Id*. § 552(a).

contract regardless of whether the contract has any relation to New York.[29]

29. N.Y. GEN. OBLIG. L. §§ 5-1401, 5-1402 (McKinney 2001).