

# RATINGS GAMES WITH CONTINGENT TRANSFER: A STRUCTURED FINANCE ILLUSION

PETRINA R. DAWSON\*

## I. INTRODUCTION

Rating agencies<sup>1</sup> have been increasingly asked to give a structured finance rating to non-U.S. transactions that rely on post-closing events to transfer any legal or beneficial interest in the assets identified for securitization.<sup>2</sup> Because these transactions are contingent on the occurrence of subsequent events, they may never happen. In this Article, I examine some of the fundamental principles of securitization and the difficulties inherent in perfection of asset transfers. In particular, I argue that contingent transfers do not provide the kind of meaningful credit enhancement in a transaction that is consistent with structured finance methodology.<sup>3</sup> Behind the terminology, a

---

\*Managing Director and Associate General Counsel, Standard & Poor's. The opinions expressed in this Article are those of the author alone and do not necessarily reflect the views of S&P. The author would like to thank Joanne W. Rose, Senior Managing Director and General Counsel, S&P, for synthesizing the approach to structured finance adopted in this Article and for invaluable insights into legal issues present in asset transfers; and Anthony Bankes-Jones, Partner at Clifford Chance, London, for his contribution to the secured loan criteria of S&P. Thanks are also due to Venkat Veerubhotla, paralegal, S&P, for research assistance.

1. In the United States, there are four nationally recognized statistical rating organizations: Standard & Poor's Ratings Group, Moody's Investors Service, Inc., Fitch Investors Service, Inc., and Duff & Phelps, Inc. Each of these agencies has specific rating criteria and differing approaches to rating transactions, and in particular structured finance. Each rating agency publishes its criteria. The author can only speak based on her knowledge of S&P criteria and methodology.

2. See Joanne W. Rose & Petrina R. Dawson, *Contingent Transfer—The Illusory Promise of Structured Finance*, S&P STRUCTURED FINANCE, Sept. 1997, at 10. Contingent transfers are currently a "hot topic among structured finance market participants who are seeking new ways to enhance securitization." Jennifer Lachanski, *Standard & Poor's Announces View on Contingent Transfer in Structured Finance*, S&P CREDITWEEK, Aug. 27, 1997, at 8. The reason is that "the rating . . . can reduce for investors the cost of information and expert evaluation of the borrowers' credit risk; consequently, ratings can lower the cost of capital . . ." 1 TAMAR FRANKEL, *SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSET POOLS, AND ASSET-BACKED SECURITIES* 393 (1991 & Supp. 1994) [hereinafter 1 FRANKEL].

3. The official view of the Standard & Poor's Structured Finance Rating Group, which is similar to that of the author, is that "transactions using 'contingent transfers' or 'contingent per-

contingent transfer provides no assets and therefore no ultimate recovery in stress scenarios. In short, contingent transfers amount to a structured finance illusion.

## II. THE RATING CONTINUUM

An issue credit rating assigned to a particular financial instrument addresses the likelihood that the issuer will be able to pay full principal and interest on the rated security in a timely manner and in accordance with the terms of the security.<sup>4</sup> The rating of a security, then, is based on the general creditworthiness of the issuer, the probability of the issuer's default, and the value of any assets or other credit enhancement that support the rated issue.<sup>5</sup>

At one end of the rating continuum is the unsecured debt of an issuer.<sup>6</sup> Further along the continuum is the issuer's secured debt. If, in addition to its promise to pay, the issuer identifies and pledges collateral available for repayment of the rated securities, then a given security may be "enhanced," that is, rated above the issuer credit rating.<sup>7</sup> The degree of rating enhancement will depend generally on

---

fection' mechanisms should not be rated higher than the transferor's issuer credit rating." Lachanski, *supra* note 2, at 8. See also Rose & Dawson, *supra* note 2, at 10.

4. See Salomon B. Samson & Gail I. Hessol, *Ultimate Recovery in Ratings: A Conceptual Framework*, S&P CREDITWEEK, Nov. 6, 1996, at 25 ("Standard & Poor's issuer credit ratings . . . address the risk of full and timely payment on all obligations of this entity. Issue ratings also take into account ultimate recovery . . .") (emphasis in original). All rating definitions criteria and rating methodology used in this Article refer exclusively to definitions of S&P Rating Services. For an overview of S&P's ratings, see STANDARD & POOR'S, CORPORATE RATINGS CRITERIA 7 (1998) (detailing rating definitions) [hereinafter RATINGS CRITERIA]. For a discussion of ratings by other agencies, see 1 SECURITIZATION OF FINANCIAL ASSETS 7-63 to 7-82 (Jason H. P. Kravitt ed., 1991) [hereinafter KRAVITT].

5. The rating for the issued security should not be mistaken for the rating for the issuer, which can be a corporation or a country. See generally RATINGS CRITERIA, *supra* note 4, at 4. As the creditworthiness for a specific transaction usually cannot exceed the creditworthiness of the issuer, the rating for the issuer is a "ceiling" for the rating of the issue, unless credit enhancement is used to bolster the rating of the security. Different methods of credit enhancement exist, e.g. letter of credit, third party insurance, over-collateralization. See KRAVITT, *supra* note 4, at 7-20. To determine the actual rating, many different factors are considered by rating agencies. The factors vary depending on the underlying transaction, the asset and even the country involved. See, e.g., Diane Audino, *Securitizing Vacation Homes Loans in Mexico*, S&P CREDITWEEK, July 31, 1996, at 15; Heidi J. Oster & Ellen C. Welsher, *Rating Structured Settlement Securitization*, S&P CREDITWEEK, June 25, 1997, at 27.

6. In this case, due to the lack of credit enhancement means, the issue credit rating is based solely on the general creditworthiness of the issuer reflecting the likelihood of an issuer default. Therefore the issue credit rating is the same as the issuer credit rating.

7. See Rose & Dawson, *supra* note 2, at 10. Because the different forms of credit enhancement (e.g., over-collateralization, letter of credit) all involve costs, the issuer has to determine whether the reduced cost of capital for a better rating outweighs the "enhancement

the probability of default by the issuer and the ultimate recovery on the assets pledged as collateral, including some assessment of the timing of recovery.<sup>8</sup>

At the far end of the continuum are true structured financings. In general, a true structured finance (or securitization)<sup>9</sup> legally isolates assets from a transferor's insolvency to enable a purchaser of securities backed by the assets to rely solely on the creditworthiness of those assets.<sup>10</sup> Thus, the structure seeks to insulate payment on the issued securities from entities (such as sellers or pledgors of assets) that are either unrated or have issuer credit ratings lower than the desired issue credit rating.<sup>11</sup> Relying on the insulation of assets in structured financings, Standard & Poor's is able to base its ratings of securities on the creditworthiness of the isolated assets, without regard to the creditworthiness of the original owner of the assets.<sup>12</sup>

When analyzing structured financings, Standard & Poor's initially examines whether the securitized assets can be sufficiently separated from the transferor that an insolvency of the transferor will not affect the creditworthiness of the assets.<sup>13</sup> Once it is determined that the assets are sufficiently separated, then the creditworthiness of the asset pool is subject to review, taking into consideration any legal

---

costs." See 1 FRANKEL, *supra* note 2, at 360.

8. See RATINGS CRITERIA, *supra* note 4, at 65; STANDARD & POOR'S, STRUCTURED FINANCE RATINGS ASSET BACKED SECURITIES: TRADE RECEIVABLE CRITERIA 21-30 (1996) [hereinafter TRADE RECEIVABLE CRITERIA]. See generally KRAVITT, *supra* note 4, at 7-16. For a detailed description of different factors influencing the extent of any enhancement, see Samson & Hessol, *supra* note 4, at 25.

9. Some authors distinguish between the terms securitization and structured finance. See KRAVITT, *supra* note 4, at 1-12.

10. See TRADE RECEIVABLE CRITERIA, *supra* note 8, at 43. See also STEPHEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION 16 (2d ed. 1993) [hereinafter SCHWARCZ]; KRAVITT, *supra* note 4, at 1-12.

11. This "insulation" primarily involves issues regarding bankruptcy law. The critical question is whether the structure makes the asset "bankruptcy remote." See SCHWARCZ, *supra* note 10, at 16.

12. See TRADE RECEIVABLE CRITERIA, *supra* note 8, at 6 ("The rating of structured financing is based primarily on the creditworthiness of isolated assets or asset pools, whether sold or pledged to secure debt, and without regard to the creditworthiness of the seller or buyer."). See also Kristin Brooks et al., *A Structured Finance Alternative to Reinsurance*, S&P CREDITWEEK, Nov. 13, 1996, at 28 ("The rating of structured financing is based primarily on the creditworthiness of the isolated assets.").

13. For a general description of Standard & Poor's rating process, see RATINGS CRITERIA, *supra* note 4, at 11. For a more detailed description of the process in the context of structured finance, see TRADE RECEIVABLE CRITERIA, *supra* note 8, at 5; STANDARD & POOR'S, STRUCTURED FINANCE RATINGS: SECURITIZATION IN LATIN AMERICA 13 (1997).

issues that may affect the cash flow of the transaction.<sup>14</sup> In each case, the methodology is tailored to the law of the relevant jurisdiction.<sup>15</sup>

For example, evaluation of securitizations may differ in civil law and common law jurisdictions.<sup>16</sup> Because of the formality of the civil codes, the inability to rely on equitable principles, and the scarcity or uncertainty of precedent to define the law, civil law jurisdictions pose special problems for securitization.<sup>17</sup> While in many cases these problems have been removed by the enactment of specific securitization laws,<sup>18</sup> the challenge in reviewing civil law transactions is to guard against an equity-like or common law analysis that may not be

---

14. See RATINGS CRITERIA, *supra* note 4, at 14-54; TRADE RECEIVABLE CRITERIA, *supra* note 8, at 5-20; SECURITIZATION IN LATIN AMERICA, *supra* note 13, at 13-18.

15. It is beyond the scope of this Article to describe in-depth the structured finance criteria used in each of the jurisdictions that has one or more rated transactions. But to illustrate the point, in December 1996 commercial mortgage securitizations "debuted" in France when Union Industrielle de Cr dit securitized commercial real estate loans. In order to rate this securitization, S&P had to amend the U.S.-based analysis to incorporate particular aspects of French borrowing entities and French bankruptcy laws. See Valerie Hart, *Commercial Mortgage Securitization Debuts in France*, S&P CREDITWEEK, Dec. 4, 1996, at 17. For documentation on how insolvency laws differ, see generally AMERICAN BAR ASSOCIATION, MULTINATIONAL COMMERCIAL INSOLVENCY (1993).

16. For publications on securitization in non-U.S. jurisdictions, especially civil law jurisdictions, see William D. Torchiana, *Asset Securitization in France*, 1990 INT'L BUS. L.J. 825; Richard Parolai & Jonathan Lewis, *France Boots Securitization Market*, INT'L FIN. L. REV., Jan. 1998, at 13; Jean-Charles Papeions, *Asset-Securitization: A Comparative Study Between the U.S. & Belgium*, 1996 INT'L BUS. L.J. 341; Michael T. Kawachi, *The New Law of Asset Securitization in Japan*, 17 U. PUGET SOUND L. REV. 587 (1994); Yoshiki Shimeda & Shinji Itoh, *Japanese Asset Securitization: A Guide for Practitioners*, 38 HARV. INT'L L.J. 171 (1997); Paul Taylor, *The Development of Securitization in Europe*, THE FINANCIER, Dec. 1994, at 33; Gary J. Kopff, *Asset Securitization in Argentina and Colombia*, THE FINANCIER, Aug. 1994, at 52; Irene Dias Da Silva & Edmundo Nejm Junior, *Legal Memoranda: Brazil: Asset Securitization*, 26 U. MIAMI INTER-AM. L. REV. 611 (1995); Jos  A. Trujillo, *The Securitization of Mortgages in Spain*, THE FINANCIER, Dec. 1994, at 14; Peter V. Maher, *Securitization Special Purpose Vehicles in Dublin's International Financial Services Centre*, TAX MGMT. FIN. PRODUCTS REP., July 4, 1997, at 382 [hereinafter *Dublin*]; Peter V. Maher, *An Irish Home For Your SPV*, INT'L ASSET-BACKED SEC. REP., Feb. 4, 1998, at 1 [hereinafter *Irish*]. For an overview and analysis of several European countries, see ASSET-BACKED SECURITIZATION IN EUROPE (Theodor Baums & Eddy Wymeersch eds., 1996).

17. An example of this is Germany, where it is not impossible to securitize, but where due to the lack of a special statutory framework it is more cumbersome. See generally Gerhard-Christoph Ihle, *Germany, in ASSET-BACKED SECURITIZATION IN EUROPE*, *supra* note 16, at 87; Taylor, *supra* note 16, at 48. Another example is Japan, which only allows the use of its securitization law for certain receivables. See Shimeda & Itoh, *supra* note 16, at 174. In other cases, another method has to be found.

18. For example, France enacted a law to make securitization easier in 1988. See Torchiana, *supra* note 16, at 825. This law was largely modified in 1993, and additional changes were made in Fall of last year. See Parolai & Lewis, *supra* note 16, at 13; see also Alain Couret, *France, in ASSET-BACKED SECURITIZATION IN EUROPE*, *supra* note 16, at 25. Japan also recently enacted laws to make this process easier. See Kawachi, *supra* note 16, at 587.

supported by the civil code or the securitization laws.

By contrast, in common law jurisdictions an issuer may be tempted to stretch the bounds of reasoned analysis beyond the level of comfort consistent with a highly rated transaction.<sup>19</sup> Rating criteria, however, should not go beyond the general consensus of the relevant legal community.<sup>20</sup> Wholesale export of U.S. criteria and methodology is generally not helpful in non-U.S. transactions. Nonetheless, experience has shown that many elements of securitization first developed in the United States, such as special purpose entities (SPEs), have become important building blocks for non-U.S. transactions.<sup>21</sup>

### III. STRUCTURED TRANSACTIONS: AN OVERVIEW

A structured financing seeks to insulate transactions from entities that are rated lower than the transaction, are unrated, or for which the rating is unable to quantify the likelihood of bankruptcy.<sup>22</sup> Such transactions are analyzed on the basis of the credit quality of the assets and the level of credit enhancement provided by the structure.<sup>23</sup> The analysis usually assumes that each transaction participant that is rated lower than the transaction, or is not a "bankruptcy-remote entity,"<sup>24</sup> will become insolvent during the time the rated se-

---

19. An example of very avant-garde theory is Professor Schwarcz's article on divisible interest. See Steven L. Schwarcz, *The Parts Are Greater Than the Whole: How Securitization of Divisible Interests Can Revolutionize Structured Finance and Open the Capital Markets to Middle-Market Companies*, 1993 COLUM. BUS. L. REV. 139.

20. An example of such a general consensus can be found in Peter V. Pantaleo et al., *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159 (1996).

21. This can be seen by reviewing the legal framework for several non-U.S. jurisdictions. They all use concepts like SPE or pay attention to the issue of bankruptcy or true sale. As Professor Schwarcz points out in his introductory article, dealing with securitization in a different jurisdiction is "like learning a new language, but one that has remarkable similarities to our own legal language if one focuses on the fundamentals." Steven L. Schwarcz, *Introduction: The Universal Language of Cross-Border Finance*, 8 DUKE J. COMP. & INT'L L. 235, 235-36 (1998) (citations omitted). See also KRAVITT, *supra* note 4, at 1-10 ("At the same time, because the fundamentals of securitization are so basic . . . the process of securitization and the underlying structures utilized will be similar to a meaningful degree wherever one seeks to securitize such assets. This may be even so in different countries."). For information on Japanese, European and Latin-American frameworks for securitization, see materials cited in note 16, *supra*.

22. See TRADE RECEIVABLE CRITERIA, *supra* note 8, at 43.

23. See 1 FRANKEL, *supra* note 2, at 397 ("Regardless of the nature of the Pool assets, rating agencies also examine the relevant risk concentration in the portfolios . . . and the record of loan delinquency and default . . . . In addition, the value of the collateral and any credit enhancement is surveyed.").

24. See discussion in Part IV, *infra*. For an extended discussion of bankruptcy remoteness, see SCHWARCZ, *supra* note 10, at 16.

curities are outstanding.<sup>25</sup>

As a general matter, a pledge of assets by a transferor as collateral for rated securities being issued in a structured transaction does not ensure that holders of the rated securities will have timely access to the collateral if the transferor becomes the subject of an insolvency proceeding.<sup>26</sup> Although, as a matter of law, a creditor ultimately should be able to realize the benefits of pledged collateral,<sup>27</sup> several provisions of the insolvency laws may cause the creditor to experience delays in payment and, in some cases, receive less than the full value of its collateral. In the United States, under Section 362(a) of the Bankruptcy Code the filing of a bankruptcy petition automatically "stays" all creditors from exercising their rights to pledged collateral.<sup>28</sup> Although a bankruptcy court may provide relief from the stay under certain circumstances,<sup>29</sup> it is difficult to predict the likelihood of relief from the stay,<sup>30</sup> or estimate its duration should relief be granted.<sup>31</sup> Similarly, under Section 363 of the Bankruptcy Code,<sup>32</sup> a bankruptcy court may permit a debtor to use pledged collateral to aid in the debtor's reorganization or, according to Section 364, to incur debt with a lien on assets that is prior to the lien of existing creditors.<sup>33</sup> Under Section 542, a secured creditor in possession of its collateral may be required to return the collateral to a bankrupt obligor.<sup>34</sup>

As a result, the existence of strong assets to secure the rated securities cannot independently determine the issue credit rating of the securities. However, the structure of the transaction ensures both timely interest payments on the rated securities and ultimate recovery of principal upon maturity, notwithstanding the insolvency, receivership, or bankruptcy of the transferor.<sup>35</sup>

---

25. See TRADE RECEIVABLE CRITERIA, *supra* note 8, at 43

26. For an extended discussion of the effects of bankruptcy, see 1 FRANKEL, *supra* note 2, at 405-24. See also SCHWARCZ, *supra* note 10, at 37.

27. See, e.g., 11 U.S.C. §§ 506, 1129(a) (1994).

28. See *id.* § 362(a) (1994).

29. *Id.* § 362(d) provides criteria for the court for a case-by-case determination of whether to lift a stay. For application of these criteria see, for example, *In re Comcoach Corp.*, 698 F.2d 571, 573-74 (2d Cir. 1983). See also 1 FRANKEL, *supra* note 2, at 406.

30. See TRADE RECEIVABLE CRITERIA, *supra* note 8, at 43.

31. See *id.*

32. See 11 U.S.C. § 363 (1994).

33. See *id.* § 364 (1994).

34. See *id.* § 542 (1994).

35. A good example of how effective those structures can be is the 1991 voluntary bankruptcy of Days Inn of America. While this case revealed some of the problems with structured

In general, the desired structure is achieved by having a pool of assets held by a transferor transferred to a bankruptcy-remote, special-purpose entity (SPE),<sup>36</sup> which in turn either functions (1) as an intermediate SPE and transfers the assets to an issuing SPE that issues the rated securities in a two-tier transaction,<sup>37</sup> or (2) as an issuing SPE which directly issues the rated securities in a one-tier transaction.<sup>38</sup>

To ensure that a given transaction structure (whether two-tier or one-tier) provides for the timely availability of assets to pay the holders of the rated securities,<sup>39</sup> a rating agency usually looks at each transfer of assets to determine whether it constitutes a sale or a pledge,<sup>40</sup> the nature of each party's property rights in the assets,<sup>41</sup> and whether third parties (that may be unrated or "non-bankruptcy remote") have retained rights that may impair timely payment on the rated securities.<sup>42</sup>

---

financing (e.g., the voluntary bankruptcy of a bankruptcy remote SPE to facilitate the sale of assets), it is notable for showing one real strength: all the secured noteholders were repaid promptly with only a slight discount. See SCHWARCZ, *supra* note 10, at 13 (discussing Days Inn bankruptcy); *In re* Buckhead Am. Corp., 161 B.R. 11 (Bankr. D. Del. 1993) (same). The strength of structured financing is also illustrated in the 1992 bankruptcy of P.A. Bergner & Co. In this debtor-in-possession case, Bergner sold credit card receivables to a bankruptcy remote SPE. Using over-collateralization and credit support to ensure payment and 100% liquidity to ensure timeliness of payment, together with the quality of the asset itself, Bergner received the highest ratings from Moody's, Duff & Phelps, and Standard & Poor's. See SCHWARCZ, *supra* note 10, at 44 & nn. 99, 100 (discussing Bergner case); *In re* P.A. Bergner v. Bank One, 187 B.R. 964 (Bankr. E.D. Wis. 1995) (same). See also Stephen I. Glover, *Asset-Backed Securitizations by Companies in Chapter 11*, INSIGHTS, Jan. 1993, at 17.

36. Instead of SPE, other terms are used in different contexts. For example: SPV (special purpose vehicle), see SCHWARCZ, *supra* note 10, at 1; SPC (special purpose corporation), see 1 FRANKEL, *supra* note 2, at 440; SIV (structured investment vehicle), see Valeria Hart, *Structured Deals Give Rise to Investment Vehicle*, S&P CREDITWEEK, July 2, 1997, at 14; SSC (structured settlement company), see Oster & Welsher, *supra* note 5, at 27. The underlying idea is nevertheless the same.

37. For a discussion of two-tier transactions, see Part III.A, *infra*. See also SCHWARCZ, *supra* note 10, at 21; KRAVITT, *supra* note 4, at 4-64.

38. See KRAVITT, *supra* note 4, at 4-3.

39. As Neil Baron, Fitch General Counsel, noted: "Timeliness is an element rating agencies are obsessive about." Neil D. Baron, *The Role of Rating Agencies in the Securitization Process*, in A PRIMER ON SECURITIZATION, 81, 88 (Leon T. Kendall & Michael J. Fishman eds., 1996).

40. See TRADE RECEIVABLE CRITERIA, *supra* note 8, at 43.

41. See *id.* at 46.

42. See 1 FRANKEL, *supra* note 2, at 399; TRADE RECEIVABLE CRITERIA, *supra* note 8, at 43.

### A. Fundamentals of the Two-Tier Transaction<sup>43</sup>

In the typical two-tier transaction,<sup>44</sup> the rated securities are issued by an issuing SPE.<sup>45</sup> In the first tier, each transferor holding assets (who, in general, has either originated the assets or purchased the assets in a chain of transfers from the originator) either sells the assets to an intermediate SPE<sup>46</sup> or makes a capital contribution of the assets to the intermediate SPE.<sup>47</sup> In the second tier, the intermediate SPE deposits or sells the assets to the issuing SPE, or borrows from the issuing SPE and pledges the assets to the issuing SPE to secure the loan.<sup>48</sup> The issuing SPE then issues the rated securities and uses the proceeds of the rated securities either to purchase the assets from the intermediate SPE (if the second-tier transfer constitutes a sale) or to make a loan to the intermediate SPE (if the second-tier transfer constitutes a pledge).<sup>49</sup> The intermediate SPE uses the proceeds of the sale or loan to purchase the assets from the transferors.<sup>50</sup>

To avoid the risk that bankruptcy may cause a court to deem some or all of the assets transferred to the intermediate SPE to be part of the transferor's bankruptcy estate (and thus subject to the automatic stay or distribution to other creditors of the transferor), each transfer should be structured as a "true sale."<sup>51</sup> Thus, each

---

43. See generally SCHWARCZ, *supra* note 10, at 21. See also KRAVITT, *supra* note 4, at 4-64; Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW. 527, 573 (1995). I use two-tier transactions as an example because one-tier transactions are analytically similar but simpler, requiring merely a direct transfer to the SPE issuer.

44. Two-tier transactions are often used in cross-border securitization, as this structure not only allows the assets to be isolated from the sovereign risk of the originator's jurisdiction, but also from U.S. bankruptcy risks. See Douglas A. Doetsch, *Emerging Market Cash Flow Securitizations Take Off*, INT'L FIN. L. REV., Nov. 1996, at 18. "In the most common two-tier structure, the originator sells receivables to a special purpose trust organized under Cayman Islands law, which issues certificates that are sold in turn to a U.S. master trust." *Id.*

45. See KRAVITT, *supra* note 4, at 4-65; SCHWARCZ, *supra* note 10, at 22.

46. See SCHWARCZ, *supra* note 10, at 21.

47. The intermediate SPE is usually a wholly-owned subsidiary of one of the transferors. See Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 142 (1994) [hereinafter *Alchemy*].

48. See SCHWARCZ, *supra* note 10, at 22.

49. See *id.* See also *Alchemy*, *supra* note 47, at 142.

50. Another possibility is to merge the intermediate SPE back into the originator or have a dividend distribution. See *Alchemy*, *supra* note 47, at 142.

51. "True sale" means the transaction effectively transfers the ownership of the asset to the SPE. For an extensive discussion of true sale, see SCHWARCZ, *supra* note 10, at 28; KRAVITT, *supra* note 4, at 7-56; *Structured Financing Techniques*, *supra* note 43, at 542. See also Parts V.B.1 and 2, *infra*. For a detailed evaluation of the role of recourse in the context of true sale, see generally Pantaleo, *supra* note 20.

transfer of assets in the full chain of transfers to the intermediate SPE must be reviewed in accordance with the factors courts generally look to in determining whether a transfer is a true sale or a secured loan.<sup>52</sup> Sometimes assets may pass through multiple owners before coming to rest in the intermediate SPE.<sup>53</sup>

#### B. Secured Loan Transactions

There are two types of transactions where the special nature of the originator has made it acceptable to use a secured loan rather than an SPE as a means of separating the creditworthiness of the assets from that of the originator. First, some government entities, such as state-funded housing agencies or military agencies, may be deemed bankruptcy remote because of their governmental purpose and lack of creditor incentive (or ability) to force them into bankruptcy.<sup>54</sup> The governmental entity even if technically insolvent would continue to make payments on the underlying assets pledged to the transaction, and it would not redirect the amounts to satisfy the claims of other creditors. Thus, the risk of default is low. A secured loan, therefore, provides the required comfort.<sup>55</sup>

---

52. As Professor Schwarcz points out, "different readers [of case law] can argue as to which factors are relevant and which entitled to the greater weight." SCHWARCZ, *supra* note 10, at 31. However, the most important factor seems to be the degree of recourse. The mere presence of recourse does not automatically mean characterization as a loan, however; rather, it depends on the nature of recourse and the nature of the transaction. *See id.* *See also* Pantaleo, *supra* note 20, at 162. Another important factor is the retained rights of the originator, including any right to surplus. Both factors favor a loan characterization. *See* SCHWARCZ, *supra*, at 32. The pricing mechanism and the actual administration and collection of accounts receivables also influence this characterization. *See id.* at 32, 33. For a list of additional factors courts have considered, *see id.* at 34.

53. An example of a multiple transfer is the Resolution Trust Company securitization loans sold by RTC (as liquidator of insolvent S&L) to an investment banker that deposited into an SPE depositor, which in turn transferred to a trust. *See* Roseann Catania, *Merrill Lynch Mortgage Investors Inc.*, S&P STRUCTURED FINANCE, Feb. 1998, at 88; Errol Arne, *IMC Home Equity Loan Owner Trust 1997-8*, *id.* at 101.

54. *See* discussion of bankruptcy remoteness, *infra* Part V. But compare the recent problems with municipalities like Orange County. Depending on the circumstances, municipalities may be able to find protection under Chapter 9 of the Bankruptcy Code. *See generally* Eric S. Pommer & Marc M. Friedman, *Municipal Bankruptcy and its Effect on Government Contractors*, 25 PUB. CONT. L.J. 249 (1996); James E. Spiotto, *Government Bankruptcy: The Myth and Reality of Financially Troubled Municipalities: A Ripple or a Tidal Wave*, 918 PLI/CORP. 1087 (1996).

55. More recently, in some jurisdictions secured loan analysis has been extended to transactions in which the originator is not deemed bankruptcy remote. Examples include the Punch Taverns Finance PLC transaction, *see Pubs Acquisition Drafts Securitization Technology*, STRUCTURED FINANCE, Mar. 1998, at 6; and the Welcome Break Finance PLC transaction, *see Welcome Break Finance PLC*, *id.*, Oct. 1997, at 88. *See generally* discussion of secured loans

The second type of transaction involves bank originators.<sup>56</sup> Bank originators are not eligible to become debtors under the U.S. Bankruptcy Code.<sup>57</sup> Under the Federal Deposit Insurance Act—which, unlike the Bankruptcy Code, does not have an automatic stay provision—the FDIC acts as receiver or conservator of the financial institution in the event of bankruptcy.<sup>58</sup> Although lacking an automatic stay provision, the FDIC has expansive powers, including the power to ask for a judicial stay of all payments and/or to repudiate any contract.<sup>59</sup> To provide for greater flexibility in securitized transactions, however, the FDIC has stated that it would not seek to avoid an otherwise legally enforceable and perfected security interest so long as the following conditions are satisfied:

(1) The agreement was undertaken in the ordinary course of business, not in contemplation of insolvency, and with no intent to hinder, delay, or defraud the bank or its creditors;

(2) the secured obligation represents a bona fide and arm's-length transaction;

(3) the secured party or parties are not insiders or affiliates of the bank;

(4) the grant of the security interest was made for adequate consideration; and

(5) the security agreement evidencing the security interest is in writing, was duly approved by the board of directors of the bank or its loan committee, and remains an official record of the bank.<sup>60</sup>

If the transaction complies with these conditions, the security interest granted by an FDIC-insured bank should not be avoidable in the event of the bank's insolvency. In addition, the FDIC has advised that a secured creditor of an insolvent bank under the supervision of the FDIC would not be stayed by the receiver or conservator from

---

securitizations *infra* Part V.C. Standard & Poor's has received proposals for rating such transactions in Australia, but has not done so.

56. Originator generally means the party that transfers the assets to the SPE. Bank originators are banks that transfer assets to an SPE. On the issue of banks in the context of bankruptcy, see 1 FRANKEL, *supra* note 2, at 447.

57. See 11 U.S.C. § 109(b)(2) (1994).

58. See 12 U.S.C. § 1821(c) (1994).

59. For an extensive discussion of the FDIC's role, see generally 2 FRANKEL, *supra* note 2, at 369-85.

60. See 12 U.S.C. § 1823(e) (1994). See also *D'Oench, Duhme & Co., Inc. v. Fed. Deposit Ins. Corp.*, 315 U.S. 447 (1942) (holding that a secret side agreement cannot be invoked in an SEC action).

pursuing its remedies,<sup>61</sup> and, upon a bank default, a creditor could foreclose on its collateral using commercially reasonable “self-help” methods, if certain additional conditions are met.<sup>62</sup>

### C. General Principles for Evaluating a Structured Financing

In summary, a structured financing can be rated according to the following factors:

(1) If the pool of assets is owned by an entity, whether that entity is bankruptcy remote (and thus unlikely to be the subject of a bankruptcy or insolvency proceeding); and

(2) whether the pool of assets supporting payments on the securities is no longer owned by the transferring entity that may be the subject of a bankruptcy or insolvency (thus the pool of assets would not be affected by the delays or court valuations in the bankruptcy process); or

(3) in some jurisdictions and for some issuers, whether a secured creditor that has a first priority perfected security interest in the pool of assets would be prevented by a liquidator, receiver or conservator from using self-help remedies to recover its collateral in a timely manner.

Finally, it should be noted that the rating analysis also depends on whether the transfer would be deemed preferential or avoidable, or a fraudulent or gratuitous conveyance under the applicable insolvency laws.<sup>63</sup> If any of these legal principles apply, the assets may be clawed back by the liquidator or receiver of an insolvent transferor.<sup>64</sup> Thus, without the underlying pool of assets, the issuer would not be able to make timely and full payments of principal and interest.

## IV. BANKRUPTCY-REMOTE ENTITIES

### A. SPEs

A creation of structured finance methodology, bankruptcy remoteness rests on the conclusion that certain entities which issue rated securities or, depending on the structure, transfer assets (e.g.,

---

61. See 1 FRANKEL, *supra* note 2, at 448.

62. See *id.* (“[T]he FDIC has assured Moody’s that if investors make a loan directly to the insolvent Institution, and the loan is collateralized by a mortgage pool, the FDIC will not attack the investors’ lien (if perfected), absent fraud on other investors.”) (citation omitted).

63. See TRADE RECEIVABLE CRITERIA, *supra* note 8, at 44.

64. See 11 U.S.C. § 548(a) (1994).

trusts, limited partnerships, limited liability companies, or corporations) should be deemed unlikely to become insolvent, to voluntarily seek insolvency proceedings, or to become subject to the claims of creditors (who may file an involuntary petition against the entity).<sup>65</sup>

A bankruptcy-remote special-purpose entity (SPE) is generally defined in accordance with the following six factors.<sup>66</sup> First, so long as the rated securities are outstanding, the entity should be prohibited from engaging in a merger, consolidation, or asset transfer with an entity not rated at least as high as the rated securities, or that lacks bankruptcy-remote, special-purpose criteria.<sup>67</sup> Second, the entity should be restricted from incurring additional debt.<sup>68</sup> In the alternative, the entity's organizational documents should prohibit the incurring of additional debt other than debt rated at least as high as the rating on the issue in question, or debt that (a) is fully subordinated to the rated debt, (b) is nonrecourse to the issuer or any assets of the issuer other than cash flow in excess of amounts necessary to pay holders of the rated debt, and (c) does not constitute a claim against the issuer to the extent that funds are insufficient to pay such additional debt.<sup>69</sup> Third, the entity should not engage in any other business or activity.<sup>70</sup> Fourth, the entity should have at least one "independent director" on the board of directors,<sup>71</sup> and the consent of

---

65. Bankruptcy remoteness means to set up a structure so that the SPE is insulated from the bankruptcy of parties other than the borrowers whose loans are held. See 1 FRANKEL, *supra* note 2, at 404. Another way to say this is that bankruptcy remoteness exists when "whatever happens to the originator cannot affect the SPV." SCHWARCZ, *supra* note 10, at 16. For a concise, but detailed treatment, see Pantaleo, *supra* note 20, at 554.

66. For a discussion of these factors, see generally TRADE RECEIVABLE CRITERIA, *supra* note 8, at 44; STANDARD & POOR'S, STRUCTURED FINANCE RATINGS: REAL ESTATE FINANCE: LEGAL AND STRUCTURED FINANCE ISSUES IN COMMERCIAL MORTGAGE SECURITIES 72 (1995) [hereinafter COMMERCIAL MORTGAGE SECURITIES]; James F. Penrose, *Special-Purpose Entities in Project Finance Transactions*, S&P STRUCTURED FINANCE, Nov. 1995, at 69.

67. See TRADE RECEIVABLE CRITERIA, *supra* note 8, at 44.

68. See 1 FRANKEL, *supra* note 2, at 441; TRADE RECEIVABLE CRITERIA, *supra* note 8, at 44; KRAVITT, *supra* note 4, at 7-61.

69. See TRADE RECEIVABLE CRITERIA, *supra* note 8, at 44.

70. See Brooks, *supra* note 12, at 28-29 ("As a threshold matter, [a bankruptcy-remote] entity's activities should be limited to only those necessary to fulfill its role in the transaction."). See also TRADE RECEIVABLE CRITERIA, *supra* note 8, at 44; KRAVITT, *supra* note 4, at 7-61.

71. In the context of asset securitization, independent director means someone who is an outsider with regard to the SPE and also the originator if the originator has a controlling influence on the SPE. Therefore, for example, an independent director could be someone who is neither an employee or officer of the company, nor in any way affiliated with the originator. See SCHWARCZ, *supra* note 10, at 17; TRADE RECEIVABLE CRITERIA, *supra* note 8, at 44. For

that director should be required to institute insolvency proceedings.<sup>72</sup> Fifth, the transaction documents should contain a covenant preventing the parties from filing, instigating or joining in any involuntary bankruptcy proceeding against the entity so long as the rated securities are outstanding.<sup>73</sup> And finally, the entity should also agree to abide by certain “separateness covenants” whereby the entity promises the following:

- (a) To maintain books and records separate from any other person or entity;
- (b) not to commingle assets with those of any other entity;
- (c) to conduct its business in its own name;
- (d) to maintain separate financial statements;
- (e) to pay its liabilities out of its own funds;
- (f) to observe all corporate formalities;
- (g) to maintain an arm’s-length relationship with its affiliates;
- (h) to pay the salaries of its own employees;
- (i) not to guarantee or become obligated for the debts of any other entity or hold out its credit as being available to satisfy the obligations of others;
- (j) to allocate fairly and reasonably any overhead for shared office space;
- (k) to use separate stationery, invoices, and checks;
- (l) not to pledge its assets for the benefit of any other entity; and
- (m) to hold itself out as a separate entity.<sup>74</sup>

If the entity is wholly owned by a parent that is not bankruptcy

---

a definition employed by S&P, see Penrose, *supra* note 66, at 73 (“Independent Director’ means a duly appointed member of the board of directors . . . who shall not have been, at the time of such appointment or at any time in the preceding five years, (a) a direct or indirect legal or beneficial owner . . . [,] (b) a creditor, supplier, employee, officer, director, family member, manager, or contractor of such entity or one of its affiliates. . .”).

72. See TRADE RECEIVABLE CRITERIA, *supra* note 8, at 44. See also KRAVITT, *supra* note 4, at 7-62. This is done to prevent a voluntary petition for bankruptcy. “Charters of SPVs usually provide that the SPV may not place itself into bankruptcy unless a requisite number of *independent* members of the board of directors vote for bankruptcy.” SCHWARCZ, *supra* note 10, at 17 (emphasis in original). The idea behind this is that an independent director “theoretically would be less influenced by the originator and more likely to consider his or her fiduciary obligations when required to vote for or against the SPV’s bankruptcy.” *Id.* Another issue in voluntary bankruptcy is the status of charities in a trust function. See *id.* at 21; KRAVITT, *supra* note 4, at 4-26.

73. See COMMERCIAL MORTGAGE SECURITIES, *supra* note 66, at 72.

74. See TRADE RECEIVABLE CRITERIA, *supra* note 8, at 44. See also Penrose, *supra* note 66, at 73. Those factors are primarily important to prevent a court from substantially consolidating an SPE. For a discussion of substantive consolidation, see note 75, *infra*.

remote, the analysis requires that in an insolvency of the parent, the bankruptcy-remote entity would not be substantively consolidated with the parent under applicable insolvency laws.<sup>75</sup>

#### B. Non-U.S. SPEs

A number of countries have enacted or are in the process of enacting statutes designed to facilitate securitization by putting in place a specific framework to address bankruptcy and security interest concerns.<sup>76</sup> Such laws typically define procedures that are deemed, in the event of an insolvency of the transferor, to transfer the assets so that they are not available to the liquidator or any third-party creditor of the transferor.<sup>77</sup> Some of these statutes require the use of an SPE.<sup>78</sup> A statute may also specify the corporate formalities necessary to create an issuing SPE, including its form (trust, fund, or corporation), its powers, and its ownership structure.<sup>79</sup>

---

75. See TRADE RECEIVABLE CRITERIA, *supra* note 8, at 7. Substantive consolidation is an equitable doctrine which allows courts under certain circumstances to consolidate the assets and liabilities of the SPE and the originator. See SCHWARCZ, *supra* note 10, at 24. Piercing the corporate veil, see *infra* note 90, and substantive consolidation are two sides of the same coin. See Penrose, *supra* note 66, at 71. It will be applied by the courts "based on an overly familiar relationship between parent and the subsidiary partner and partnership." *Id.* at 72. Several factors are considered by courts to determine whether substantive consolidation would be justified. See SCHWARCZ, *supra* note 10, at 25; KRAVITT, *supra* note 4, at 7-58; 1 FRANKEL, *supra* note 2, at 427 (listing such factors as the commingling of assets and business functions, unity of interest and ownership among the two entities, and whether there are intercorporate guarantees on loans).

76. In 1993, Japan enacted the Law Relating to the Regulation of Business Concerning Specific Claims. See Shimeda & Itoh, *supra* note 16, at 174. In 1992, Belgium amended its Law of December 4, 1990 on Financial Transactions and Financial Markets. See Papeions, *supra* note 16, at 353. Spain passed legislation in 1992 and 1993 to allow for asset securitization as well. See Trujillo, *supra* note 16, at 15. Ireland passed the Irish Finance Act of 1996 to facilitate securitization. See *Dublin*, *supra* note 16 at 382. See also *Irish*, *supra* note 16, at 1. Similar developments have occurred in Latin America. Brazil has enacted specific legislation which regulates the securitization of real estate receivables—Law No. 9,514, of November 20, 1997. See Levy & Salomão Advogados, *Real Estate Financing with Securities*, LATIN AMERICAN FIN. & CAPITAL MARKETS, Jan. 31, 1998, at 5. See generally Silva & Junior, *supra* note 16, at 618-20. Argentina passed the Housing and Construction Financing Law in 1995; Chile its Capital Markets Law in 1981 (Title XVIII of Law No. 18,045); and Colombia its Title III of Resolution No. 0400 of the *Superintendencia de Valores* in 1995. See Lewis Rinaudo Cohen & Jorge Calderon, *Developments in Domestic Latin American Securitization* (handout for a presentation about Latin American securitization held in Cancun, Mexico in May 1996) (on file with the *Duke Journal of Comparative & International Law*).

77. The recent Japanese Small Claims Law, for example, defines certain perfection procedures. See Shimeda & Itoh, *supra* note 16, at 180.

78. For example, the Japanese Small Claims Law, which requires an SPE in form of a qualified assignee. See *id.* at 177.

79. For example, the recently amended framework for securitization in France. See inter-

In most cases, however, the structure offered under the statute is not mandatory or may cover only a limited number of assets.<sup>80</sup> In other cases, the statute may not define the SPE requirements, leaving transaction participants with the option of structuring securitizations under local law. In that event, as in the case where there is no securitization statute at all (or where the statute insufficiently addresses bankruptcy remoteness concerns), the analysis generally must rely on local corporate law to assess whether an SPE organized in that country can be bankruptcy remote and therefore used as an intermediate or issuing SPE.

The rating agency analysis evaluates whether the purpose of the chosen entity can be limited and whether the entity can truly be an SPE as described above.<sup>81</sup> It also focuses on the validity and enforceability of any covenants against the entity's incurrence of indebtedness and voluntary bankruptcy or reorganization.<sup>82</sup> For instance, in a number of jurisdictions voluntary bankruptcy filing or dissolution of a company is a shareholder decision by statute, and any restriction of that shareholder power (or transfer of that power to another corporate body such as the board of directors) would most likely be unenforceable.<sup>83</sup> In those jurisdictions (such as Japan and France), a securitization would not be able to use a wholly-owned subsidiary of a transferor as truly bankruptcy remote and will require that transactions be structured through an orphan SPE organized offshore (typically in a jurisdiction where the SPE will be exempt from income taxes).<sup>84</sup> Transactions may incorporate structural features that are offered by the participants with a view to circumventing the risks identified.<sup>85</sup>

---

nal memorandum by the law firm Cleary, Gottlieb, Steen & Hamilton regarding securitization of financial assets under French law (Nov. 17, 1997) (on file with the *Duke Journal of Comparative & International Law*) [hereinafter Cleary Memo].

80. See, for example, the Japanese Small Claims Law, which covers only certain types of receivables. See Shimeda & Itoh, *supra* note 16, at 176. For other assets, the use of a foreign SPE is necessary. See *id.* at 175.

81. See Part IV.A, *supra*. See also TRADE RECEIVABLE CRITERIA, *supra* note 8, at 6.

82. See TRADE RECEIVABLE CRITERIA, *supra* note 8, at 44.

83. In the U.S., it is possible to limit this power. However, as Professor Schwarcz points out, it seems "to be against public policy to remove entirely a company's power to place itself in voluntary bankruptcy." SCHWARCZ, *supra* note 10, at 17.

84. For example, in Japan only certain receivables are covered by the new securitization law. For other assets an SPE formed in a foreign jurisdiction is used. See Shimeda & Itoh, *supra* note 16, at 125.

85. For instance, in certain cases a pledge by the parent of the shares of its SPE subsidiary, together with a power of attorney may, if such power of attorney is enforceable in the insolvency of the parent, eliminate the risk of voluntary filing described above.

Although the six-factor analysis for defining an SPE was developed based on U.S. law and principles of substantive consolidation,<sup>86</sup> as a general matter the limitation of powers and covenants contained in those criteria are necessary and desirable in any jurisdiction to ensure that the issuing SPE continues to exist as a separate entity involved in securitization only, and that its assets do not become commingled with those of either its parent or seller.

In many cases, an independent director<sup>87</sup> or a "golden share"<sup>88</sup> plays both a necessary due diligence role in the continued performance of the issuing SPE's obligations and reduces the likelihood of a voluntary filing.<sup>89</sup> Some transactions rely on the existence of a golden share held by the trustee as an independent third party to provide equivalent comfort.

In analyzing the structure of an SPE, a rating agency considers whether the transferor's jurisdiction has any theory similar to the U.S. theories of substantive consolidation, alter ego, or piercing the corporate veil.<sup>90</sup> Most common law jurisdictions recognize both alter ego and piercing the corporate veil theories.<sup>91</sup> Civil law jurisdictions sometimes have statutes that allow for the consolidation of affiliates upon a showing of confusion of patrimony (assets) or exclusive deal-

---

86. For a description of substantive consolidation, see note 75, *supra*.

87. For a description of the role of independent director, see note 71, *supra*.

88. The concept of the "golden share" originated in Great Britain under Margaret Thatcher's privatization of British state own enterprises in the 1980s. See Andrei A. Baev, *Is There a Niche for the State in Corporate Governance? Securitization of State-Owned Enterprises and New Forms of State Ownership*, 18 HOUS. J. INT'L L. 1, 20 (1985). It is designed to provide the holder of the share with the power to veto major decisions of the corporation. See *id.* at 23. It can also be set up in a way that mandates its affirmative vote to achieve the required voting percentage. For a detailed discussion of the concept, see *id.* at 20-32.

89. The successful performance of their roles, however, is not guaranteed. In the Days Inn case, a solvent SPE filed for voluntary bankruptcy to facilitate the sale of Days Inn secured notes. The independent director voted for the action, together with the rest of the board. See SCHWARCZ, *supra* note 10, at 19. See generally discussion of Days Inn case in note 35, *supra*.

90. See Penrose, *supra* note 66, at 71. S&P therefore usually requests an opinion from outside counsel regarding the risk of consolidation—a so-called non-consolidation opinion. See *id.* at 72. Substantive consolidation is described in note 75, *supra*. For a description of the theories of piercing the corporate veil and alter ego, see generally Sung Bae Kim, *A Comparison of the Doctrine of Piercing the Corporate Veil in the United States*, 3 TULSA J. COMP. & INT'L L. 73 (1995); David S. Bakst, *Piercing the Corporate Veil for Environmental Torts in the United States and the European Union: The Case for the Proposed Civil Liability Directive*, 19 B.C. INT'L & COMP. L. REV. 323 (1996); Carsten Alting, *Piercing the Corporate Veil in American and German Law: Liability of Individuals and Entities: A Comparative View*, 2 TULSA J. COMP. & INT'L L. 187 (1995).

91. See Jonathan Lux, *Piercing the Corporate Veil: An English Perspective*, in 1991 COMPARATIVE LAW YEARBOOK OF INTERNATIONAL BUSINESS 3.

ings.<sup>92</sup>

## V. TRANSFERS OF ASSETS AND PERFECTION<sup>93</sup>

Generally, the second step in structuring a transaction is to review the bankruptcy and reorganization laws of the particular jurisdiction to determine the effect of an insolvency proceeding on the assets of a bankrupt entity (automatic stay equivalents, repudiation or rejection of contracts, treatment of secured creditors, etc.).<sup>94</sup> The transfer of the assets should be effected in a manner that will shield the assets from the bankruptcy risk of the transferor.<sup>95</sup> Certain countries (such as Belgium and France) have enacted securitization statutes that clearly delineate the conditions and formalities under which the transfer must take place in order for the transfer to be a true sale.<sup>96</sup>

### A. Potential Obstacles

Securitization laws, however, are not always successful in eliminating obstacles to transfers. General laws must be relied upon in countries where no special statute exists, and in many jurisdictions there are significant legal and practical obstacles to structuring a true securitization.<sup>97</sup> One of the more common problems is that the trans-

---

92. See Shimeda & Itoh, *supra* note 16, at 188 (describing Japanese equivalent to piercing the veil). In some civil law countries, like for example Spain, the technique of piercing the corporate veil is created by the courts. It is more like a common law country in this regard. See Jorge Angell, *Piercing the Corporate Veil: A Spanish Perspective*, in 1993 COMPARATIVE LAW YEARBOOK OF INTERNATIONAL BUSINESS 341. The courts play a similar role in Germany and the Netherlands. See generally S.M. Barman & J. Roest, *Piercing the Corporate Veil in the Netherlands and Germany: A Convergent Legal Development*, in COMPARABILITY AND EVALUATION: ESSAYS ON COMPARATIVE LAW, PRIVATE INTERNATIONAL LAW AND INTERNATIONAL COMMERCIAL ARBITRATION IN HONOR OF DIMITRA KOKKINI-IATRIDOU 3 (1994).

93. Substantial portions of Parts V and VI are taken from Rose & Dawson, *supra* note 2.

94. See TRADE RECEIVABLE CRITERIA, *supra* note 8, at 46.

95. This is necessary to ensure bankruptcy remoteness and true sale. See Part IV, *supra*, and Part V.B, *infra*.

96. See generally Eddy Wymeersch, *Belgium*, in ASSET-BACKED SECURITIZATION IN EUROPE, *supra* note 16, at 25. See also Papeions, *supra* note 16, at 353. For France, see generally Couret, *supra* note 18, at 71. See also Torchiana, *supra* note 16, at 828. It should be noted that in 1997 France amended the legislation referred to in those articles. See Parolai & Lewis, *supra* note 16, at 13. See generally Cleary Memo, *supra* note 79.

97. An example is Japan, where the Small Claims Law covers only a relatively narrow scope. See Shimeda & Itoh, *supra* note 16, at 174. Another, rather astonishing example is Germany. While one of the major economic players, it has not enacted a specific regulatory and legal framework for securitization. While it is possible to use securitization, the lack of specific rules makes it more difficult. See Ihle, *supra* note 17, at 88.

fer of assets is cumbersome, time consuming, and costly.<sup>98</sup> Depending on the asset, the transfer (whether structured as a sale or a transfer for security) may require either the consent or notification of the ultimate obligors on the underlying assets (the borrowers).<sup>99</sup> In some cases, a transfer requires preparation and registration of notarial deeds and payment of stamp or transfer taxes.<sup>100</sup> These perfection requirements generally inhibit the use of structured finance as a financing technique. Additionally, in many cases the transferor is reluctant to notify the borrowers, because culturally a sale of assets may be viewed as a last-ditch effort to stave off bankruptcy, rather than a viable and efficient funding technique.<sup>101</sup>

A rating agency will also review the circumstances in which a bankruptcy court in a given country may avoid a transfer of assets effected by a bankrupt debtor before the bankruptcy filing (e.g., as a preferential transfer, transfer at undervalue, gratuitous or fraudulent transfer), and require that safeguards be incorporated in the transac-

---

98. Another example of this is the transfer of receivables in France. See Parolai & Lewis, *supra* note 16, at 13 ("Under French Law it is complex and cumbersome to transfer title to receivables. . . . This process is expensive and time-consuming.").

99. An example is Japan, which requires different methods for different assets. For receivables (*shimei-saiken*) under art. 467 of the Japanese Civil Code (MINPO), notice to the obligor or the obligor's consent is required to perfect the transfer against the obligor. To perfect the transfer of receivables against third parties, this notice or consent must be done in an instrument bearing a confirmed date. For pledges of claims, notice or consent of the obligor is required, see MINPO, art. 467, while pledges for certain other assets (like personal property or real estate) employ other methods, like registration. See MINPO, arts. 344, 352, 364. Mortgages and securities, and shares and bonds, use methods like delivery or registration as well. See MINPO arts. 86-3, 117, 178, and the Japanese Commercial Code (SHOHO), art. 205-206. See generally legal memorandum from Tetsuya Sho, Associate, Coudert Brothers, to Marilyn Selby Okoshi, Partner, Coudert Brothers, discussing securitization in Japan (Mar. 18, 1998) (on file with the *Duke Journal of Comparative & International Law*) [hereinafter Sho/Okoshi Memo].

100. The Argentine Civil Code, for example, mandates the use of public deed for mortgages in art. 3128, and art. 997 requires that public deeds be instrumented by public notaries. See letter from Jorge Solari, Associate Director, S&P (Buenos Aires), to Petrina Dawson (March 11, 1998) (on file with the *Duke Journal of Comparative & International Law*). Another example is Ireland, which has a stamp duty for certain instruments. See *Dublin*, *supra* note 16, at 383.

101. This is a problem practitioners often run into. The author has heard it in almost every meeting in Mexico, Latin America, Germany, Thailand and Japan. But it is a problem that is not documented in the literature. For a slight "hint" of the problem, see Shimeda & Itoh, *supra* note 16, at 183 ("Some originators are also reluctant to disclose to the underlying debtors their intention to sell receivables because these debtors are also their customers."). This problem can also be seen reflected in the following quote: "Japanese law does not allow for public notice perfection of these asset classes so, rather than give notice to powerful corporate clients, the bank has chosen to make use of the contingent perfection system—where clients are notified and loans perfected when certain triggers are hit." *Bank of Yokohama's Ambitious March*, ASSET SALES REPORT INT'L, Mar. 9, 1998, at 2.

tion documents addressing that risk.<sup>102</sup> For example, under English law, German law and Argentine law, one ground for preferential claw-back of assets is that the transferee knew at the time of the transfer that the transferor of the assets was insolvent.<sup>103</sup> In some jurisdictions, the court may determine at which point, prior to a formal insolvency filing, a transferor became de facto insolvent and establish a “look back” period which, depending on the jurisdiction, may be several years.<sup>104</sup> All transfers that occurred during the look back period are subject to avoidance by the court, regardless of whether the transferor received fair market value for the transfer.<sup>105</sup> To minimize the risk of avoidance in those jurisdictions, transferors of assets and their independent auditors must represent at closing that they are solvent and do not know of any event that would make them insolvent. Such representations need to be repeated periodically in a solvency certificate if the transaction is structured with a revolving feature. More generally, the rating analysis will focus on any legal ground that may be used in the jurisdiction that would adversely affect the cash flows of the transaction, whether retroactively or prospectively.

#### B. Defining the “Transfer”

Although the word “transfer” is often used without regard for its scope, in non-U.S. or multi-jurisdictional transactions, a successful transaction may depend on the precise definition of the breadth of transfer required for securitization.

As a legal matter, a transfer can be thought of as fulfilling one or more of three specific goals. A transfer may be valid and enforceable (1) against a solvent transferor, resulting in the transferee having priority against third-party creditors (a contractual matter); (2) against the regulator (if any), debtor in possession, or a liquidator, receiver or administrator of the transferor in an insolvency or reorganization proceeding, and against other creditors of an insolvent transferor; or (3) against the ultimate borrower (the obligor on the assets), enabling

---

102. See TRADE RECEIVABLE CRITERIA, *supra* note 8, at 46.

103. For Argentina, see MULTINATIONAL COMMERCIAL INSOLVENCY, *supra* note 15, at A-10; for Germany, see *id.* at K-7; for England, see *id.* at I-24.

104. For example Argentina—2 years, see *id.* at A-10; France—18 months, see *id.* at J-25; Brazil—60 days before first nonpayment/judgment, see *id.* at D-8; England—6 months to 5 years, see *id.* at I-23.

105. See, e.g., MULTINATIONAL COMMERCIAL INSOLVENCY, *supra* note 15, at J-25 (distinguishing between the period during which a transfer can be avoided, and grounds to set aside a pre-bankruptcy transfer).

the transferee to enforce the transfer of assets directly without relying on the transferor (e.g., the ability to foreclose on a mortgage or repossess an automobile after default on the loan).

The sale of an asset—i.e., the transfer of an ownership interest—is a transfer that meets all three goals. The sale of an equitable interest may meet only (1) and (2) above, but may not be recognized in an action against the ultimate borrower. An equitable interest also may be more likely to be challenged in an insolvency or corporate reorganization proceeding. A promise to transfer assets in the future is only enforceable against the transferor and thus would meet the first goal.

1. *True Sale of a Legal Interest.* A sale of an asset to an issuing SPE is a securitization technique that, although at times complicated or costly, is likely to be effective in all jurisdictions. The typical two-tier transfer, described above in Part III, is structured as a true sale of a legal interest.

A true sale of an asset is a transfer that is effective against the transferor, its creditors, its regulator, its liquidator or receiver, and can be enforced against the borrower. Such a transfer legally separates the credit risk of the assets from that of the transferor.<sup>106</sup> The fully perfected sale of ownership interests<sup>107</sup> vests legal title in the issuing SPE on the closing day. A sale transaction generally does not use transfer-related triggers<sup>108</sup> because the issuing SPE, as owner of

---

106. See SCHWARCZ, *supra* note 10, at 29; *Structured Financing Techniques*, *supra* note 43, at 543 (stating that the transfer of risk of loss is the most important factor in a true sale).

107. See SCHWARCZ, *supra* note 10, at 37.

108. Triggers are clauses included in the transaction documents that provide for specific actions to be taken by one of the transaction participants upon the occurrence of a condition subsequent. Examples of triggers are the following: The seller will deposit \$3 million in a reserve fund if and when delinquencies on the asset pool exceed \$5 million; the trustee will give notice to the collection account bank that the servicer is no longer entitled to withdraw funds from the account if the servicer's rating falls below BBB-; or the issuer will draw the full amount available under the liquidating letter of credit if the letter of credit bank is downgraded below A-1. A recent "real world" example is the use of such triggers to solve the concerns of the Bank of Yokohama with notifying large corporate customers when securitizing loans. The Bank resorted to a system of contingent perfection, under which those clients were notified when certain triggers are met. The triggers chosen were the downgrading of the Bank's senior debt to BBB by Moody's, or the downgrading of the Bank's long-term subordinated debt by Nippon Investor Services to BB+. See *Bank of Yokohama's Ambitious March*, *supra* note 101, at 2. Another recent example are the acceleration events used in transactions by Orico Asset Funding Japan (a special-purpose, bankruptcy-remote entity). For those transactions, certain events (such as seller termination, redemption of a certain class of note, or collection failing to reach certain limits) lead to a conversion of the notes. See Yu-Tsung Chang, *Orico Asset Funding Japan (¥30.0 billion series)*, STRUCTURED FINANCE, Mar. 1998, at 85; Masahiko

the assets, is able to collect scheduled payments and enforce security against the borrower. A sale transaction also cuts off the borrower's ability to set off against the transferor or discharge the debt by paying the transferor.

Trigger events, if used in sale transactions, provide additional comfort only to investors that already own the assets. Structured finance transactions generally will include some trigger events to cover a variety of ancillary or related risks. For example, a trigger event may enable the issuer to terminate a revolving period for purchasing assets, or wind down a transaction when asset quality deteriorates. Sometimes trigger events are used to safeguard the funds received as proceeds or distributions on the assets (for example, moving a bank account to a different financial institution, or requiring the servicer to establish a segregated bank account). A trigger event also may be used to replace the credit support provider. These triggers, however, do not affect the validity of the asset transfer and thus should not be confused with the trigger events associated with contingent transfers, discussed below in Part VI of this Article. Where the trigger event merely touches on ancillary or related risks, the assets can be realized at all times, notwithstanding the insolvency of the transferor.

2. *True Sale of an Equitable Interest.* A sale of an equitable interest (more likely to be available in common law jurisdictions or under securitization statutes) is a transfer of full beneficial (but not legal) interest that is enforceable against the transferor, its regulator, its creditors, and also against its liquidator or receiver, without a significant probability of affecting timely payment on the rated securities.<sup>109</sup>

In structured finance transactions that involve the sale of equitable interests, legal ownership may remain with the transferor, but the economic benefits of assets are not viewed as the property of its insolvency estate. These transactions generally rely on pre-insolvency trigger events to perfect the legal transfer against the ultimate obligors. If the trigger event does not occur before an insolvency, the risk is only that: (1) the obligors get discharged by paying the transferor, (2) the obligors could set off against amounts owed by the transferor to the obligors, or (3) the issuer would need the cooperation of the transferor, its receiver or liquidator (as legal owner) to en-

---

Mimura, *Orico Asset Funding Japan (¥20.0 billion series)*, *id.* at 87.

109. For a description of a typical structure involved in the sale of those interests, see KRAVITT, *supra* note 4, at 4-6.

force or realize the transfer of assets against the ultimate obligors. Insolvency or reorganization of the transferor does not affect the equitable interest, as the assets are not available for distribution by the liquidator or receiver to other creditors of the transferor.

In some transactions, the trigger event could be the actual insolvency of the transferor. For example, in England and Australia, a durable power of attorney, enforceable notwithstanding the insolvency, enables the issuer to accomplish the legal transfer of the assets even after insolvency proceedings begin.

In many cases, early amortization events are also pre-insolvency trigger events designed to avoid the necessity of opposing an equitable transfer against a liquidator or receiver of the transferor. These early amortization trigger events may help in providing comfort to investors that the transaction will amortize before insolvency proceedings. However, failure to hit a pre-insolvency trigger is unlikely to affect the ability of the issuer to pay timely principal and interest on the rated securities.

### C. Secured Loan Transactions Ratable as Structured Finance

In some jurisdictions, it may be possible to structure transactions as first priority, perfected secured loans if neither an insolvency nor a reorganization proceeding would interfere with full and timely payment on the rated securities, or the interference is limited and quantifiable<sup>110</sup> (e.g., in the Netherlands the stay following bankruptcy is limited to two months).<sup>111</sup> In these transactions, a liquidity source may be used to cover timing delays that may occur in an insolvency proceeding.<sup>112</sup> To receive a rating divorced from the issuer's credit rating, there must be significant certainty that the holders of the rated securities have true control over the disposition and enforcement of the assets.<sup>113</sup> In jurisdictions where a liquidator or receiver could substitute collateral or force its public sale, secured loan securitizations are unlikely. Secured loan transactions, however, may use trigger

---

110. Because in this case the interference can be appropriately considered in the ranking.

111. A stay is governed by arts. 63a and 241a of the Dutch Bankruptcy Act of 1893. See ASSET-BACKED SECURITIZATION IN EUROPE, *supra* note 16, at 170. See also MULTINATIONAL COMMERCIAL INSOLVENCY, *supra* note 15, at P-5.

112. Such sources are commonly called liquidity facilities. They do not cover the actual credit risk, but only the risk of untimely payment. See *Structured Financing Techniques*, *supra* note 43, at 550.

113. For a detailed discussion of factors relevant to achieve true control, see Joanne W. Rose & Petrina R. Dawson, *Analyzing English Secured Loans*, S&P STRUCTURED FINANCE, Sept. 1997, at 33 [hereinafter *English Secured Loans*].

events to anticipate commencement of insolvency proceedings where failure to foreclose or to enforce the collateral before insolvency would not result in a default on the rated securities.

Standard & Poor's employs four levels of review for secured loan securities that are rated as structured finance transactions.<sup>114</sup>

1. *Status of the Originator.* A secured loan security has the greatest chance of achieving a rating that is significantly higher than the rating of the transferor if the transferor is a single-business/single-activity entity. If the transferor is a multiple-business/multiple-activity entity, it is far more complicated to identify and measure liabilities and risks because of the variations possible as a result of the numerous combinations of risks between different business activities.

2. *Full Enforceability of Secured Loans and Security.* The second level of review is to ensure that, as a legal matter, the secured loan and the security are enforceable and not subject to any legal challenge. In a proposed secured loan structured financing, any significant risk of challenge to the enforcement of security has obvious and serious implications for the rating. Where security is unenforceable and the originator is insolvent, investors will not be paid in full. The security may be challenged on such grounds as the transferor did not have the capacity to grant the security, misrepresentation, or fraud. Security is also vulnerable in the event of the transferor's insolvency. Under English Law, the main grounds for avoidance in an insolvency are that the transaction is undervalued or defrauds the transferor's creditors, that the security is not properly perfected, preference, extortionate credit bargain, and the grant of floating security for past value.<sup>115</sup>

3. *True Control.* The third level of review is to ensure that the issuer has true control over its security, i.e., the assets that make up its collateral. The following factors determine whether the issuer has true control:

(a) Whether the issuing SPE, as a secured creditor, has control over the enforcement of its security;

(b) whether the security confers priority in favor of the issuing SPE against all other creditors; and

---

114. The following discussion is based on Rose & Dawson, *supra* note 113.

115. See also MULTINATIONAL COMMERCIAL INSOLVENCY, *supra* note 15, at I-23.

(c) whether the security covers appropriate assets and whether the proceeds of such security, once realized, are adequate to repay investors.

The greater the lack of control, the greater the risk that an investor will receive delayed payment of the interest and principal due on a rated security because of an insolvency. It may mean that, in addition to delay in payment, full recovery of interest and principal will not be possible.

4. *Liquidity.* The fourth level of review is liquidity risk.<sup>116</sup> Additional structural requirements, such as credit enhancement and other measures,<sup>117</sup> may be necessary to reduce any incentive to file for the insolvency of the issuer or otherwise challenge the secured loan structure rated as a structured finance.<sup>118</sup>

#### D. Transactions Ratable as Enhanced Issuer Credit Rating

Although secured creditors may be entitled to post-insolvency interest on the rated securities (if the collateral is sufficient to cover post-insolvency interest), in many cases insolvency or reorganization proceedings impose a stay on payment of interest or principal due on secured debt.<sup>119</sup> In many jurisdictions, insolvency (liquidation) proceedings do not affect secured creditors, but corporate reorganization laws provide that the debtor may ask the courts to place a temporary stay or moratorium on payments of principal and interest on secured debt.<sup>120</sup> The creditors also may be stayed from enforcing the collateral or may be forced to sell the collateral in time-consuming public auctions that may well result in additional losses. Secured creditors, however, will have a higher likelihood of recovering full principal and interest than unsecured creditors. Thus, certain secured debt of an

---

116. Liquidity risk means the risk that cash flow from securitized assets will not come in timely enough to pay the securities. To cover this risk, liquidity facilities are used. Liquidity facilities are discussed in note 112, *supra*.

117. Credit enhancement covers the risk that the SPE might not have enough funds to pay the securities. Common forms of credit enhancement are letters of credit issued by banks, surety bonds by insurance companies, guarantees issued by financial assurance companies, and subordinated loans from third parties. See *Structured Financing Techniques*, *supra* note 43, at 549. To cover the risk of untimely payment, liquidity facilities are used. See note 112, *supra*.

118. See *English Secured Loans*, *supra* note 113, at 31, 36.

119. See SCHWARCZ, *supra* note 10, at 30.

120. For example, this procedure exists in the Netherlands, France and England. See F.G.B. Graaf et al., *The Netherlands*, in *ASSET-BACKED SECURITIZATION IN EUROPE*, *supra* note 16, at 170; *MULTINATIONAL COMMERCIAL INSOLVENCY*, *supra* note 15, at P-5, J-25.

issuer may be rated higher than the issuer's credit rating.<sup>121</sup> These enhanced ratings are based on the creditors' status as holders of first priority, perfected security interests, the value of the collateral pledged as security, the time estimated for enforcing the collateral, and the availability of other assets to pay priority debts of the issuer in an insolvency (e.g., taxes, insolvency expenses, wage claims, etc.). The analysis recognizes that payments are likely to be interrupted immediately after an insolvency filing or declaration.<sup>122</sup> The enhancement can be as much as one full rating category above the issuer credit rating<sup>123</sup> and is evaluated on a case-by-case basis. These transactions are linked to the issuer credit rating and are subject to downgrade based on either the deterioration or insufficiency of assets held as collateral or a decline in the issuer's creditworthiness.<sup>124</sup>

These transactions generally use trigger events to anticipate the insolvency of the issuer (i.e., to give the secured creditor the ability to enforce the security directly without the help of the transferor). They also use trigger events to effectuate a sale and avoid timing delays. These trigger events are generally requested by the creditors as additional enhancement. The failure to hit a trigger, however, does not affect the amount of security available to pay principal and interest on the rated securities, but rather only the timing of the recovery.

## VI. CONTINGENT TRANSFERS AND PERFECTION

In some jurisdictions, prospective issuers contend that transactions that rely solely on the occurrence of certain post-closing events (trigger events) to transfer (or perfect the transfer of) assets at a future time should be rated under traditional structured finance methodology.<sup>125</sup> Thus, they argue that when a transferor agrees to transfer

---

121. See generally RATINGS CRITERIA, *supra* note 4, at 65.

122. An example demonstrating this recognition is the first commercial mortgage securitization in France. As the Associate Director of S&P's Structured Finance Group (Paris), Alain Carron, noted: "We are adapting the U.S. model to incorporate particular aspects of French borrowing entities and French bankruptcy law. Investors are concerned that the time taken to foreclose on property in France is longer than in the U.S., but this has been factored into our analyses." Hart, *supra* note 15, at 17.

123. See generally RATINGS CRITERIA, *supra* note 4, at 65.

124. For a recent example, see *Spotlight: Japanese Bank Turmoil Reverberates in CP Market*, S&P STRUCTURED FINANCE, Feb. 1998, at 9 (describing the case of a Japanese bank whose commercial papers were downgraded from A-1 to A-2 after the issuing bank had its short term rating cut down to A-2).

125. S&P has received requests to rate transactions structured to include contingent perfection in Japan, Argentina, Italy, Scotland, the Netherlands, and Mexico. S&P has not rated these transactions. S&P has rated the EMSI transaction that includes a contingent sale but was

securities with an issuer credit rating of "A" when the transferor's issuer credit rating is downgraded below "BBB," the transaction should be rated "AAA" because the assets are "AAA". They argue that the rating agency should look only to the quality of the future assets and not to the issuer credit rating of the transferor.

At first blush, such an argument may seem appealing: if a highly rated transferor agrees that at some future date it will deliver assets (or perfect the delivery of assets), then an investor should be better off than if the investor had relied solely on a promise of the transferor to pay principal and interest. The trigger event would be some specified event, including a default by, or downgrade of, the transferor's issuer credit rating. However, on closer examination it becomes apparent that a promise to deliver assets in the future is only as good as the creditworthiness of the transferor. At closing, the investor has no additional security and, in fact, no additional assurances that a trigger event will occur. If the transferor becomes insolvent before the trigger event occurs, there will be no assets.

Part of the argument favoring contingent transfer arrangements seems rooted in the belief that a transferor will only become insolvent, and thus take advantage of an insolvency proceeding, after a slow and gradual decline in its creditworthiness accompanied by a slow migration through the rating categories. Rating agency default studies show, however, that a certain percentage of investment grade transferors default while rated at investment grade levels.<sup>126</sup> Gradual rating migration is by no means assured. The litmus test for structured finance transactions, therefore, is whether they can withstand a transferor default, thus garnering a rating that is independent of the transferor's rating.

An additional argument is that, at a minimum, contingent transfers provide the benefit of the assets in those situations in which the transferor does migrate through the rating categories. As such, the rating should consider the future transfer as an enhancement of the issuer credit rating. As shown below, however, the presence of the contingency is likely to be the very event that disrupts the slow migration by making it more economically palatable to take advantage of insolvency proceedings. Moreover, structured financings have generally withstood periods of severe economic stress that had sig-

---

rated based on a perfected secured loan analysis, and S&P also rated one Argentine and one Italian transaction based on the issuer credit rating of the transferor.

126. For an overview of defaults by rating and time, see STANDARD & POOR'S, RATINGS PERFORMANCE 1997, 3 (1998).

nificant impact on transferors, such as the U.S. savings and loan crisis and the U.K. mortgage recession.<sup>127</sup> Thus, it seems likely that a contingency allowing transferors to avoid transferring assets in periods of economic crisis would undoubtedly be invoked, to the detriment of creditors.<sup>128</sup>

Transactions that are not ratable above the issuer credit rating fall into two categories: (1) those that involve transfers that are effective as a contractual matter only against the transferor but not against its creditors, regulator, liquidator, or receiver (for example, where the transferee is an unperfected buyer or an unperfected secured creditor); or (2) those that contain solely the promise of the transferor to grant security or sell assets in the future (whether or not accompanied by a power of attorney). These transactions rely on trigger events to perfect the sale of, or the security interest in, an asset prior to an insolvency or reorganization of the transferor.

In a typical proposal, a transferor purports to sell assets to the issuing SPE but does not perfect the sale by notifying the ultimate borrower as required by law.<sup>129</sup> Alternatively, the transferor agrees to pledge assets to secure its obligations but does not perfect the pledge by notifying the ultimate borrowers and, if required, by filing notarial deeds in the appropriate recording offices. Instead, in each case the transferor delivers to the issuer or the trustee prepared notices and a power of attorney that enable the issuer to perfect the transfer or security on a future date after the occurrence of a trigger event (for example, a downgrade of the transferor). However, usually a review of the law in the jurisdiction reveals that an insolvency of the transferor invalidates and revokes all powers of attorney (whether coupled with

---

127. See Richard Stow, *Arrears Stress U.K. Mortgage-Backed Securities*, S&P CREDITWEEK INT'L, Apr. 6, 1992, at 29 ("To date, no rating actions have been necessary due to asset-quality decline because transactions include strong credit and liquidity enhancements that serve to protect the bondholder's interest from delinquent and defaulting borrowers."). See also Kenneth Degen, *'AAA' Affirmed on Bank-Backed Mortgages*, S&P CREDITWEEK, May 12, 1986, at 17; James Titus, *Mortgage REITs Fundamentally Sound*, S&P CREDITWEEK, July 4, 1988, at 18 (indicating that despite strong economic pressure in the U.S., those markets remained fundamentally sound in the view of Standard & Poor's).

128. The Author recognizes that the counterarguments may not apply with equal force if the transferor is very highly rated and the trigger is set sufficiently early in the transaction, such that the transferor would not seek to avoid the transfer. A highly rated transferor may be economically disadvantaged by resorting to untimely insolvency proceedings upon a downgrade from a high investment grade rating (for example, from AA to AA-). These enhanced transactions would, however, be more volatile than a traditional asset-backed structure.

129. In some countries, like for example Japan, notification is required. See Sho/Okoshi Memo, *supra* note 99, at 1; Shimeda & Itoh, *supra* note 16, at 179. Similar concepts also exist, for example, in Latin America. See Doetsch, *supra* note 44, at 21.

an interest or not).<sup>130</sup> In some cases, the transferor may deposit with the issuer sufficient funds to enable the transferor to perfect the transfer (including stamp and transfer taxes).<sup>131</sup> More often, the transferor promises that it will deliver these funds at the time of the trigger event, arguing that the trigger will occur at a time when the transferor will not have any financial difficulty.

With nothing more, these transfers are only enforceable as a contractual matter against the transferor. Because the borrowers are not notified and/or notarial deeds are not filed (as required to perfect the transfer under the law), the transferor's other creditors have no means of determining whether the transferor sold or pledged these assets. The transfer or pledge exists as an unsecured contract right only against the transferor. The transfer is not valid against a regulator, liquidator, receiver, or any third-party creditor.

Both kinds of transactions rely only on a trigger event that is sufficiently prior to the insolvency to perfect the sale or the pledge and to protect the transfer from challenge in an insolvency proceeding. This in itself may create additional legal issues. For example, since the transfer occurs on a future date, there may no longer be a contemporaneous exchange for value at the closing of a transaction. Thus, the subsequent transfer of the assets would be subject to further scrutiny by regulators, creditors, liquidators or receivers as gratuitous, fraudulent or preferential.<sup>132</sup> In some jurisdictions, the transfer may not relate back to the date of the original transaction.<sup>133</sup> The transfer, almost by definition, occurs at a time when the financial condition of the transferor has deteriorated. Many jurisdictions have long look back ("suspect") periods before an insolvency in which gra-

---

130. For example, in Japan according to art. 653 of the MINPO, bankruptcy terminates a power of attorney mandate. See Sho/Okoshi Memo, *supra* note 99, at 2. But this is different in England, where a power of attorney is enforceable notwithstanding an insolvency.

131. Several jurisdictions have transfer taxes, which can be sizable. See Levy & Salomão Advogados, *Credit Assignments by 'Special Purpose Companies' and the Tax on Financial Transactions (IOF)*, LATIN AMERICA & BUS. REP., Feb. 1998, at 11. Ireland has a stamp duty on certain instruments. See *Irish*, *supra* note 16, at 3. England and Italy also have stamp taxes. See Taylor, *supra* note 16, at 37, 48.

132. For a discussion of the treatment of fraudulent conveyances in an insolvency situation, see also 1 FRANKEL, *supra* note 2, at 414.

133. See, e.g., Douglas A. Doetsch, *Emerging Market Cash Flow Securitizations Take Off*, INT'L FIN. L. REV., Nov. 1996, at 19 ("Virtually no precedents exist in most countries as to whether a future export 'sale' would be respected in a bankruptcy proceeding."); Parolai & Lewis, *supra* note 16, at 15 (stating that it is unclear under French law whether future receivables can be securitized if "the amount is not determinable at the time of transfer or when the amount depends on a subsequent action or utilization. . .").

tuitous or preferential transfers can be avoided.<sup>134</sup> Failure to perfect in a timely manner (or the avoidance of a transfer perfected too close to insolvency) will lead to default on the rated securities.

If an insolvency occurs before the trigger event in one of the above two transaction categories, the holders of the rated securities are at best unsecured creditors of the transferor. In many cases they may be viewed as subordinated unsecured creditors. If the transaction documents provide for recourse only to the assets but not to the transferor, the liquidator may use the assets to pay other priority debts of the transferor (such as wages, taxes, and even other creditors). Once the assets are exhausted, the holders of the rated securities will have no claim against the transferor and will receive no distribution in a liquidation or reorganization. Thus, a promise to deliver security or assets in the future should not be viewed as adding creditworthiness to an issuer's promise to pay principal and interest in the future. A power of attorney that is not enforceable in an insolvency cannot enhance the promise to pay principal and interest.

Moreover, the presence of a trigger event could provide an incentive to a transferor to seek reorganization or bankruptcy protection earlier than otherwise anticipated to try to prevent the transfer of assets. A trigger event also encourages creditors to petition for liquidation of the issuer. By avoiding the transfer (or the perfection of a security interest), the creditors could share in assets that would not be available to them after a transfer occurs (or a security interest is perfected). For regulated entities (e.g., banks or other financial institutions), the trigger may accelerate regulatory intervention. Most regulators are able to declare moratoria on payments and other transfers (which generally would include the exercise of powers of attorney) to preserve the assets and the liquidity of the transferor. Therefore, the trigger event will serve as the catalyst for an early default in the rated transactions.

A rating that relies on the promise of a future transfer, a contractual right only, is fraught with uncertainty. The rating should not be based solely on the credit quality of the underlying assets because, in most jurisdictions, a breach of contract is not enforceable by specific performance.<sup>135</sup> If the transferor breaches its promise to transfer

---

134. See note 104 and accompanying text, *supra*.

135. It should be noted that in common law countries specific performance is an equitable remedy and therefore only available when money damages will not suffice. See BLACK'S LAW DICTIONARY 1139 (6th ed. 1990). Generally, civil law countries have a different perspective and allow for specific performance as a standard contract remedy. This difference can be par-

the assets, the sole remedy of the holders of the rated securities is an action for damages in local courts. Complex, costly, and time-consuming litigation should not be viewed as a ready substitute for creditworthy collateral. Irrevocable powers of attorney may mitigate the risk of breach of contract, but they are generally avoidable in an insolvency or reorganization procedure.<sup>136</sup> Therefore, a power of attorney will increase the incentive to use insolvency proceedings proactively. If this happens, the holders of the rated securities would be, at best, unsecured creditors of the transferor.

## VII. CONCLUSION

Structures that rely on trigger events to perfect the sale of assets, or to perfect security interests at a future date, often are called contingent transfer or contingent perfection structures. The term "contingent," however, may imply more comfort than the legal analysis reveals. Indeed, perfection of the collateral or the transfer may not be possible. These structures may also increase the incentives of the transaction participants to commence proceedings to avoid the transaction.

Given such negative incentives and the genuine risk of loss on the rated securities, it is inappropriate and analytically compromising to rely on a contingent transfer to enhance the rating above the issuer credit rating.

---

ticularly seen in the Convention on the International Sale of Goods, which adopted the civil law approach towards specific performance. See JOSEPH M. LOOKOFKY, UNDERSTANDING THE CISG IN THE USA 66 (1995).

136. See LOOKOFKY, *supra* note 135, at 66. See also note 85, *supra*.