

CORPORATE LOAN SECURITIZATION: SELECTED LEGAL AND REGULATORY ISSUES*

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I. INTRODUCTION

The past three years have witnessed significant developments in the use of securitization as a financing technique. A form of financing that was initially used to finance relatively simple, self-liquidating assets such as mortgage loans has expanded in its application, and is now frequently employed in more complicated financing structures.¹ For example, risk in project lending is now being securitized, and, more importantly for the purposes of this Article, securitization is being employed by banks and finance companies to finance more individualized credits such as corporate loans. The resulting securitization structures are complicated, primarily as a result of the requirement within a securitization transaction to produce a structure that insulates investors against a multiplicity of risks. Credit risk, market risk and liquidity risk are all possible consequences, and when retained by the original lending institution, would be managed on an institutional basis, and supported by the institution's equity base.² The more complicated the securitized asset and the less uniform its characteristics, the more difficult it is to achieve the balance required to satisfy investor concerns. Nonetheless, the number and size of asset-backed issuances in the past two years in particular, appear to signal another significant move in the on-going process of disinter-

*Note: Many of the citations in this article refer to English cases. Since it is the policy of the *Journal* that text and footnotes conform to the latest edition of *The Bluebook: A Uniform System of Citation* and *The Chicago Manual of Style* (16th ed. 1996), citations for these cases may not adhere to the traditional English form.

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1. See, e.g., *Cash Flow CBO/CLO Transaction Rating Criteria: 1996 Update*, STANDARD & POOR'S STRUCTURED FINANCE, Nov. 1996; *Slicing Up Bank Loans*, INVESTMENT DEALER'S DIGEST, Dec. 22, 1997.

2. See *id.*

mediation in today's capital markets.

The objective of this Article is to indicate the legal issues that commonly arise in the securitization of corporate credits. It is impossible in a brief Article such as this to focus on particular legal requirements in particular jurisdictions. Rather, this Article presents a summary of the types of issues that arise commonly in certain jurisdictions.

II. WHY SECURITIZE? REGULATORY CAPITAL REQUIREMENTS

This Article focuses on the securitization of corporate loans originated by banks and other financial institutions. The first question in relation to such assets is this: why do the originators of the assets want to securitize them? More so than other bank assets (in particular consumer assets such as mortgage loans and credit card receivables), corporate loans derive from hard won relationships between lenders and their corporate customers. Some of these customers have sufficient credit-worthiness to access the bond markets in their own right, particularly since the advent of the junk bond and the expansion in the private placement markets. Any decision by a bank or finance company to securitize its corporate credits is usually the outcome of a delicate balance between the benefits of maintaining a business relationship with its corporate customers, and thus carrying corporate loans on its balance sheet, and the cost savings, increase in return on equity, and funding diversity that can be achieved through securitization. Pivotal in this decision, however, will be a desire not to upset the existing commercial relationship between lender and borrower.

Banks and other credit institutions are subject to stringent capital and capital adequacy requirements.³ Until the late 1980s, bank capital requirements were established independently by the regulatory authorities from around the world, without formal regard to each other's approach. The increased globalization of the financial

3. See generally BANK FOR INT'L SETTLEMENTS, *Proposal for International Convergence of Capital Measurement and Capital Standards*, COMM. ON BANKING REGULATIONS AND SUPERVISORY PRACTICES CONSULTATIVE PAPER 1 (1987), reprinted in 27 I.L.M. 530 (1988) [hereinafter *Basle Accord*]. The Committee was established in 1975, and has been variously referred to as the Basle Committee, the Basle Supervisors' Committee and the Cooke Committee, after its second chairman, Peter Cooke, the former Head of Banking Supervision at the Bank of England. See Cynthia C. Lichtenstein, *Introductory Note*, 30 I.L.M. 967 (1991).

markets rendered this dislocated method of supervision less and less relevant to the business, and the risks, that banks were undertaking. In recognition of the increasing need to establish common criteria to measure the financial soundness of a credit institution, as well as to reduce competitive inequalities caused by the application of different supervisory standards, the G10 nations (under the auspices of the Bank for International Settlements and the Basle Committee on Banking Supervision) agreed upon a common approach to the measurement of bank capital and a methodology for the weighting of bank assets for risk-based capital purposes.⁴

The Basle Accord approaches the measurement of bank capital adequacy by categorizing the types of capital maintained by a bank under three general headings.⁵ The first type, or Tier 1 capital, represents the most permanent forms of capital, such as ordinary shares or common stock, non-cumulative perpetual preferred stock, and disclosed reserves.⁶ The second type of capital, or Tier 2 capital, represents less permanent forms of capital, or capital that carries a fixed or cumulative cost, such as general provisions, redeemable preference shares, cumulative preferred stock, hybrid (debt/equity) instruments or subordinated debt.⁷ The third type, or Tier 3 capital, is a new addition to the Basle Accord agreed upon in 1996. Compared with the more permanent Tier 1 and Tier 2 capital held to support losses on longer-dated, illiquid bank assets,⁸ Tier 3 capital represents the types of less permanent, more fluid capital (such as short-dated subordinated debt) retained to cover losses on trading activities and other market-related risks. The Basle Accord, however, takes care not to attempt to draft exclusive definitions of capital. Capital can take different forms under various legal, accounting and economic systems. In order for the Basle Accord to have practical application in each jurisdiction in which it is applied, its requirements for the components of capital are set out in a purposeful or functional way.⁹

4. *See id.*

5. *See* Basle Accord, *supra* note 3, Section I. *See also* BASLE COMM. ON BANKING SUPERVISION, *Amendment to the Capital Accord to Incorporate Market Risks*, (Jan. 1996), Section II (on file with the International Financial and Tax Law Unit, Centre for Commercial Law Studies, Queen Mary and Westfield College, University of London) [hereinafter *Capital Accord Amendment*].

6. *See* Basle Accord, *supra* note 3, Annex 1, Parts A and D(i).

7. *See* Basle Accord, *supra* note 3, Annex 1, Parts A and D(ii).

8. *See* Capital Accord Amendment, *supra* note 5, Definition of Capital, Section II, n.2.

9. *See, e.g.*, Basle Accord, *supra* note 3, para. 14. Hence the focus in the Basle Accord is

The Basle Accord further refines its definition of qualifying (i.e. qualifying capital for the purposes of measuring the ratio of capital to weighted risk assets of a bank) by setting limits on the types of capital available for inclusion in the calculation of the ratio. For example, Tier 2 capital may not exceed one hundred percent of total Tier 1 capital,¹⁰ and subordinated debt may not constitute more than fifty percent of Tier 1 capital.¹¹ Tier 3 capital is limited to supporting the "trading book" (market risk) activities of a bank, and should not exceed 250 percent of a bank's Tier 1 capital required to support market risks.¹² General provisions included in Tier 2 capital should not exceed 1.25% of weighted risk assets.¹³

The other side of the calculation of a bank's capital adequacy is represented by its assets. The calculation of a bank's capital adequacy requirement is intended primarily to ensure that banks have sufficient capital available to support or absorb the risk of losses should their assets fail to perform.¹⁴ By far the greatest type of risk incurred in carrying on a banking business is the credit risk inherent in the holding of long-dated assets, particularly since the principal funding source of most banks traditionally has been short-dated deposits. In general, Tier 1 and Tier 2 capital is intended as a buffer against credit losses that may be incurred on traditional, long-dated, illiquid bank assets such as corporate loans and syndicated credits. The Basle Accord is based on the premise that the amount of capital required to be held against the credit risk associated with an asset, such as a loan, depends upon the perceived creditworthiness of the bank's counterparty.¹⁵

The categories of risk-weighting developed for counterparty risk are based on very rudimentary principles, essentially on the perceived likelihood of default by the category of counterparty in question. For example, all claims against or collateralized by countries that are members of the Organization for Economic Cooperation and Development (OECD) are risk-weighted at zero percent, and all

on the constituents of capital, i.e., the key elements that capital is required to contain in order that it may serve its function as protection for depositors and other creditors of banks and the banking system as a whole.

10. See Basle Accord, *supra* note 3, para. 44. See also *id.*, Annex I, Part B.

11. See Basle Accord, *supra* note 3, para. 23. See also *id.*, Annex I, Part B.

12. See Capital Accord Amendment, *supra* note 8, para. 1.

13. See Basle Accord, *supra* note 3, para. 21. See also *id.*, Annex I, Part B.

14. See *id.*

15. See Basle Accord, *supra* note 3, para. 28.

claims on corporates are risk-weighted at one hundred percent, regardless of whether the corporate in question is a Fortune 500 corporation or a small, family-owned company.¹⁶ The approach taken by the Basle Accord, therefore, is significantly less sophisticated than the process of credit analysis that a bank would undertake itself before granting facilities to a corporate borrower. The risk-weighted value of an asset for capital adequacy purposes is calculated by multiplying the principal amount of the asset by the risk-weighting of the associated counterparty.¹⁷ Off-balance sheet assets, such as bank guarantees, letters of credit, note issuance facilities and committed but undrawn lines of credit, are allocated a credit conversion factor. This is expressed in percentage terms by reference to the perceived credit risk arising from the nature of the off-balance sheet item in question.¹⁸ The face amount of the off-balance sheet item is multiplied first by the credit conversion factor, and the result of this calculation is then itself multiplied by the risk-weighting of the bank's counterparty.¹⁹

A bank's capital adequacy requirement for assets held in its banking book under the Basle Accord (excluding capital required to be held against foreign exchange risk, which is the subject of a separate calculation)²⁰ is determined by calculating the ratio of total qualifying Tier 1 and Tier 2 capital against the total of its risk-weighted assets, both on and off-balance sheet.²¹ The Basle Accord sets a minimum capital/risk asset ratio of eight percent.²² This is strictly a minimum requirement, and individual regulators are entitled to set higher capital ratio requirements if they so desire.

Banks incorporated in a member state of the European Union are subject to very similar requirements to those established by the Basle Accord. These requirements are found in three directives: the Own Funds Directive,²³ the Solvency Ratio Directive,²⁴ and the Capi-

16. See Basle Accord, *supra* note 3, para. 28. See also *id.*, Annex 2.

17. See *id.*

18. See *id.* See also Basle Accord, *supra* note 3, paras. 42 and 43, and Annex 3.

19. See *id.* See also Basle Accord, *supra* note 3, Annex 3.

20. See Capital Accord Amendment, *supra* note 8, Section A.3.

21. See Basle Accord, *supra* note 3, para. 44.

22. See *id.*

23. Council Directive 89/299/EEC, 1989 O.J. (L 124) 16 [hereinafter Own Funds Directive] establishes the parameters for Tier 1 and Tier 2 capital.

24. Council Directive 89/647/EEC, 1989 O.J. (L 386) 14 [hereinafter Solvency Ratio Directive] establishes the criteria for the risk-weighting of bank assets and off-balance sheet

tal Adequacy Directive.²⁵ As with the Basle Accord, the three directives set a minimum capital/risk asset ratio of eight percent for credit institutions incorporated in a member state,²⁶ though the institutions are subject to lower requirements for capital supporting market risks on more liquid assets held in the trading book.²⁷ The three directives are required to be implemented by each of the fifteen member states, although a number of those states have been given individual exemptions from immediate implementation of certain items.²⁸ Most member states had implemented the requirements of all three directives by the beginning of 1998.²⁹

As with much European Council legislation implemented in the financial services sector, the three directives relating to capital adequacy establish only the minimum regulatory requirements. Any member state may impose stricter criteria on banks incorporated in that country and subject to its supervisory jurisdiction.³⁰ The United Kingdom is one member state that has taken advantage of this rule. The principal bank regulatory authority in the United Kingdom, the Bank of England, continues the practice implemented prior to the introduction of the Basle Accord of setting a target and trigger risk asset ratio for each bank subject to its supervision.³¹ These ratios are set according to the business in which each particular bank is engaged, and the Bank of England's view of the degree of risk associated with that business.³² As a result, there is probably not a single U.K. bank whose capital/risk asset ratio requirement is eight percent; most are likely to be subject to ratio requirements of at least ten percent.

items.

25. Council Directive 93/6/EEC, 1993 O.J. (L 141) 1 [hereinafter Capital Adequacy Directive] sets capital requirements for foreign exchange risk in respect of all assets, as well as capital requirements for market risk in relation to assets in the trading book, and for underwriting and associated market-related activities.

26. See Solvency Ratio Directive, *supra* note 24, art. 10(1).

27. See Capital Adequacy Directive, *supra* note 25, art. 4. For more detailed information on the EC capital adequacy requirements, see MARC DASSESSE ET AL., *EC BANKING LAW* (2nd ed. 1994).

28. See *id.*

29. See *id.*

30. See, e.g., Solvency Ratio Directive, *supra* note 24, art. 10(2); Capital Adequacy Directive, *supra* note 25, art. 1(2).

31. See, e.g., Statement of Principles issued in May 1993 by the Bank of England pursuant to the Banking Act 1987 (on file with authors). See also Banking Coordination Regulations 1992, paras. 2.13, 2.14 and 2.15 [hereinafter Second Council Directive].

32. See *id.*

Corporate loans are relatively expensive items, in terms of capital, to hold on a bank's balance sheet, because they are risk-weighted at one hundred percent, irrespective of the actual credit quality of the counterparty. Corporate loans are more expensive to hold on the balance sheet than, for example, residential mortgage loans secured by a first ranking security interest, an asset type that is risk-weighted at fifty percent, and which has long been securitized.³³ Banks which are focused on increasing return on equity and reducing the cost of capital have been assessing the possibilities of securitizing their corporate loan book for some time. Until very recently, however, very few supervisory authorities had published the criteria that must be satisfied in order for a transfer of assets (or the credit risk associated with assets) to be treated as a clean transfer for the purposes of a bank's capital/risk asset ratio requirement. So new is this technology that securitization structures involving corporate loan assets are still reviewed on a case-by-case basis by the regulator.

A. Specific Regulatory Concerns

The complexity of a securitization structure generally depends on two factors: the complexity of the underlying assets and the complexity of the funding side of the structure. For the purposes of this Article, it is assumed that asset-backed securities are issued by a bankruptcy-remote special purpose vehicle (SPV). In a classic securitization structure, the assets to be securitized would be transferred by the originator of those assets (Originator) to the SPV pursuant to a "true sale," i.e., a sale in law that constituted a transfer of rights and property that would be upheld even if the Originator were subsequently to go bankrupt. The SPV would benefit from credit enhancement and liquidity facilities, provided either by external third parties (such as financial institutions which provide a first loss letter of credit, or short-term liquidity facilities) or from within the structure itself. Internal credit enhancement would be achieved, for example, through the issuance of subordinated classes of securities or the use of excess cash (spread) generated by the portfolio of securitized assets. Alternatively, the SPV might rely on a combination of both internal and external enhancement. In a traditional securitization structure, the SPV will not have any credit risk exposure to the

33. Basle Accord, *supra* note 3, para. 41 and Annex 2. *See also* Solvency Ratio Directive, *supra* note 24, art. 6(1)(c).

Originator, unless the Originator's own independent debt rating at least matches the debt rating of the most senior tranche of debt issued by the SPV. Traditional securitization structures such as those described above have had to be adapted to address legal and structural issues arising from corporate loan assets, as summarized below.

1. *Revolving Credits.* Corporate loan assets can take a variety of different forms. The simplest type of loan asset is a fully drawn term loan. In this type, the full amount of the debt facility is extended, the facility does not contain a revolving element that would permit the borrower to repay and request new advances, and any commitment period is ended. Absent other complicating factors (such as whether the SPV requires a license to lend to the debtor concerned), this type of corporate loan asset is relatively simple to securitize. At the other end of the spectrum are corporate loan facilities that take the form of committed, revolving lines of credit. In these cases, the unpredictability of the borrower's funding requirements must be accommodated within the SPV's own funding structure. If the SPV assumes the commitment to lend, and then finds itself unable to do so because it cannot access its own funding sources, it will be vulnerable to suits for breach of contract and to lender liability suits. On the other hand, the SPV will not wish to issue debt immediately up to the aggregate face amount of the committed lines of credit that it is funding, because the unutilized portion of the debt that it has raised (i.e., the portion retained to fund presently undrawn commitments) will not be earning interest at a rate commensurate with the SPV's own funding costs. Thus the structure will inevitably incur negative carry. This is a conundrum to which there is no definitive answer.

For the Originator, if the committed line of credit has a commitment period of more than 365 days,³⁴ that commitment will be a risk-weighted off-balance sheet item.³⁵ If the SPV agrees to assume the commitment under a participation arrangement with the Origina-

34. Both the Basle Accord and the Solvency Ratio Directive risk weight undrawn commitments with an original maturity of up to and including one year at zero percent, and undrawn commitments with an original maturity of more than one year at fifty percent. See Basle Accord, *supra* note 3, para. 42 and Annex 3; Solvency Ratio Directive, *supra* note 24, art. 6(2) and Annex I. However, the U.S. regulatory authorities differentiate between facilities with an original maturity of 364 days or less, and those of 365 days or more. This Article proceeds on the assumption that the framework of the Basle Accord or the EC Directives will apply to the risk-weighting of assets.

35. See, e.g., Basle Accord, *supra* note 3, Annex 3; Solvency Ratio Directive, *supra* note 24, arts. 6(2), 6(4) and 6(5).

tor, but does not provide cash collateral for its funding obligation, the Originator may be obliged (depending on its regulator's interpretation of the Basle Accord) to assign a risk-weighting to the commitment of the SPV, substituting this for the risk-weighting of the original counterparty. Because most SPVs are not banks or financial institutions, claims on SPVs are ordinarily risk-weighted at one hundred percent, as with any other corporate entity.³⁶ This treatment means that, in the absence of cash collateral for the SPV's funding obligation, the Originator will have the same capital/risk asset ratio requirement in respect of its commitments to lend after the securitization as it had before.

At this point, a cost/benefit analysis must be conducted to determine a number of things: the amount of committed lines of credit present in a portfolio selected for securitization; the historical use of those committed lines; and finally whether it makes more economic sense to incur negative carry at the SPV level by cash collateralizing this exposure, or to forego the better capital adequacy treatment that the Originator would achieve if the committed but undrawn facilities were fully transferred to (or cash collateralized by) the SPV. Structures have now been developed, in part relying on U.S. master trust credit card structures, that enable an SPV to issue variable tranches of debt. This permits the SPV to reduce and subsequently increase the amount of its outstanding debt as assets pay down and are then subsequently redrawn. Although this type of structure provides flexibility to the funding side of the equation, the Originator's cost of capital must still be considered if it is relying on a commitment to fund provided by an SPV.

2. *Achieving Capital Release.* The method chosen to transfer credit risk is an integral part of the transaction. The rules applied by bank regulatory authorities to determine whether a bank Originator should be permitted to release capital formerly held against assets transferred pursuant to a securitization transaction do not necessarily follow accounting rules developed for determining whether assets should be derecognized for the purpose of preparing accounts for shareholders. Thus bank regulatory authorities do not necessarily treat the consequences of a transfer of risk in the way that lawyers or auditors would. For example, banks subject to the supervision of the Office of the Comptroller of the Currency (OCC) in the United

36. See generally Basle Accord, *supra* note 3.

States are required to account for the sale of financial assets in accordance with U.S. Generally Accepted Accounting Principles (GAAP). The previously applied Regulatory Accounting Principles (RAPs) were discontinued in the first quarter of 1997, following the adoption of Financial Accounting Standard (FAS) No. 125.³⁷ However, the OCC Guidelines are still categorical in stating separate rules for determining whether a sale of financial assets will be effective to relieve a reporting institution from its capital requirement associated with that asset.³⁸ In general, no asset sale will qualify for capital relief unless it complies with FAS 125,³⁹ but an asset sale, even if it complies with FAS 125, will not be treated as derecognized for regulatory capital purposes unless it is clear that (except for a very limited number of exceptions) the selling institution has retained no recourse whatsoever in relation to the assets transferred.⁴⁰

To take another example, the accounting rules for the derecognition of the sale of financial assets by companies incorporated in the United Kingdom are set out in Financial Reporting Standard (FRS) 5.⁴¹ FRS 5 specifies three different methods of accounting for sale:

37. See Federal Financial Institutions Examination Council Press Release, Nov. 3, 1995, reprinted in 61 Fed. Reg. 48,687 (1996).

38. See OFF. OF THE COMPTROLLER OF THE CURRENCY, OCC HANDBOOK ON ASSET SECURITIZATION 59 (1997).

39. See FASB STATEMENT OF STANDARDS, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, Statement of Financial Accounting Standards No. 125, June 1996, at 7067. Among the requirements necessary under FAS 125 to achieve sale treatment is the delivery by counsel for the selling institution of an opinion letter stating that the transfers constitute a sale of the underlying loans rather than a secured loan and, as such, such loans would not constitute property of the selling institution's estate for purposes of Section 541 of the Bankruptcy Code, as amended, 11 U.S.C. § 101 et seq. (1983) [hereinafter Bankruptcy Code]. Section 109 of the Bankruptcy Code exempts banks, including U.S. branches of foreign banks, from the provisions of the Bankruptcy Code. Therefore, there may be circumstances under which a sale opinion may not be necessary to achieve FAS 125 treatment. As more fully described below, the reported decisional authority is not conclusive as to the relative weight to be accorded to various sale elements present in a transaction. Furthermore, the results reached in certain cases addressing true sale matters may be inconsistent, principally because the legal analysis is so dependent upon the facts and circumstances of a particular case. Accordingly, opinions delivered under FAS 125 are typically reasoned opinions that caution the recipient that the conclusions expressed therein are not predictions of what a particular court would hold.

40. See generally OFF. OF THE COMPTROLLER OF THE CURRENCY, *supra* note 38. FAS 125 permits a certain degree of recourse, without disqualifying the sale for accounting purposes.

41. See U.K. FIN. REPORTING STANDARD 5 [hereinafter FRS 5] (on file with the *Duke Journal of Comparative & International Law*).

full derecognition of assets;⁴² linked presentation;⁴³ and sales which re not derecognized or delinked for accounting purposes, because the selling institution retains too much recourse or involvement in the assets.⁴⁴ FRS 5 will apply to banks incorporated in the United Kingdom, inasmuch as it concerns the preparation of annual accounts required under U.K. company law legislation (principally, the Companies Act of 1985⁴⁵). The Bank of England, however, applies its own rules to determine whether or not capital should be released.⁴⁶ More often than not, if one looks at the statutory accounts prepared by U.K. banks that have securitized their assets, one will find a linked presentation for U.K. accounting purposes.⁴⁷ This notwithstanding, the Bank of England will permit those banks to release the capital previously held against such securitized assets.

The different approaches taken by regulators and accountants or auditors is borne of the different functions each undertakes. Regulators are concerned with the risk, primarily credit risk, associated with loan assets. Accountants and auditors, however, seek to identify not only the risk associated with carrying assets but also the value of the assets and the benefits associated with the assets. They seek to ensure that the statutory accounts provide a true and fair view of the

42. In which case there will be no recourse available to the selling institution following the transfer of the asset.

43. In which the selling institution has retained some recourse or some benefits in the transferred assets, which will result in a requirement to report the entire transaction in gross and net terms on its balance sheet.

44. See generally FRS 5, *supra* note 41.

45. See generally Companies Act, 1985 (Eng.).

46. See BANK OF ENGLAND NOTICES BSD/1989/1, BSD/1992/3 and S&S/1996/8. Note that in January 1998 the Bank of England's Supervision and Surveillance Division issued a consultation document entitled *Amendments to Policy on Loan Transfers and Securitization* [hereinafter the Consultation Document], which seeks to restate and clarify the Bank's current policy in relation to loan transfers and securitization (on file with the *Duke Journal of Comparative & International Law*). The Notice to be issued by the Bank of England after completion of the consultation period will consolidate and amplify Notices BSD/1989/1, BSD/1992/3 (Part C of which has already been repealed by Notice S&S/1996/8) and S&S/1996/8. The Consultation Document contains more specific guidance on the regulator's approach to the provision, and risk weighting, of credit enhancement and liquidity facilities provided to SPVs by originating banks, and on specific issues arising from revolving purchase structures. The Consultation Document was sent to a relatively restricted group of recipients, principally to authorized institutions under the U.K. Banking Act of 1987 who are already actively involved in securitized products, either as originators or as the providers of third party credit enhancement and liquidity facilities. References in this Article to the Bank of England's policies relating to securitization are to its existing policies published in Notices BSD/1989/1, BSD/1992/3 and S&S/1996/8, unless otherwise stated.

47. See generally FRS 5, *supra* note 41.

overall financial condition of the owner of the assets. Thus, retained rights such as servicing revenue, swap fees or excess profit fees should be represented within the statutory accounts; and the assets giving rise to these revenues should be recognized. For a bank regulator, on the other hand, once credit risk has been removed from an asset, there is no need to insist on the Originator bank holding capital against a non-existent risk.⁴⁸ The approach taken by the regulatory authorities has permitted those who structure securitization transactions to exercise more latitude in developing the legal structures, a topic dealt with below.

3. *Moral Hazard.* One of the principal concerns of bank regulators around the world who have examined securitization structures is the question of moral hazard. A bank may transfer the credit risk associated with an asset, but will almost always retain servicing rights and remain as the principal point of contact for borrowers. In most securitization structures, borrowers are not aware that their loan has been transferred to an SPV; in some structures, there is not even a true sale of the loan asset.

The regulators' concern is that a bank will feel obliged to step in and assume responsibility for an asset or customer relationship, notwithstanding the transfer of risk achieved through the securitization. This risk may arise in a number of different circumstances. For instance, a borrower may default and, in order to protect future customer relationships, the Originator would repurchase the defaulted asset, rather than leave the SPV to pursue its own remedies. The Originator will be aware that an SPV will have a relatively rigid funding structure, and will be less able to exercise discretion in favor of defaulting borrowers than the Originator.⁴⁹ Alternatively, the Originator may step in to protect investors in securities issued by the SPV if default levels on the underlying assets prove to be higher than expected. An Originator would probably only undertake such extreme measures if it was concerned that the SPV's failure to meet its liabilities would impact its own reputation. Such action would, however, undermine the objectives of securitization.⁵⁰

48. See generally Basle Accord, *supra* note 3.

49. See, e.g., Steven L. Schwarcz, *Structured Finance: The New Way to Securitise Assets*, 11 CARDOZO L. REV. 607 (1990).

50. Reputation risk is one of a number of risks identified by the Office of the Comptroller of the Currency in the OCC BULLETIN ON SECURITIZATION, OCC 96-52, Sept. 25, 1996. This OCC Bulletin highlights the principal risks that originating banks which use securitization as a

Bank regulators, including the OCC, the Bank of England and the Dutch and German regulatory authorities, are all clear in their insistence on ensuring that originating banks divorce themselves completely from the securitization SPVs.⁵¹ Most regulatory authorities will not permit originating banks to own any shares or other proprietary or capital interests in such SPVs.⁵² Additionally, SPVs are prohibited from having names that imply a relationship with the Originator of the assets they purchase, and there are strict limits on the type of facility an Originator may provide to an SPV.⁵³ For example, both the British and the German regulators restrict the types of credit enhancement that may be provided by an Originator to subordinated debt subscribed for at the closing of the first issuance of securities, as well as on terms that the debt cannot be redeemed until all other debt in the structure has paid out.⁵⁴

On the other hand, bank regulators and Originators will wish to ensure that there is as little disruption as possible in the banker-customer relationship. The banker-customer relationship gives rise

funding strategy should identify and manage, including reputation risk, strategic risk (banks should compare the strategic and financial objectives that securitization will achieve to the various risk exposures and resource requirements inherent in this form of financing), credit risk (which should be transferred, but because the performance of securitized portfolios is public information, securitization has the potential to highlight problems previously hidden by overall portfolio performance), transaction risk (servicer/originators should ensure that they understand, and have the systems and internal controls necessary to cope with, securitization structures), liquidity risk and compliance risk. See also BANK OF ENGLAND, NOTICE ON LOAN TRANSFERS AND SECURITIZATION, BSD/1989/1, paras. 10-13, and the requirements specified in para. 14; and BANK OF ENGLAND, SECURITIZATION OF REVOLVING CREDITS, S&S/1996/8, which replaced Part C of Notice BSD/1992/3.

51. See BANK OF ENGLAND NOTICES, *supra* note 46. See also BUNDESAUFSICHSAMPT FÜR DAS KREDITWESEN, CIRCULAR LETTER 04/97, May 1997 [hereinafter BAK CIRCULAR]; DE NEDERLANDSCHE BANK, MEMORANDUM ON SECURITIZATION AND SUPERVISION, Sept. 25, 1997, paras. II.2 and IV.2, and app. 2 [hereinafter DNB MEMORANDUM].

52. See, e.g., BANK OF ENGLAND NOTICE BSD/1989/1, *supra* note 46, para. 14(ix); BAK CIRCULAR, *supra* note 51, para. 7; DNB MEMORANDUM, *supra* note 51, app. 2, para. 7 under the heading "Conditions to be Met by a Bank acting as Originator." Note that the *DNB Memorandum* specifically provides for Dutch banks to incorporate SPV subsidiaries for the purpose of undertaking securitization transactions: see paras. III.2.4 and IV.3 of the memorandum. Such a structure is likely to result, however, in the SPV subsidiary being included in the parent bank's consolidated capital return, and thus although capital may be released on a solo accounts basis the parent credit institution will not achieve any release of capital at the consolidated accounts level.

53. See, e.g., BANK OF ENGLAND NOTICE BSD/1989/1, *supra* note 46, para. 14(xi), (xii) and (xiv); BAK CIRCULAR, *supra* note 51, art. I, paras. 5 and 7; DNB MEMORANDUM, *supra* note 51, app. 2, paras. 8 and 10.

54. See BANK OF ENGLAND NOTICE BSD/1989/1, *supra* note 46, para. 14(xii). See also BAK CIRCULAR, *supra* note 51, art. I, para. 5.

to unique legal issues, which are more fully addressed later in this Article. Bank regulators will seek to ensure that any bank asset securitization causes neither a breach of any of the bank's legal duties to its customer (such as the banker's duty of confidentiality) nor any unreasonable disruption in the banker-customer relationship from a commercial perspective.⁵⁵

4. *Banker-Customer Relationship.* The banker-customer relationship and the specter of moral hazard takes on particular importance in the regulatory treatment of securitizations of uncommitted lines of credit.⁵⁶ On the one hand, it might be argued that such facilities are relatively easy to securitize because undrawn amounts under uncommitted lines of credit, and commitments with a tenor of 365 days or less, have a credit conversion factor of zero percent; thus they incur no capital cost.⁵⁷ Once drawn, the resultant loan asset will be risk-weighted at one hundred percent, as with other corporate credits. Since there is no capital cost so long as the facility is undrawn, the structure does not have to address the complicated funding and cash collateralization issues alluded to above. Furthermore, because the facilities are uncommitted, or committed only for short time periods, it is simple (theoretically) to terminate the credit line or to wind down the commitment once the time comes for the SPV to amortize and pay down its debt.

The reality is somewhat different, however, primarily because the funding sources of an SPV are relatively rigid. Although revolving assets are securitized, and revolving structures have been developed to permit an SPV to use collections on securitized assets to purchase or fund additional assets or new drawings under existing assets, these structures all eventually enter a wind-down or amortization period.⁵⁸ A bank will not wish to prejudice a corporate relationship by permitting an SPV to make a demand under an overdraft facility simply because the SPV needs to pay down its own debt. As with credit card facilities (which have no stated maturity), a bank Originator will wish to continue to fund these facilities. Such additional

55. See e.g., BAK CIRCULAR, *supra* note 51, art. III.

56. Such as money market lines or overdraft facilities, as well as committed short-term lines of credit that are habitually renewed.

57. See Basle Accord, *supra* note 3, para. 42(d) and Annex 3. See also Solvency Ratio Directive, *supra* note 24, Art. 6(2) and Annex I.

58. During this wind down period all collections are applied in the repayment of the SPV's debt, and cannot be used to fund new assets or existing assets in the portfolio.

funding can come only through a new securitization of the asset in question, or by the Originator reacquiring either the asset or the responsibility for funding the asset. In a U.S. master trust structure, the latter can be achieved by an increase in the seller interest in the trust.

An Originator may incur significant liquidity and capital adequacy liabilities if large numbers of such assets start returning to its balance sheet within a relatively short time period.⁵⁹ In addition, regulators have expressed their concern that the Originator not unwittingly provide credit enhancement to the SPV during any wind-down period by an indiscriminate application of collections. Thus, if both the SPV and the Originator are funding a particular asset, in different proportions, incoming collections should be applied to the Originator and the SPV in the appropriate proportion, rather than all being paid first to the SPV until its interest is reduced to zero.⁶⁰ This requirement can result in complex systems necessary to trace the appropriate allocations.

5. *Cherry Picking and Lemon Selling.* Regulators have voiced concern that banks are securitizing their best assets, or to put it another way, that they are cherry picking the portfolios identified for securitization. This will cause concern for a number of reasons. The minimum capital/risk asset ratio of eight percent, established by the Basle Accord and the EC Directives on capital adequacy requirements for credit and financial institutions, assumes a diversification of assets within a bank's overall portfolio. This is based upon four elements: industry diversification; diversification by the country of the borrower; diversification by economic sectors; and diversification in the types of borrower and credit facility. Without this diversification, it must be assumed that the minimum eight percent requirement would be significantly higher.

On the other hand, neither the Basle Accord nor the EC Directives apply any type of methodology to measure the credit risk associated with a corporate loan asset, other than to assume the worst and apply a one hundred percent risk-weighting to all such assets. Notwithstanding the simplistic approach to risk-weighting, some regulatory authorities (such as the German supervisory authority) have indicated in their guidelines for securitization that banks must choose

59. See generally Basle Accord, *supra* note 3.

60. See, e.g., OCC BULLETIN 96-52, *supra* note 50. See also BANK OF ENGLAND NOTICE S&S/1996/8, *supra* note 46.

assets for securitization on a random basis. Furthermore, if the remaining assets show a material deterioration in credit quality from the bank's asset profile pre-securitization, a bank may be subject to "exceptional circumstances" under the German regulatory rules (which gives the regulator a right to deviate from the general eight percent capital/risk asset ratio requirement).⁶¹ Additionally, the auditors of German banks are required to indicate in their annual report to the regulators whether the remaining asset portfolio of a bank has deteriorated "as a consequence of any asset backed security (ABS) transaction."⁶² This in itself is a difficult issue for any auditor to gauge, not least because the credit quality of a bank's remaining assets may deteriorate for reasons wholly unconnected with securitization, and the credit quality of the securitized assets themselves may decline post-securitization as a result of changes in both macro- and micro-economic conditions. Nor is it entirely clear how credit quality is to be determined for these purposes: Is a bank supposed to weight its asset portfolio on the basis of its own internal credit-scoring methodology, or is it supposed to track only defaults on remaining assets and compare these defaults to historical data?

The approach taken on the issue of cherry picking and its corollary, lemon selling (whereby the Originator deliberately sells non-performing or less credit-worthy assets), by regulators with more experience of securitization is less formalistic. Neither the Bank of England nor the OCC impose strict limitations or restrictions on the selection of assets for inclusion within a securitization portfolio.⁶³ To the extent that certain asset types are homogenous, such as credit card receivables, assets should generally be chosen at random from within a bank's overall portfolio.⁶⁴ Corporate loan assets, however,

61. See BAK CIRCULAR, *supra* note 51, art. II.

62. See *id.* art. IV.

63. See *e.g.*, Federal Reserve System, Supervision and Regulation, Task Force on Securitization, AN INTRODUCTION TO ASSET SECURITIZATION (1990). See also BANK OF ENGLAND NOTICE S&S/1996/8, *supra* note 45.

64. See, *e.g.*, BANK OF ENGLAND NOTICE S&S/1996/8, *supra* note 46, para. 11. Random selection of assets such as credit card receivables is required in this instance to ensure that, among other things, there is no systematic selection of higher quality assets for inclusion in the securitization pool, to the benefit of the investor interest in the pool and the relative detriment of the Originator's seller interest. However, securitization pools of credit card receivables generally comprise thousands of credit card accounts, each giving rise to receivables of a relatively small amount, originated in accordance with standard credit underwriting procedures and standard documentation. It should be relatively simple to select assets bearing such homogenous characteristics on a random basis. See also Consultation Document, *supra* note 46, sec. 5, para.

are far from homogenous; corporate borrowers have credit profiles that differ markedly from each other, depending on the structure of their capital base, the markets in which they operate, their gearing (or ratio of debt to equity), the jurisdiction in which they are incorporated, and other factors.⁶⁵ Furthermore, loan documentation is likely to have been the subject of negotiation. It is far more likely that individual and extensive credit assessments have been carried out on corporate borrowers than on consumers applying for volume products such as mortgage loans or credit cards; thus it is easier to identify the best and the worst credits and to produce a more systematic evaluation of the Originator's own credit-underwriting systems.⁶⁶

The best corporate credits (in terms of risk profile) may be excluded in any event from a securitization portfolio because their high credit-worthiness is reflected in a low interest rate that falls below the threshold rate that the SPV requires in order to meet its own funding costs. However, the regulatory authorities in the United States and the United Kingdom generally recognize that, at least initially, banks will seek to identify good assets for their securitization programs, since they want to ensure their ability to access the capital markets. If their securitized assets fail to perform as expected, investors will shy away from asset-backed securities originated by them. This in itself is perceived by the regulators to be an incentive to originating banks to ensure that standards of origination and credit underwriting do not decline once banks begin to securitize their assets.⁶⁷

Regulators in both the United States and United Kingdom also recognize that if banks retain only those assets that do not perform well, this approach will rebound on them in at least three ways. First,

5.2.3, which addresses issues arising from asset replenishment in a securitization structure. Two of the criteria listed as required to be satisfied if additional assets are added to a securitization are (a) that the asset quality of the pool is not materially altered by the addition of further tranches of assets to the securitization pool, and (b) that any change to the quality of the assets remaining with the originating bank is either not material or is acceptable to the Bank of England. The test of material alteration of the quality of the asset pool is to be applied to the quality of the asset pool at the time of the proposed addition of assets, not the quality of the pool at the time of the original securitization, thus preventing originating banks from shoring up the quality of securitized assets of deteriorating credit quality with the addition of new, better quality assets. As discussed in the text above, the Bank of England may use its general supervisory powers to discourage banks from securitizing only their best assets. *See also* Consultation Document, *supra* note 46, sec. 3, para. 3.5, regarding the implications of a securitization on the profile of a bank's remaining assets, in terms of both quality and spread.

65. *See* Basle Accord, *supra* note 3, sec. 1.

66. *See id.*

67. *See* OCC BULLETIN 96-52, *supra* note 50.

the Originator's capital/risk asset ratio requirement is likely to be raised, in line with the perceived increase in credit risk with respect to the remaining assets and other risks incidental to a securitization program.⁶⁸ Second, if assets start to default, the Originator will have to set aside specific provisions; unlike general provisions, specific provisions do not count as Tier 1 capital. The result will be that a bank's qualifying capital will fall at the same time as its capital/risk asset ratio requirement is rising, which would be counter-productive for any bank engaging in securitization. Third, the retention of poorly-performing assets is likely to have an impact on a bank's overall profitability, as earnings will be reduced.⁶⁹

6. *Liquidity Facilities and Large Exposures.* As mentioned above, in order to address both credit concerns and concerns regarding moral hazard, the types of credit enhancement that a bank Originator may provide to an SPV acquiring assets that it has originated are generally very limited. Pure credit enhancement provided to an SPV by a bank originator is required to be deducted on a one-for-one basis from the total qualifying Tier 1 and Tier 2 capital.⁷⁰ On the other hand, interest rate and foreign exchange contracts may generally be entered into between a bank originator and an SPV to which the bank has sold loan assets, provided that the swap contracts are concluded at arm's length and at market prices.⁷¹

Some corporate loan securitization structures rely, in addition, on the provision of liquidity facilities to the SPV, particularly in connection with variable funding arrangements extended to the SPV. Different regulatory authorities have taken different approaches to formulating policies relating to the provision of liquidity facilities to SPVs. The Bank of England, for example, prohibits Originators from providing liquidity facilities to SPVs that have previously purchased their assets.⁷² Banks authorized by the Bank of England may, how-

68. See, e.g., Consultation Document, *supra* note 46, sec. 3, para.3.3, regarding the impact of operational risks on the setting of a bank's trigger capital ratio.

69. See *id.* para. 3.5.

70. See, e.g., BANK OF ENGLAND NOTICE BSD/1989/1, *supra* note 46, para. 14(xii); BAK CIRCULAR, *supra* note 46, art. I, para. 5, and DNB MEMORANDUM, *supra* note 46, app. 2.

71. See, e.g., BANK OF ENGLAND NOTICE BSD/1989/1, *supra* note 46, para. 14 (xiii), and DNB MEMORANDUM, *supra* note 46 app. 2.

72. See BANK OF ENGLAND NOTICE BSD/1989/1, *supra* note 46, para. 14 and the clarifying statements in the Consultation Document, *supra* note 46, sec. 6.3.3, stating that an "originator or servicing agent may not provide a liquidity facility as it is deemed to be funding. If it does, it is deemed not to have achieved a clean break with the assets, which will then be taken on its

ever, provide liquidity facilities to securitization SPVs which purchase assets originated by third party banks. The Dutch Central Bank, on the other hand, does not in practice prohibit the provision of liquidity facilities by originator banks.⁷³ Such liquidity facilities may be acceptable to U.S. regulators, but the analysis is heavily dependent upon the particular facts and circumstances relating to the individual SPV.

Liquidity facilities, particularly those granted in support of commercial paper (CP) programs, are generally provided in the form of a committed line of credit with a tenor of 364 days or less,⁷⁴ and are risk-weighted at zero percent. However, this risk-weighting assumes that the providers of the facility are not providing *de facto* credit enhancement.⁷⁵ Thus any liquidity facility must be true liquidity and not trick liquidity,⁷⁶ and as such should cover only short term funding needs, and not bear any of the credit risk associated with the non-performance of the underlying assets. Banks providing such facilities should ensure that the facilities granted do not breach other regulatory requirements, such as large exposure limits on single counterparties. For example, a number of bank Originators have securitized their loan assets by selling participations or assignments to SPVs, which have then raised debt by issuing commercial paper (thus arbitraging between the interest rate payable on short term CP and the interest earned on longer-dated assets). In order to protect the hold-

balance sheet." There is an exception for provisions of liquidity facilities to cover very short timing differences.

73. See DNB MEMORANDUM, *supra* note 46, app. 2, which contains no express prohibition against the provision of liquidity.

74. See Basle Accord, *supra* note 3, Annex 3, and the Solvency Ratio Directive, *supra* note 24, art. 6(2) and Annex I. Off-balance sheet commitments which, in fact, operate as direct credit substitutes are required to be assigned a credit conversion factor of one hundred percent.

75. See *id.*

76. The availability of liquidity facilities provided in connection with the issuance of commercial paper by an SPV is determined by reference to an SPV's borrowing base. The borrowing base should represent the aggregate amount of performing (non-defaulted) assets in the SPV's receivables portfolio at the time the facility is drawn. The restriction on the availability of funds is intended to ensure that banks providing liquidity are not also assuming credit risk on the portfolio, hence they will lend only up to the amount that will ultimately be received by the SPV as the performing assets pay out. Liquidity facilities which in fact import credit risk on the liquidity banks are referred to as trick liquidity, and should carry a higher credit conversion factor for risk asset weighting purposes than true liquidity, because they operate, in effect, as direct credit substitutes. Trick liquidity is usually achieved by adjusting the dates at which receivables are deemed to have become delinquent, defaulted or written off (and thus excluded from the definition of borrowing base) to dates which fall a relatively long period after the contractual due date for payment on the receivables.

ers of the CP, and to protect the SPV generally from this structural mismatch between the tenors of its assets and liabilities, standby liquidity facilities are provided to the SPV. Such facilities must be, in an aggregate amount, at least equal to the aggregate amount of CP in issuance, plus a small amount to cover accrued interest or accreted discount. In the past couple of years, billions of dollars of CP have been issued in this manner, backed by corporate loan assets. This must mean that banks have booked billions of dollars of liquidity commitments.

Although liquidity facilities are usually granted for a period of 364 days or fewer, to avoid a capital charge on the commitment, the large exposure rules will still apply to these commitments. A bank incorporated in a member state of the European Union, for instance, should not incur an exposure of greater than ten percent of its qualifying (Tier 1 plus Tier 2) capital base to any counterparty or group of connected counterparties.⁷⁷ The sheer size of the liquidity facilities backing CP issuance will require either that liquidity facilities be syndicated, or alternatively, that banks providing liquidity facilities persuade their regulators that they should be permitted to look through the SPV to the underlying corporate credits when dealing with large exposures. If the latter approach is taken, the Originator's reporting and risk management systems would have to be amended to ensure that they encapsulate the underlying corporate risks. However, it is unlikely that such an approach would be agreed upon. Third party liquidity providers are unlikely to know the identity of the borrowers included in the securitized pool.⁷⁸

7. *Which Regulator?* By which supervisory rules is the Originator bound? This is a question that arises in all cross-border securitizations of bank assets. Within the European Union, the answer is relatively simple when dealing with credit institutions incorporated in a member state. The principles of harmonization of minimum regulatory requirements, recognition of supervisory standards, and the concept of home country supervision, mean that a bank incorporated in any member state of the EU need be concerned only with the regulatory and supervisory standards of its home supervisory authority.⁷⁹ Host member states, in which the credit

77. See Council Directive 92/121/EEC, 1992 O.J. (L 29) 1.

78. See discussion *infra* Part III.

79. See Council Directive 89/646/EEC, 1989 O.J. (L 386) 1, art. 14 and tit. V.

institution may have branches, or may offer cross-border services, generally have very little authority over credit institutions incorporated elsewhere in the EU. They do, however, retain the responsibility, in cooperation with the supervisory authority in the home member state, for the supervision of the liquidity of local branches within their territory.⁸⁰ This right could be important in the context of a securitization.

Elsewhere in the world, regulators may take markedly different approaches. In general, a bank Originator will always have to comply with the regulatory and accounting requirements established by its jurisdiction of incorporation. Some jurisdictions will also allow branches of foreign banks to apply the rules of their home jurisdiction to determine whether or not capital release is obtained.⁸¹ Others insist that local rules must be satisfied in addition to the rules of the home jurisdiction.⁸² Compliance with local rules on bank secrecy and banker-customer relationships is also typically required. In the United States, foreign banks that do not take deposits within the United States, and which are not, therefore, subject to oversight by the FDIC, may generally apply the rules of their home jurisdiction.⁸³

In addition to the requirements of local regulators, the legal advisors to any transaction involving the securitization of corporate loans originated by branches of a bank situated outside its jurisdiction of incorporation must consider the impact of bankruptcy or insolvency laws in two jurisdictions: that in which the branches are located, and the bank's jurisdiction of incorporation.⁸⁴

III. SALES OF LOAN ASSETS

There are three methods by which a loan asset may be "sold" to achieve release of regulatory capital. The three methods are novation, assignment and participation. Each of these three methods is briefly described below.

80. *See id.*

81. *See id.*

82. *See id.*

83. *See e.g.*, 12 C.F.R. pt. 28; 12 C.F.R. pt. 211.

84. The analysis of the impact of cross-border insolvency laws is beyond the scope of this Article, but a good understanding of the issues concerned is imperative to structuring a successful CLO transaction. For a comprehensive analysis on this subject, see 6A NORTON BANKR. L. & PRAC. 2d §152 (1998).

A. Novation

Novation is the “cleanest” method of transfer of a loan asset and—under English law at least—it is the only means by which obligations may be transferred. In the context of loan securitization, novation is the only sure method to transfer an ongoing commitment.⁸⁵ In this context, a novation involves a tripartite arrangement whereby the two parties to an original contract, the Originator and the debtor, agree with a SPV that the SPV shall become a substitute for the Originator, and thus assume the Originator’s rights and obligations under the original contract.⁸⁶ This substitution process results in the termination of the original contract, and in the creation of a new contract between the SPV and the debtor. It is imperative, therefore, that the debtor consents to any such arrangement, and that there is adequate consideration for the new contract between the SPV and the debtor.⁸⁷

While from a legal perspective novation represents the cleanest form of transfer, there are a number of legal and practical reasons why novation is rarely used in securitization transactions. First, banks generally do not want their customers to know that they are securitizing their assets. A requirement to obtain the customer’s consent to the transfer would defeat this objective; many customers are likely to object in any event—particularly those with ongoing funding requirements and concerns about the SPV’s ability to fund such requirements in a timely manner. Second, if the loan asset is secured by collateral, the novation terminates the original security interest, which must be replaced by a new security interest. The result would be the same if the facility was guaranteed because a novation extinguishes the original contract between the Originator and the debtor and replaces it with a new contract between the SPV and the debtor. Since a novation extinguishes the original contract, it must also *ipso facto* extinguish any security or guarantee for that security. As a result, it may be necessary to make additional filings to perfect the new security interest.⁸⁸ In addition, avoidance periods will start to run again.⁸⁹ If the avoidance periods do start to run again, the asset or se-

85. See NOTICE BSD/1989/1, *supra* note 46 & Annex.

86. See, e.g., The Aktion [1987] 1 Lloyd’s Rep. 283, 310-311(Q.B). On the issue of consideration, see *Tatlock v. Harris*, 100 Eng. Rep. 517, 520 (K.B. 1789).

87. *Id.*

88. See, e.g., U.C.C. Art. 9 (1994); Companies Act, 1985, ch. 6 § 395 (Eng.)

89. See, e.g., Insolvency Act, 1986, ch. 45 §§ 238-245 (Eng.); 11 U.S.C. § 547 (1994).

curity for the asset may become vulnerable to challenge if the debtor becomes subject to bankruptcy or other insolvency proceedings.

B. Assignment

Under English law, there are two methods by which a debt or other chose in action may be assigned: legal assignment and equitable assignment.⁹⁰ A legal assignment is an assignment that satisfies the criteria of Section 136 of the 1925 Law of Property Act, namely that the assignment (i) is an absolute assignment (i.e., not purported to be by way of charge only), (ii) is in writing, (iii) is of the whole of the debt,⁹¹ and (iv) is notified expressly in writing to the underlying debtor.⁹² Any assignment that does not satisfy all four criteria of Section 136 will generally be given effect as an equitable assignment.⁹³

An assignment, whether legal or equitable, operates under English law to transfer a proprietary interest in the asset in question. A legal assignment operates from the date on which notice is given to the underlying debtor to transfer: 1) the legal right to the debt; 2) the

90. Contractual rights, being choses in action as opposed to things in possession, were not assignable at common law without the consent of both parties to the original contract. The courts of equity, however, did give effect to assignments of choses in action. Perhaps the most significant feature of the division between the English courts of law (i.e., common law) and equity was the almost complete refusal by the courts of law to recognize that equitable rights, titles and interests entitled their holders to any relief at law. Each system, law or equity, devised its own procedural rules and remedies, resulting in substantive differences in the approaches of the two jurisdictions. For a discussion of the history of the divisions between and subsequent fusion of the courts of common law and equity, see R.P. MEAGHER ET AL., *EQUITY: DOCTRINES AND REMEDIES* 36-41 (3d ed. 1992). Section 16 of the Judicature Act of 1873 fused the administration of law and equity, and brought both within the jurisdiction of the new High Court of Justice. In addition, and pertinent to this Article, general statutory provision was made for the first time, by Section 25(6) of the Judicature Act, for the assignment of choses in action. *See id.* Section 25(6) of the 1873 Act was repealed, and was substantially re-enacted by the provisions of section 136 of the 1925 Law of Property Act. *See Law of Property Act, 1925, 15 & 16 Geo. 5, ch. 20, § 136 (Eng.)*. Thus, "legal assignments" are also frequently referred to as "statutory assignments," in recognition of the fact that under the common law it was not possible to assign a chose in action without obtaining consent, and the void created by the common law was required to be filled by express statutory provision.

91. The requirement that a statutory assignment be an assignment of the whole debt or chose in action in question is an aspect of the requirement under section 136 of the 1925 Law of Property Act that the assignment be "absolute." *See, e.g., Jones v. Humphrey* [1902] 1 K.B. 10 (1901); *Forster v. Baker* [1910] 2 K.B. 636 (C.A.); *In re Steel Wing Co., Ltd.* [1921] 1 Ch. 349 (1920); *Walter and Sullivan Ltd. v. Murphy & Sons Ltd.* [1955] 2 Q.B. 584 (C.A.).

92. *See Law of Property Act, 1925, 15 & 16 Geo. 5, ch. 20, § 136 (Eng.)*.

93. Difficult, and as yet unresolved, issues may arise as to whether consideration is necessary for the effectiveness of an equitable assignment. However, these issues are beyond the scope of this Article.

legal and other remedies for the same; and 3) the power for the assignee to give a good discharge for the debt without the concurrence of the assignor.⁹⁴ An equitable assignment, however, will operate to transfer only the beneficial interest in the asset, and legal title will remain with the assignor.⁹⁵ A transfer pursuant to an equitable assignment results in some procedural inconvenience, because under English law and rules of procedure the holder of the equitable title generally may not sue on the asset.⁹⁶ Instead, the holder of the equitable title must join the owner of the legal title.⁹⁷ Joining the owner of the legal title may be done with the owner's consent, in which case the owner will be joined as a co-plaintiff to the proceedings; however, it may also be done without the owner's consent, in which case the owner is joined as a co-defendant.⁹⁸

An assignment under English law operates only to transfer *rights* in assets; it is not possible to "assign" obligations without obtaining the consent of the debtor⁹⁹—notwithstanding the frequency with which this rule is misunderstood.¹⁰⁰ In the context of a corporate loans securitization, therefore, only the rights under existing loan assets are capable of assignment; obligations to fund undrawn commitments cannot be "assigned" and must be transferred by another means. To date, such commitments have been transferred under participation structures rather than by novation.

When loan asset assignments are structured under English law, the method of assignment used will be equitable assignment. An equitable assignment is used principally because the Originator will not want its customers to be aware of the securitization of their assets. Banks that have a significant connection with the United Kingdom

94. See Law of Property Act, 1925, 15 & 16 Geo. 5, ch. 20, § 136 (Eng.).

95. See, e.g., *Holroyd v. Marshall*, 11 Eng. Rep. 999 (H.L. 1862); *Tailby v. Official Receiver*, 13 App. Cas. 523 (1888) (appeal taken from Eng.). As to the capacity in which the assignor holds the legal title, see for example, *Howard v. Miller*, 1915 App. Cas. 318 (P.C. 1914) (appeal taken from Can.).

96. See *Durham Bros. v. Robertson* [1898] 1 Q.B. 765 (C.A.). But see *William Brandt's Sons & Co. v. Dunlop Rubber Co., Ltd.*, 1905 App.Cas. 454 (appeal taken from Eng.). See also *The Aiolos* [1983] 2 Lloyd's Rep 25, 33-34 (C.A.).

97. See cases cited *supra* note 96.

98. See *id.* See also R. SUP. CT, Order 15, r. 6.

99. Thereby effecting a novation.

100. See *Tolhurst v. Associated Portland Cement Mfrs. (1900) Ltd.* [1902] 2 K.B. 660 (C.A.). In particular, note the speech of Lord Collins, M.R. See *id.* at 668 ("Neither at law nor in equity could the burden of a contract be shifted off the shoulders of a contractor on to those of another without the consent of the contractee.").

will avoid legal assignments for another reason: documents evidencing the conveyance of choses in action are stampable at an ad valorem rate under the Stamp Act of 1891 unless the documents fall within a statutory exemption.¹⁰¹ Since a legal assignment must be evidenced by a document, such a document will almost always be stampable if brought into the United Kingdom. In addition, the language of any notice of an assignment that is sent to debtors must be carefully drafted. The notice may itself constitute written evidence of the transfer of a proprietary interest, and thus be a stampable instrument.¹⁰² If the underlying debtors are not informed of the transfer of the assets in question, the securitization structure will carry additional legal risks. These risks tend to be prevalent in all common and civil law jurisdictions. An example of such a risk is that as long as debtors have not received a notice of the assignment, debtors may continue to pay the Originator, and receive a good discharge of their debt.¹⁰³ So, if a debtor pays an Originator which becomes insolvent immediately after receiving the payment and prior to paying the SPV, the SPV will have no recourse against the debtor.¹⁰⁴ The SPV must then either claim that the Originator received the payment in trust for the SPV,¹⁰⁵ or it must claim against the Originator's estate, in common with other creditors.¹⁰⁶ There are also risks regarding proprietary interests. As previously indicated, an assignment should operate to transfer a proprietary right in the debt and the proceeds of the debt. This proprietary right may be lost, however, if the SPV permits the Originator to commingle the proceeds of the SPV's assets with its own assets or to treat the SPV's cash as fungible with its own. In such cases, a debtor-creditor relationship is likely to arise between

101. See *English, Scottish and Australian Bank Ltd. v. Commissioners of Inland Revenue*, 1932 App. Cas. 238. (1931) (appeal taken from Eng.).

102. An instrument that is stampable under the Stamp Act, and which has not been stamped with the appropriate duty, is inadmissible in evidence in any English civil court proceeding. See Stamp Act, 1891, 54 & 55 Vict., ch. 39, § 14(4) (Eng.). However, the failure to stamp a stampable instrument does not have any effect on the validity of the instrument as between the parties thereto.

103. See Law of Property Act, 1925, 15 & 16 Geo. 5, ch. 20, § 136 (Eng.). For equitable assignments, see *Stocks v. Dobson*, 43 Eng. Rep. 411 (Ch. App. 1853).

104. See sources cited *supra* note 103.

105. Applicable to those jurisdictions that recognize the concept of trust, and thus trace its entitlement outside the Originator's bankruptcy estate. This may be futile if the money was paid into an overdrawn account.

106. This would occur if the SPV is unable to establish a proprietary right to the payment received, or to trace its proprietary interest in the payment into the hands of the Originator.

the Originator and the SPV, but the SPV's proprietary interest in particular payments will be lost.

In addition, the failure to notify the borrower of the assignment may permit the borrower to set off claims that it has against the Originator against obligations it owes to the Originator. Under English law, an assignee (legal or equitable) takes "subject to equities," which means that the assignee should be in no better position vis-a-vis the debtor than the assignor was prior to the assignment.¹⁰⁷ Once the assignee notifies the borrower of the assignments, any *future* right to set-off will be lost. The future right of set-off will be lost in this situation because under English law once notice of assignment has been given the debtor cannot do anything to take away or diminish the rights of the assignee as they stood at the time of the notice.¹⁰⁸ However, set-off rights will continue to exist and be binding on the assignee to the extent that they arise out of the same contract which gives rise to the loan asset.¹⁰⁹

Set-off rights are fundamentally important to securitizations by banks for two reasons. First, because banks are deposit-taking institutions, some corporate borrowers will also maintain deposit or trading accounts with their lenders, and will therefore be entitled to set off their deposits against their debt obligations to the bank.¹¹⁰ Once the assignee has given notice to the debtor of his interest in a loan—or in the context of U.S. law, once contractual privity is established between the borrower and the SPV—the borrower will lose

107. See, e.g., *Dawson v. Great Northern & City Railway Co.* [1905] 1 K.B. 260 (C.A. 1904). See also *In re Harry Simpson & Co. and The Companies Act 1936*, 1964 N.S.W.R. 603, 605 (Jacobs J., dictum), which is a decision of a New South Wales court, but nonetheless applies in this case the long-standing principles of equity as developed by the English courts.

108. See *Roxburghe v. Cox*, 17 Ch. D. 520, 526 (C.A. 1881). A set-off claim under U.S. law is comprised of three elements: (i) a contractual relationship, (ii) mutuality of the parties (e.g., the set-off and the cause of action are between the same parties and in the same capacity or right) and (iii) due and owing obligations. See 20 AM. JUR. 2D *Setoff or Compensation* § 6 (1995). As for mutuality of the parties, as one court has noted, set-off "is permissible where mutual debts and credits exist. [F]or debts and credits to be mutual [they] must be due from the same persons in the same capacity. They cannot be liabilities held in inconsistent relations." *Diesel Motors Co. v. Kaye (In re Diesel Motors Co.)*, 345 N.Y.S.2d 870, 875 (N.Y. Nassau County Ct. 1973).

109. See *Business Computers Ltd v. Anglo-African Leasing Ltd.* [1977] 1 W.L.R. 578 (Ch.). The latter point is generally more relevant to securitizations involving the sale of goods, in which case it is not possible to deprive a debtor of his right to set-off damages for breach of contract, for example, as a result of the failure to deliver goods of the appropriate quality or type from the purchase price payable for the goods.

110. See sources cited *supra* note 108.

any *future* right to set off deposits but will retain any rights or equities accrued up to the date on which he received notice.¹¹¹ The set-off right itself may be diluted if the deposits or the loan assets turn over and are replaced with new deposits and loan assets.¹¹² Second, if a bank has extended a loan commitment to the borrower and if the bank fails to honor that commitment, any damages that the borrower incurs as a result of such failure may be set-off against the borrower's loan obligation.¹¹³

Under U.S. law, if the "transfer" from the bank to the SPV establishes contractual privity between the borrower and the SPV, set-off is not permissible because the damages claim is unrelated to an act or omission of the SPV. If the "transfer" merely establishes contractual privity between the bank and the SPV, however, then the mutuality requirement for set-off is satisfied because the bank both owns the loan obligation and is contractually committed to the borrower to make new loans. It is rare for a solvent bank to breach valid loan commitments, however, so this set-off concern arises principally when considering the impact of bank insolvency proceedings upon the credit strength of the securitization structure. In addition, there may be other limitations on the borrower's ability to assert a set-off.¹¹⁴ Although the SPV will have a contractual claim against the

111. *See id.*

112. *See, e.g.,* Devaynes v. Noble, Clayton's Case, 35 Eng. Rep. 767, 781 (Ch. 1816); Deely v. Lloyds Bank, Ltd., 1912 App. Cas. 756 (appeal taken from Eng.).

113. Under English law, it is clear that if a claim for unliquidated damages can be set off against an assignor, it can also be set off against the assignee if it arises out of the transaction giving rise to the assigned debt. *See* Government of Newfoundland v. Newfoundland Ry. Co., 13 App. Cas. 199 (P.C. 1888) (appeal taken from Can.).

114. Under U.S. law, a receiver appointed for an insolvent bank may repudiate the Bank's contractual obligation to make future loans. *See* 12 U.S.C. § 1821(e)(1) (1994). The borrower is entitled to a claim against the Bank's receiver for "actual direct compensatory damages." *Id.* at § 1821(e)(3)(A)(i). In assessing any damages related to the repudiation, however, the statute provides that only actual direct compensatory damages may be awarded and that such damages are determined "as of the date of the appointment of the conservator or receiver." *Id.* at § 1821(e)(3)(A)(ii)(I). "Punitive or exemplary damages, damages for lost profits or opportunity or damages for pain and suffering" are exempted from recovery. *Id.* at § 1821(B)(i)-(iii). One court has found that, in its capacity as receiver of a failed institution, the FDIC's repudiation of a borrower's line of credit gave rise to damages related to lost profits or lost opportunities, not actual direct compensatory damages. *See* Fed. Deposit Ins. Corp. v. Cobblestone Corp., 1992 WL 333961, at *3-*5 (D. Mass. Oct. 28, 1992) (finding a borrower's payments due on drawn funds impermissible because the borrower failed to demonstrate that there was any "value" to the credit line on the date of the FDIC's repudiation given that the originating institution was "insolvent and facing possible liquidation" and holding that repudiation of such line of credit amounted only to "lost profits and opportunities for which Congress expressly precluded re-

Originator for reimbursement of any loan obligation amounts subject to a set-off under most set-off scenarios, securitization structures involving corporate loan assets typically require reserve mechanisms to protect the SPV from the effects of a set-off. These reserve mechanisms are designed to reduce the credit exposure that the SPV incurs with respect to the Originator.

The legal consequences of an assignment in breach of a contractual prohibition on assignment will vary according to the proper law of the contract under which the asset assigned comes into being. Under English law, for example, if there is a prohibition on assignment in the underlying contract, any purported assignment will be ineffective to vest any contractual rights in the assignee.¹¹⁵ While the House of Lords stated in *Linden Garden Trust Ltd. v. Lenesta Sludge Disposal Ltd.* that a purported assignment in breach of a prohibition on assignment is ineffective to transfer contractual rights, it also stated that

a prohibition on assignment normally only invalidates the assignment as against the other party to the [underlying] contract . . . in the absence of the clearest words, it cannot operate to invalidate the contract as between the assignor and the assignee, and even then may be ineffective on the grounds of public policy.¹¹⁶

The assignee may attempt to acquire an assignment of the *proceeds* of the contractual right, which would constitute a different proprietary interest outside the underlying contract. Such an assignment would not give the assignee any direct rights against the borrower, but would be effective to remove the proceeds from the assignor's estate should it become insolvent.¹¹⁷

The legal consequences in the United States of an assignment that violates an anti-assignment provision in a contract varies from state to state. Under other legal systems, the assignment may be effective as between assignor and assignee, but not as between the as-

covery under FIRREA"; however, the court refused to determine whether a "claimant who has sustained actual damage has a common law right of set off"). *But see* *Nashville Lodging Co. v. Resolution Trust Corp.*, 59 F.3d 236, 245 (D.C. Cir. 1995) (sanctioning, in dicta, damages claims for a receiver's repudiation of a promised loan premised in both the borrower's expectation interest (e.g., "the value of the expectancy which the [breached] promise created") and the borrower's "reliance interest" (e.g., restoring the borrower to the position it was in before the broken promise was made)).

115. *See* *Linden Garden Trusts, Ltd. v. Lenesta Sludge Disposals, Ltd.* [1994] 1 App. Cas. 85, 98-117 (1993) (appeal taken from Eng.) (speech of Lord Browne-Wilkinson).

116. *See id.*

117. *See id.*

signee and the underlying debtor. These different legal consequences require a careful review of the assignment provisions of each loan agreement prior to finalizing the securitization structure. Because of the expense associated with this due diligence—as well as the other limitations of an assignment structure as discussed above—most securitization transactions involving corporate loans have used a participation structure to transfer interest in the loans to the SPV.

Under U.S. law, it is generally recognized that the right to receive monies due or to become due under an existing contract may be assigned.¹¹⁸ This right may be limited where such assignment is prohibited by statute,¹¹⁹ where such assignment is contrary to public policy,¹²⁰ or where the contract expressly provides that the right is not assignable.¹²¹ Courts examining the enforceability of contractual language which prohibits assignment generally distinguish between cases involving assignors and assignees, and those involving assignors and obligors.¹²² Numerous cases support the proposition that the assignee can maintain an action to enforce the assignment as against the assignor even in the presence of a contractual provision that precludes assignment.¹²³ The assignor may be liable, however, for damages from a breach of such contractual provision.¹²⁴

The majority of jurisdictions in the United States have adopted the “American rule,” which provides that notice to an obligor of a

118. See, e.g., *Martin v. Barclays Amer./Leasing, Inc.*, (In re Martin), 117 B.R. 243, 249-50 (Bankr. N.D. Tex. 1990); *Village of Westville v. Loitz Bros. Constr. Co., Inc.*, 519 N.E. 2d 37 (Ill. App. 4th Dist. 1988); *Miller v. Wells Fargo Bank Int'l Corp.*, 406 F. Supp. 452 (S.D.N.Y. 1975), *aff'd*, 540 F.2d 548 (2d Cir. 1976); *Continental Oil Co. v. U.S.*, 326 F. Supp. 266 (S.D.N.Y. 1971). See generally III E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS §11.2 (1990).

119. See *Martin v. Barclays Amer./Leasing, Inc.*, (In re Martin), 117 B.R. 243, 249-50 (Bankr. N.D. Tex. 1990).

120. See *id.*

121. See, e.g., *Hurst v. West*, 272 S.E. 2d 378, 382-83 (N.C. Ct. App. 1980).

122. See *Portuguese-Amer. Bank v. Welles*, 242 U.S. 7, 10-12 (1916); *Fox-Greenwald Sheet Metal Co. v. Markowitz Bros., Inc.*, 452 F.2d 1346, 1351-52, 1355-56 (D.C. Cir. 1971); *Frank Sullivan Co. v. Midwest Sheet Metal Works*, 335 F.2d 33, 39 (8th Cir. 1964); *Paxson v. Commissioner*, 144 F.2d 772, 775 (3d Cir. 1944). See also RESTATEMENT (SECOND) OF CONTRACTS: ASSIGNMENT & DELEGATION § 322(2)(C) (1981); RESTATEMENT OF CONTRACTS § 176 (1932) (stating that “[a] prohibition in a contract of the assignment of rights thereunder is for the benefit of the obligor and does not prevent the assignee from acquiring rights against the assignor by the assignment or the obligor from discharging his duty under the contract in any way permissible if there were no such prohibition.”).

123. See sources cited *supra* note 122.

124. See *Cedar Points Apts. v. Cedar Point Inv. Corp.*, 693 F.2d 748, 754 (8th Cir. 1982).

choses in action is not necessary to preserve the priority of right as between bona fide assignees of an assignment of such choses in action.¹²⁵ Courts applying the American rule generally state that any subsequent assignee has no better right to a chose in action than his assignor; and, if the assignor has previously assigned such rights, there remains no title or right to pass to the subsequent assignee. Consequently, notice to the account debtor is irrelevant to a determination of rights because the subsequent assignee has no such rights.¹²⁶ A minority of jurisdictions in the United States do not follow the American rule, however, but instead adopt the "English rule."¹²⁷ The English rule provides that priority as between bona fide assignees is determined by the first assignee to give notice to the debtor of the assignment.¹²⁸

Any legal system may be chosen to govern an assignment; it is generally not necessary to choose the same law that governs the underlying loan contract or choses in action arising under that contract. The law of the underlying contract, however, will generally determine whether the chose in action arising under the contract is capable of assignment. If the chose in action is assignable, the law of the underlying contract will also determine whether other formalities are necessary¹²⁹ to ensure the enforceability of such assignment and the priorities of competing assignees.¹³⁰ In some jurisdictions, the law applicable to a resolution of such issues may not be determined simply by reference to the governing law clause in the underlying contract.¹³¹ For example, under the law of the United States, a determi-

125. See, e.g., *Salem Trust Co. v. Manufacturers' Fin. Co.*, 264 U.S. 182 (1923); *In re Rosen*, 157 F.2d 997 (3d Cir. 1946), cert. denied, 330 U.S. 835 (1947). See generally 110 A.L.R. 774, 775-78 (1937) (discussing American rule cases).

126. See, e.g., *Salem Trust Co. v. Manufacturers' Fin. Co.*, 264 U.S. at 182 (discussing rationale for American rule).

127. See, e.g., CAL. CIV. CODE § 955.1 (West 1982 & Supp. 1998) (expressly prescribing that, as between bona fide assignees, "the assignee first giving notice thereof to the obligor in writing has priority.").

128. See, e.g., *Costello v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 141 F. Supp. 225 (N.D. Cal. 1956), aff'd, 246 F.2d 807 (9th Cir. 1957). See generally 110 A.L.R. at 774-775 (discussing English rule cases).

129. An example of a necessary formality would be notice to the obligor.

130. Under English law, the priorities of competing successive assignees under assignments of choses in action is governed by *Dearle v. Hall*, 38 Eng. Rep. 475 (Ch. 1828), which provided that the first assignee to give notice of his interest to the underlying debtor has priority—irrespective of the date of the assignment under which he claims—if the assignee entered into the assignment in good faith and without notice of any earlier assignment.

131. See *Gray v. Travelers Indemnity Co.*, 280 F.2d 549, 553-54 & n.2 (9th Cir. 1960); *In re*

nation of the relative priorities between a non-notifying assignee and a subsequent assignee may be dependent upon the place of performance of the contract of assignment. The place of performance of a contract of assignment, while not clearly delineated in the case law, appears to be the jurisdiction where the assignment is made or where the assignor is located.¹³²

In some legal systems, perfection of the assignment by notification to the underlying debtor must be effected according to the procedural rules of the forum in which the debtor is incorporated or resident. In many civil law jurisdictions, this will involve either obtaining the consent of the debtor, or serving notice of assignment on the debtor through a court bailiff or by registered post, both of which will be expensive.¹³³ Under Article 12 of the Rome Convention on the Law Applicable to Contracts, which has been adopted by most Member States of the EU, the law governing the right assigned¹³⁴ will determine: 1) the capability of a right to be assigned; 2) the conditions under which a right is assignable; 3) the relationship between the assignee and the debtor; 4) the conditions under which the assignment can be invoked against the debtor; and 5) the discharge of the debtor's obligations.¹³⁵ Article 12 is interpreted to mean that the law under which the assigned right is created governs issues such as perfection against the debtor, priorities between competing assignees and the effect of a discharge.¹³⁶ This may be a different legal system from that which governs the contract of assignment itself, and the mutual obligations of the assignor and the assignee.¹³⁷ However, there

Rosen, 157 F.2d 997, 999 (3d. Cir. 1946); *Wishnick v. Preserves & Honey, Inc.*, 275 N.Y.S. 420, 422 (Sup. Ct. 1934), *aff'd*, 285 N.Y.S. 522 (App. Div.), *rev'd on other grounds*, 5 N.E. 2d 808 (N.Y. 1936).

132. See *Gray v. Travelers Indemnity Co.*, 280 F.2d at 553-54 & n.2; *In re Rosen*, 157 F.2d at 999; *Wishnick v. Preserves & Honey, Inc.*, 275 N.Y.S. at 422, *aff'd*, 285 N.Y.S. 522 (App. Div.), *rev'd on other grounds*, 5 N.E. 2d 808 (N.Y. 1936).

133. See, e.g., C. CIV. art. 1690 (Fr.).

134. In the case of a receivable, it will generally be the proper law of the contract under which the right was created.

135. See European Communities Convention on the Law Applicable to Contractual Obligations, June 19, 1980, art. 12, 19 I.L.M. 1492 (1980) [hereinafter Convention on the Law Applicable to Contracts].

136. For the application of English conflict of law rules, see 2 ALBERT V. DICEY & JOHN H.C. MORRIS, *THE CONFLICT OF LAWS* Rule 120, at 979 (Lawrence Collins et al. eds., 12th ed. 1993).

137. The same result would arise under English common law principles of conflict of laws, which will apply to all contracts governed by English law and entered into on or prior to April 1, 1991.

is very little case law on the interpretation of Article 12.¹³⁸

C. Participation

It is important to note that a “participation” under U.S. law will have different legal consequences from a “sub-participation” under English law. In English law, the term “participation” does not have a distinct legal connotation, but can be used to mean a number of different things. Sub-participation, on the other hand, has a distinct meaning: a sub-participation represents a purely contractual funding arrangement whereby one party, the “sub-participant,” agrees to fund a loan asset of another institution, the “seller.”¹³⁹ This funding arrangement may take one of two forms. The first form is a “funded” sub-participation, where the sub-participant deposits money with the seller which may only be repaid as and when the underlying asset pays interest or principal. The second form is an “unfunded” sub-participation, in which the sub-participant pays no money up-front to the seller, but agrees to pay either as the related loan is drawn down, or if and when the underlying asset defaults.¹⁴⁰ The risk weighting of a sub-participation will depend on whether it is a funded or unfunded sub-participation. A funded sub-participation will be treated as a

138. *But see* the decision of the Dutch Supreme Court in *Brandasma q.q. v. Hansa Chemie AG, Hoge Raad der Nederlanden*, 16 mei 1997, RvdW, 126, in which the Court held that Article 12, paragraph 1 of the Convention on the Law Applicable to Contracts (which provides that the mutual obligations of the assignor and assignee under an assignment of a right against another person (the “debtor”) shall be governed by the law which under the Rome Convention applies to the contract as between the assignor and the assignee) applies not only to the contract of assignment between the assignor and the assignee, but also to the assignment itself (*i.e.*, under Dutch law, the legal act that accomplishes the transfer of the assigned right from the assignor to the assignee). The assignment in question was made between a Dutch assignor and a German assignee under a contract of assignment governed by German law. As a matter of German law, there had been compliance with the formal requirements for a valid assignment as between assignor and assignee. However, as a matter of Dutch law, there had been no compliance with the formal requirements for a valid assignment. The court held that, as a matter of Dutch law, the law governing the contract of assignment should also govern the assignment itself (a different legal right), and thus, that as German law governed the contract of assignment, the validity and effect of the assignment itself should be determined by reference to German law. As noted above, the assignment was valid under German law. It is unlikely, however, that this decision will have any bearing on the relationship between the assignee of a right and the debtor in respect of that right, which relationship should be determined on the basis of the law governing the right. *See generally* Convention on the Law Applicable to Contracts, *supra* note 135.

139. *See, e.g.*, Notice BSD/1989/1, *supra* note 46 & Annex.

140. In which case it acts as a guarantee.

claim collateralized by cash,¹⁴¹ so it will be risk-weighted at zero percent.¹⁴² An unfunded sub-participation will be risk-weighted according to the risk-weighting of the sub-participant, which in the case of an SPV means a risk weighting of one hundred percent. If the unfunded sub-participation relates to an undrawn commitment, it will be risk-weighted at fifty percent if the commitment period exceeds 365 days, and zero percent if the commitment period is 365 days or less.¹⁴³

Under English law, the sub-participant never acquires any proprietary interest in the underlying asset. The sub-participant's rights are represented purely by its contract with the seller, even if the seller becomes insolvent. In these circumstances, the sub-participant cannot claim any interest in either the loan asset itself, which will become part of the bankruptcy estate of the seller, or any of the proceeds of payment realized from the asset.¹⁴⁴ The sub-participant never acquires any rights or interest against the underlying debtors, and it remains vulnerable to rights of set-off available to the underlying debtors against the bank "selling" the participation.¹⁴⁵ In order to give some protection to sub-participants, banks may be asked by the sub-participant to declare a trust over the proceeds of payments received from underlying debtors. The sub-participant is still not acquiring a proprietary interest in the asset itself, but only the proceeds of payment of that asset.¹⁴⁶ Subject to the provisions of the underlying documents,¹⁴⁷ and to the bank's existing funding documents,¹⁴⁸ banks may declare a trust over both the loan assets and the proceeds of those assets. A mechanic may also be incorporated in the sub-participation documentation for such a trust to be established if certain thresholds—such as the bank's own independent credit rating—

141. Which would be provided by the sub-participant.

142. See Basle Accord, *supra* note 3, at para. 42 & Annex 3. See also Solvency Ratio Directive, *supra* note 24, art. 6(2) & Annex I.

143. See sources cited *supra* note 142.

144. There is no specific case law involving the sales of sub-participations by banks. The principles stated in this section derive from general common law principles relating to the law of contract.

145. See, e.g., *Glegg v. Bromley* [1912] 3 K.B. 474 (C.A.); *In re Irving. Ex parte Brett*, 7 Ch. D. 419 (Ch. App. 1877).

146. See *id.*

147. The provisions of the underlying document may prohibit assignment or the transfer of proprietary interests

148. The bank's existing funding documents may contain negative pledge or anti-disposal clauses that may be tripped by the establishment of a trust structure.

are crossed.

In the United States, the proper legal classification of loan participations in the event of the insolvency of the lead lender has been debated for years. For example, courts have characterized loan participations as assignments, sales, trusts, tenancies in common, debtor/creditor relationships, joint ventures or combinations of the foregoing.¹⁴⁹ The determination of whether a loan asset subject to a participation constitutes property of the Originator is subject to applicable state law.¹⁵⁰ Under New York law, the court first reviews the written agreement to determine the intent of the parties; unless the written agreement is ambiguous, the agreement will be dispositive of such intent.¹⁵¹ Unambiguous intent to create a sale, however, will not necessarily lead to a conclusion that such a sale has occurred if the economic elements of the transaction are inconsistent with such characterization.¹⁵² In assessing the economic substance of the transaction, the courts generally examine a number of factors. Different courts may apply different factors or may give the same factors different weights when considering the status of participations. Perhaps the most significant of these factors is whether the Originator transferred the risks of ownership of the loans to the SPV.¹⁵³ Accordingly, a participation agreement that obligates the Originator to compensate the SPV if a loan obligation is not paid when due is unlikely to be viewed as having transferred risks of ownership to the SPV.¹⁵⁴

In some instances, a participation agreement may be viewed as not having transferred sufficient ownership rights to the SPV to mandate sale characterization.¹⁵⁵ Examples of such instances include the

149. See, e.g., Debora L. Threedy, *Loan Participations—Sales Or Loans? Or Is That The Question?* 68 OR. L. REV. 649 (1989).

150. See *Superintendent of Banks v. CITIC Indus. Bank (In re New York Agency)*, 645 N.Y.S.2d 779 (App. Div. 1996), *appealed in part and affirmed*, 683 N.E. 2d 756 (N.Y. 1997). See also *Barnhill v. Johnson*, 112 S. Ct. 1386, 1389 (1992).

151. See *Eastern Sys. Inc. v. West 45th St. Industr. Condominium Inc. (In re Eastern Systems, Inc.)*, 105 B.R. 219, 228 (Bankr. S.D.N.Y. 1989), *aff'd*, 1991 WL 90733 (S.D.N.Y. 1991).

152. See *Fireman's Fund Ins. Cos. v. Grover (In re Woodson Co.)*, 813 F.2d 266, 272 (9th Cir. 1987); *Liona Corp., N.V. v. PCH Associates (In re PCH Associates)*, 804 F.3d 193, 199 (2d Cir. 1986).

153. See, e.g., *European Amer. Bank v. Sackman Mortgage Corp. (In re Sackman Mortgage Corp.)*, 158 B.R. 926, 932 (Bankr. S.D.N.Y. 1993).

154. See, e.g., *In re Coronet Capital Co.*, 142 B.R. 78, 80 (Bankr. S.D.N.Y. 1992); *Fireman's Fund Ins. Cos. v. Grover (In re Woodson Co.)*, 813 F.2d 266, 271 (9th Cir. 1987); *Northern Trust Co. v. Fed. Deposit Ins. Co.*, 619 F. Supp. 1340, 1341 (W.D. Okla. 1985).

155. See, e.g., *In re Coronet Capital Co.*, 142 B.R. at 80; *In re Woodson Co.*, 813 F.2d at 271; *Northern Trust Co. v. Fed. Deposit Ins. Co.*, 619 F. Supp. at 1341.

following: a participation agreement that 1) has a term shorter than that of the underlying loans; 2) provides for different payment terms between the borrower and the SPV; 3) permits the Originator to retain more than its pro rata share of the interest payments on the loans subject to the participation; or 4) grants the Originator the unilateral right to change the terms of the loan or to repurchase the loans subject to participation. In structuring a corporate loan securitization, it is not always possible to eliminate all factors that may weigh against a sale characterization. For example, notification to the borrower of the transfer to the SPV would be a factor supporting sale characterization, but is rarely present in securitization transactions because of the Originator's concern for its relationship with the borrower. Counsel delivering a "true sale" opinion will typically alert the recipient to the presence of these negative factors, but the overwhelming presence of other factors that support a sale characterization may permit the opinion to be rendered.

Even if a participation/sub-participation does not constitute the sale of an asset in a legal sense, it is treated by the regulators in both the United States and the United Kingdom as a transfer of credit risk for the purposes of risk-based capital requirements.¹⁵⁶ The "sale" of participations or sub-participations is the most popular form of transfer used in CLO structures, partly because such "transfers" are simpler from a legal perspective, and also because the "transfer" by sale of a participation avoids issues presented by alienation provisions in the underlying loan documentation. As already mentioned, corporate loan assets are not homogenous; they are frequently not originated under standard forms in the same way as consumer assets are, but under negotiated contracts. In the case of syndicated loan agreements, it is even more likely that key provisions of the document, such as the assignment provision, will have been negotiated.¹⁵⁷ Many corporate borrowers choose their financiers on the basis of re-

156. See Glossary to the Call Report, 3-97 edition, page A-49 (FFIEC 031, 032, 033 and 034). Note, however, that sales of so-called "strip participations" (the "sale" of a short-term loan under along-term credit commitment) will constitute a sale with recourse for purposes of U.S. regulatory accounting, and will therefore not enable the seller to release the associated risk-based capital.

157. The sale into a securitization structure of participations in syndicated loan agreements raises a host of complex legal issues that are beyond the scope of this Article. For example, the Originator (and thus the SPV) will be subject to syndicate democracy rights restraining the ability of a single lender to call a default under the agreement, and by the effect of pro rata sharing clauses now standard in most syndicated loan agreements.

lationship, reputation and their requirements for funding. Similarly, corporate borrowers will will arrange their financing in accordance with a clear funding strategy. Such a strategy may involve direct capital markets financings, bank syndicates or bilateral lines of credit. Having taken the time and trouble to build up a "bank group," corporate borrowers will also take the trouble to ensure that this group will remain largely intact for the required funding period or, if particular lenders withdraw from the facilities, that they are replaced with equally acceptable lending institutions.

While corporate loan agreements are likely to contain restrictions on the novation or assignment of loan assets, restrictions on participations are less likely. This is true, provided that the agreement is clear that any such participation is a contractual funding arrangement by a lending bank, and it will not result in the borrower having a direct contractual relationship with the participant.

Frequently, assignment is permitted provided that the borrower's consent is obtained, and provided that the assignee is a bank. This may be particularly important for withholding tax reasons. For example, companies in the United Kingdom are generally required to withhold tax from interest payments unless the payment is made to a bank recognized as such by the United Kingdom Inland Revenue.¹⁵⁸ An SPV will not be recognized as a bank for the purposes of Section 349 of the Income and Corporation Taxes Act of 1988, and although the loan documentation will invariably contain a gross-up clause, most well-negotiated assignment provisions will prohibit assignments that would result in the borrower paying more under tax indemnities or gross-up provisions.¹⁵⁹ A participation in a loan will not trip any withholding tax requirements between the underlying debtor and the assignee, because there is no contractual relationship there. On the other hand, banks are usually exempted from withholding tax on payments they make on their own debt service, which would include for these purposes payments to participants.

Similarly, borrowers will wish to ensure that the admission of a new lender will not result in higher costs for its funding generally, or under general indemnities or increased costs clauses. Increased cost clauses, as currently drafted in most corporate loan documents, are

158. See Income and Corporation Taxes Act, 1988, ch. 1 § 349 (Eng.) (as amended).

159. Under general equitable principles, unless varied by contract the debtor should not in any event be prejudiced by an assignment of his debt. See, e.g., *Dawson v. Great N. & City Ry. Co.* [1905] 1 K.B. 260 (C.A. 1904).

unlikely to be affected by the introduction of an SPV to the funding group because, superficially at least, the SPV itself will not incur increased "capital costs" because it will not be a regulated entity subject to a capital adequacy requirement. However, the SPV may be reliant on third party facilities such as liquidity facilities or credit enhancement facilities provided by entities which are subject to capital adequacy requirements. Therefore, the SPV's own funding costs will depend, to this extent, on the cost of capital factored into the pricing of these third party facilities. Standard increased cost clauses currently used in the documentation for corporate loans are unlikely to cover an increase in the SPV's cost of funds caused by a repricing of third party facilities as a consequence of a change to the risk weighting of these facilities. Also, if the SPV's funding is of a short-term nature¹⁶⁰ any disruption in the renewal of this financing source may result in the SPV relying on second line sources such as liquidity facilities. For this reason, the loans selected for inclusion in a securitization program should generally bear interest at a rate at least equal to the SPV's cost of funds under the drawn liquidity facilities.

IV. BANKER'S DUTY OF CONFIDENTIALITY

Some legal systems impose strict duties of confidentiality on banks and other financial institutions in possession of sensitive financial information.¹⁶¹ The duty of confidentiality may arise under various different legal headings. In common law jurisdictions, there is generally a common law duty of confidentiality as well as more recent statutory duties, particularly relating to data protection;¹⁶² in civil law jurisdictions, the duty may arise under the civil code or under general principles of constitutional law. Under English common law, the duty of confidentiality derives from the contractual relationship between a bank and its customer, and extends to all information acquired by the bank during the course of the banker-customer relationship.¹⁶³ Remedies for breach will be measured and awarded, therefore, on a contractual basis. The English common law provides four exceptions to the overriding duty of bankers to abide by their

160. Such as commercial paper.

161. *See, e.g.*, Data Protection Act, 1984, ch. 35, (Eng.). *See also* *Tournier v. Nat'l Provincial and Union Bank of England* [1924] 1 KB 461 (C.A. 1923).

162. *See, e.g.*, Data Protection Act, 1984, ch. 35, (Eng.).

163. *See* *Tournier v. Nat'l Provincial and Union Bank of England* [1924] 1 KB 461 (C.A. 1923).

duty of confidentiality. These exceptions include disclosure that is expressly or impliedly permitted by the customer, and disclosure that is required in the interests of the bank.¹⁶⁴ None of the four exemptions, however, provides a clear-cut safe haven for banks which need to release customer information for the purposes of a securitization transaction.¹⁶⁵ In addition, the underlying loan documentation must be reviewed to determine the scope of the contractual provisions relating to the disclosure of information. Such contractual exceptions may be limited to information directly related to the loan agreement, or may extend to unrelated, but sensitive, general commercial information concerning a borrower.

There are a number of parties to a securitization transaction who may need potentially confidential information concerning the underlying assets. Such parties include the SPV and its directors, the rating agencies rating the transaction, any liquidity banks providing liquidity facilities backing up commercial paper, the trustee for the debt holders, and the servicing agent¹⁶⁶ appointed by the SPV to service and enforce the loan assets.

For example, a rating agency may need potentially confidential information because the credit rating of the securitization transaction partially depends on an analysis of the underlying corporate loans.¹⁶⁷ In addition, in order to achieve a balanced portfolio without undue concentration in any particular economic or industrial sector or in any particular borrower or group of connected borrowers, the rating agencies will insist on disclosure of the portfolio's financial characteristics. To date, this has been achieved by supplying rating agencies with encrypted data (unless particular borrowers account for a significant portion of the securitized portfolio),¹⁶⁸ in which case the agencies will insist on named disclosure. In the case of investment grade borrowers who have their own corporate debt rated by the rating agencies, it is unlikely that they could claim damages for the disclosure of confidential information by the Originator to rating agencies. Such a claim for damages would be unlikely because the borrowers

164. *See id.*

165. Although in principle it might be argued that a bank may rely on the "interests of the bank" exemption in order to permit disclosure of confidential information, this appears to be self-serving, particularly in the context of a large-scale securitization.

166. The servicing agent typically is the Originator, unless replaced following its insolvency or breach of its obligations as servicer.

167. *See* sources cited *supra* note 1.

168. Such as a loan asset in excess of five percent of the overall portfolio size.

have provided the rating agencies with much the same—and probably more—financial information on themselves.

In addition, corporate entities that list their stock or debt on public exchanges are generally obligated to file their annual audited accounts with a public authority for inspection by the public. Therefore, their general levels of indebtedness will be public information. More corporate information is likely to come into the public domain as the bond markets, particularly in Europe, open up to weaker credits. A more difficult scenario will arise if, after the securitization, a borrower defaults on a debt that has been securitized. This default is not likely to be information immediately available to the public, nor is it information that would immediately be disclosed to a rating agency, unless by the borrower itself. Under English law, information relating to the default itself and provided as a consequence of the default is likely to be impressed with a duty of confidentiality, either by contract¹⁶⁹ or under the common law principle that a duty of confidence arises when confidential information is provided in circumstances where the recipient has notice that it is confidential.¹⁷⁰ In addition, the Originator may want to delay publication of such default to allow the Originator to negotiate with the borrower before other creditors become aware of the default.¹⁷¹ Under this scenario, it is likely that the Originator will choose not to disclose the identity of the defaulting borrower, but only the amount defaulted, or it will disclose the identity only to the trustee¹⁷² appointed under the SPV's trust deed or indenture.

If the securitization transaction includes a variable funding option that is supported by a liquidity facility extended by other commercial banks, the Originator will resist disclosure of the borrowers'

169. See *Tournier v. Nat'l Provincial and Union Bank of England* [1924] 1 KB 461 (C.A. 1923).

170. See CLERK & LINDSELL ON TORTS para. 26.01 (R.W.M. Dias et al. eds., 17th ed. 1995).

171. The ability to do this will depend on the terms of other loan agreements by which the borrower is bound: They may contain cross default clauses that have been triggered in any event.

172. Trustees are generally financial institutions with a statutory or fiduciary duty to preserve the confidentiality of information provided to them. A number of legal jurisdictions permit disclosure of otherwise confidential information to persons who are themselves subject to a duty of confidentiality, such as auditors and legal advisors. See, e.g., BAK CIRCULAR, *supra* note 51, art. III.

It is generally thought safe, therefore, to permit disclosure to trustees, in their capacity as such, although there is no clear exemption provided for such disclosure in most legal systems.

identities to such liquidity providers on both legal and commercial grounds. For example, an Originator will not want its potential competitors (i.e., the liquidity providers) to gain any insight into its corporate loan portfolio. In addition, liquidity providers are not intended to take any credit risk on the underlying assets, so the Originator may argue with some logic that the composition of the securitized portfolio should be largely irrelevant to the liquidity banks. To the extent the composition is relevant, the trustee typically holds the required information and reveals it to the liquidity provider only under very rare circumstances.

Furthermore, if it were a normal trading company, the SPV would also ordinarily insist on knowing the identity of the underlying borrowers. In addition, the SPV directors, under general principles of company law, would be lacking in their fiduciary duties to the company if they did not satisfy themselves as to the credit quality of the securitized portfolio, or had at least verified that the assets securitized complied with the eligibility criteria established for the securitization. In practice, this verification process will be undertaken either by the trustee, who will know the identity of the underlying debtors, or by the Originator's external auditors, who are subject to a duty of professional confidence. The SPV will receive the same portfolio-wide information and encrypted information on individual loans as do the rating agencies, but the list of actual borrowers is delivered only to the trustee.

As previously noted, the underlying corporate loan documents must be reviewed to identify any contractual restrictions on disclosure. Such restrictions may prevent disclosure even to trustees, and thus render the assets ineligible for securitization. Banks that may wish to securitize their assets in the future would benefit from taking immediate steps to standardize the assignment and disclosure clauses in their documentation to avoid the described limitations.

V. LICENSING REQUIREMENTS ON THE SPV

The final legal aspect of securitization examined by this article is whether there are any licensing or regulatory requirements binding on the SPV.¹⁷³ The objective in securitizing is to release risk-based

173. We assume for these purposes that none of the corporate loans are subject to consumer credit legislation in any jurisdiction (ordinarily consumer credit legislation does not extend to protect corporate borrowers).

capital and/or achieve a lower cost of funds for the securitized assets.¹⁷⁴ If the SPV is subject to regulation or licensing requirements, compliance with these requirements may increase its funding costs to an extent that renders it economically unsustainable.

In some jurisdictions, however, lending may be a regulated activity even if the lender does not accept deposits. Still, with any cross-border securitization, the only prudent course to follow is to examine the rules in each jurisdiction in which a borrower is located to ensure that an SPV may legally lend there. In addition, the jurisdictional problem may be avoided if a participation structure is used.

In the United Kingdom, Bank of England regulations apply only to entities that take deposits from the public within the meaning of Sections 5 and 6 of the Banking Act of 1987.¹⁷⁵ In the United States, regulation is also focused primarily on entities that raise their funds from deposit-taking activities, so an SPV should not generally be subject to regulation by a federal entity such as the FDIC. However, it is important to carefully monitor the amount of lending that the SPV makes to borrowers in a particular state. Persistent business activity in a state, such a regular lending to a number of borrowers located in that state, may trigger "doing business" legislation. Doing business legislation requires, among other things, registration with a state agency. In addition, it is important to ensure that the debt issued by the SPV is not treated as the acceptance of public deposits. This is definitely an issue in the United Kingdom, primarily because of the broad definitions of "deposit" and "deposit-taking business" in the Banking Act of 1987.¹⁷⁶

In addition, there are strict rules in England that apply to the issuance of Sterling commercial paper and other longer term debt through the capital markets. The rules regarding the issuance of commercial paper will prevent most SPVs from issuing such debt, except where the issue is made pursuant to debt issuance programs listed on a recognized stock exchange.¹⁷⁷ The use of an English law sub-participation structure, whereby the SPV acquires no contractual

174. See sources cited *supra* note 1.

175. See Banking Act, 1987, ch. 22, §§ 5-6 (Eng.).

176. See the Bank of England's Notice dated Mar. 18, 1997, entitled *The Bank of England (Exempt Transactions) Regulations 1997 and issues of Commercial Paper*, applicable from Apr. 3, 1997, and, for medium-term debt issuances, the Bank of England's Notice dated Mar. 18, 1997, entitled *Issues of Debt Securities of One Year or Over under The Bank of England (Exempt Transactions) Regulations 1997*, applicable from Apr. 3, 1997.

177. See *id.*

or proprietary rights against the underlying debtors, will usually avoid the need for the SPV to comply with local licensing requirements relating to lending activities. However, the SPV may still need to obtain certain licenses. In Europe, for example, a data protection license may be required before the SPV may retain computer data on individuals and, in some cases, on corporations. Data on individuals may be relevant even in the context of corporate loans if the corporation is family-owned or controlled, or if personal guarantees have been given in respect of the corporation's debt.

The final issue that may arise from an SPV's unlicensed status is that in some jurisdictions, interest payments to non-banks are subject to a withholding tax.¹⁷⁸ It is most unlikely that a corporate borrower would agree to a securitization of its loan in circumstances where it becomes required to gross-up its interest payments. This would remain true despite the argument that the effect of a gross-up is not to increase the cost of borrowing, but is it rather a timing issue, since the person making the gross-up will eventually receive a tax credit.

VI. CONCLUSION

The dramatic growth in the use of securitization to fund corporate loan assets suggests that this is a form of financing that is here to stay. However, the process of securitizing complex and non-homogenous assets gives rise to a number of legal and structural complexities. It is not possible to identify all the issues that will arise in the context of a corporate loan securitization, but this Article has provided important insights into the principal concerns that must be addressed.

178. See Income and Corporation Taxes Act, 1988, ch. 1 § 349 (2) (Eng.) (as amended).