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Structuring asset-backed securities in the US market

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The successful implementation of a securitisation will depend, in part, upon how the transaction is treated under relevant law. In structuring asset-backed securities (ABS), one must consider the impact of a variety of laws. These include bankruptcy laws, tax laws and securities laws. Securities registration and disclosure laws are always extremely important in securitisation transactions and may determine whether the securities are publicly offered or privately placed. However, these laws do not generally affect how the deal is structured. In addition, other laws may be relevant to a transaction, such as real estate laws in commercial mortgage-backed securities transactions. These laws can significantly affect how the underlying loans are structured for securitisation, but may not materially impact the securitisation structure itself.

Although many laws may have to be considered in a securitisation transaction, three areas that sponsors of securitisations in the United States need to analyse in structuring the transaction are bankruptcy, tax and investment company laws. With respect to bankruptcy laws, sponsors need to ensure that the issuer and its assets will neither be subject to any bankruptcy proceedings nor adversely affected by the bankruptcy of any other entity. Where tax laws are concerned, the transaction must be structured to be tax-efficient, thereby avoiding double taxation of the issuer and the investor. Finally, due to the legal requirements imposed on investment companies that would be prohibitively burdensome for ABS transactions, sponsors need to find an exemption to the registration requirements of the federal investment company laws.

Bankruptcy

One of the goals in a securitisation is to have the rating of the securities based solely on the credit quality of the assets. Achieving this goal is necessary to ensure that the rating will not be adversely affected by the sponsor's actions outside the scope of the securitisation. Therefore, the sponsor must ensure that

the issuer itself will not become a debtor in bankruptcy and that the issuer and its assets will not be adversely affected by the bankruptcy of the sponsor or its affiliates. In other words, the issuer and its assets need to be 'bankruptcy-remote.'

To structure a bankruptcy-remote issuer, the sponsor must address three concerns: the scope of the issuer's activities, the characterisation of the transfer of assets to the issuer, and the potential for substantive consolidation of the issuer (and its assets) with the sponsor or its affiliates in a bankruptcy proceeding affecting them.

Bankruptcy-remote issuer

To avoid the risk that the issuer will itself become a debtor in bankruptcy, the sponsor must prohibit the issuer from engaging in activities other than those related to owning and managing the assets that are the subject of the securitisation. A corollary to this requirement is that the issuer generally cannot incur debt or other obligations (other than the ABS, if they are in the form of debt securities). Unless these restrictions are in place, there is no assurance that the issuer will not engage in activities that increase the risk of the issuer becoming a debtor in bankruptcy.

The issuer must also be prohibited from making certain major decisions involving the assets. For example, the issuer should not have the right to engage in, with respect to all or substantially all of its assets, any dissolution, liquidation, merger, consolidation or similar activity.

True sale

Concerns over the characterisation of the transfer of the assets relates to the bankruptcy of the transferor. To ensure that the issuer and its assets will not be affected by the transferor's bankruptcy, the transfer of the assets to the issuer must be structured as a 'true sale', not a loan by the issuer to the transferor. If the transfer is considered a loan, then a court may deem the assets to be owned by the transferor, leaving the issuer with nothing more than a security interest in the assets. Such a result in a bankruptcy context could adversely affect the ability of investors to get paid on a timely basis, or to realise on the assets being securitised. But if the transfer is considered a true sale, then the assets are not part of the transferor's bankruptcy estate and will consequently be free from any claim of right by the transferor in bankruptcy, or by any of its creditors.

Guidance on how to secure status as a true sale has come from the courts which first look to the parties' true intentions. Documenting the transaction as a sale and indications of intended accounting treatment are examples of the parties'

intentions of sale treatment. Courts also examine the legal structure and characteristics of the transaction to determine whether the rights of the transferor after the sale are consistent with the rights that one would expect to pass to a transferee in a sale. Last, courts examine the economic substance of the transaction to determine whether the risks and rewards of owning the assets have passed to the issuer. Thus, for example, rights of recourse that the issuer has against the transferor when the assets deteriorate in value, or rights of the transferor to any surplus collections on the assets, may lead a court to find that the transfer is a loan and not a sale.

Substantive consolidation

The issuer must also be structured to minimise the risk of itself being included in the bankruptcy of either the transferor of the assets, or one of its affiliates under the doctrine of 'substantive consolidation'. Substantive consolidation is an equitable doctrine which provides that in order to prevent a perceived injustice, the separate legal status of two or more entities may be disregarded so that the assets and liabilities of these entities may be consolidated and dealt with as if the assets were held by, and the liabilities were incurred by, a single entity.

The possibility that an issuer will be consolidated with a bankrupt transferor or affiliate may be avoided by prohibiting the issuer from engaging in any activity that could suggest that the issuer is merely the alter ego or instrument of the bankrupt transferor or affiliate. Courts view the following matters as indications where consolidation may be proper:

- common officers or directors;
- lack of separate financial statements;
- sharing of operational expenses;
- commingling of funds; and
- assumption of the issuer's obligations by the bankrupt entity.

Tax considerations

The primary tax concern with regard to securitisations is the avoidance of double taxation of income from the assets – once to the investor and once to the issuer. To avoid income taxation at the issuer level, the sponsor must establish a tax-free entity. The choice of entity will turn, in part, on whether the sponsor wants to finance the pool of assets through the issuance of debt, or through instruments representing beneficial ownership of the underlying assets. If the issuer holds certain types of

assets, such as mortgage loans, additional structures may be available to avoid taxation at two levels.

Debt

Sponsors can create debt structures by using one of five forms of entities to act as issuer of the debt: special purpose corporations, owner trusts, limited liability companies, partnerships, and non-US entities.

- (1) **SPCs:** A special purpose corporation (SPC) may be created as a subsidiary of the sponsor, in which case tax at the SPC level is avoided through consolidation for tax purposes with the sponsor. Other structures, particularly asset-backed commercial paper, use 'stand-alone' corporations nominally owned by an unaffiliated accommodation party to help achieve off-balance sheet financing. These stand-alone corporations are usually thinly capitalised and are generally designed to have zero taxable income through their fee structures. Due to changes in US accounting rules, this type of structure may not lead to the desired off-balance sheet financial accounting result.
- (2) **Owner trusts:** The issuer may also avoid taxation by being structured as an owner trust, which can be in the form of a common law trust or a statutory business trust. However, it is often unclear whether an owner trust should be treated as a grantor trust or a partnership for tax purposes. Typically, the more activity the trust permits in the way of substituting collateral or reinvesting reserve funds, the more likely a court is to find that a partnership exists if there is more than one owner. Under current federal tax regulations, an unincorporated entity can 'check the box' to be treated as a partnership instead of having to possess certain non-corporate features as regulations required before 1997. Under current regulations, an unincorporated entity that is not a grantor trust and has only one owner is disregarded (i.e. combined with the owner) for federal income tax purposes.
- (3) **LLCs:** Limited liability companies (LLCs) have become increasingly common in securitisations, given that they may now be formed under statutory authority in nearly all the states and set limitations on an owner's liability for LLC obligations. While pre-1997 LLCs had to meet certain requirements to be treated as partnerships, under the 'check the box' regulations they will either be automatically treated as partnerships (with two or more owners) or disregarded.

- (4) **Partnerships; publicly-traded partnerships:** Structuring the issuer as a partnership – rather than an owner trust or LLC which seeks to be treated as a partnership under the 'check the box' regulations – will also avoid taxation at the issuer level. However, both partnerships and owner trusts or LLCs treated as partnerships must avoid being classified as a 'publicly-traded partnership' (PTP), which is taxable as a corporation. Interests in a PTP are either traded on an established securities market or are readily tradable on a secondary market. However, an issuer will not be a PTP if its interests are not offered to the public and fewer than 100 beneficial owners exist at any given time. An issuer will also not be a PTP if 90 per cent or more of its gross income is qualifying passive income, including interest that is not derived in the conduct of a 'financial business'. The scope of this last exception is unclear but might exclude securitisations involving fixed pools of assets.
- (5) **Non-US entities:** Organising an entity in a non-US jurisdiction that does not impose income tax, such as the Cayman Islands, allows an issuer to be treated as a corporation without two layers of federal income tax. Non-US issuers are often used to securitise non-mortgage debt, such as corporate bonds or asset-backed bonds, for the European market. The key is to avoid being treated as engaged in business in the US, since this treatment would subject the issuer to federal income tax. Avoiding this treatment is generally accomplished by imposing restrictions on the issuer's activities and investments that allow the issuer to qualify for the exception under federal tax law for being a mere 'trader' in stock or securities.

Grantor trust or fixed investment trust

An alternative to the above debt structures is to form the issuer as a grantor trust or fixed investment trust. To obtain such classification, the trust must meet two requirements. First, the trust generally cannot have multiple classes of ownership, other than interests that qualify as coupon strips or senior and subordinated interests that pay *pro rata* unless a default occurs. The formation of multiple classes generally conflicts with the idea of each owner in the trust having an undivided beneficial interest in all of the trust's assets, which undivided beneficial interests are central to the idea of avoiding tax at the issuer level. Second, the trust cannot have the power to vary the investment of the holders of the certificates in order to profit from changes in the market. Such a power would suggest that the trust itself acts as an income-producing entity and therefore should be taxed.

REMICs

Sponsors of multi-class mortgage-backed securities typically structure the issuer as a 'real estate mortgage investment conduit' (REMIC), as it is the only tax vehicle that can be used for a multi-class, sequential pay, mortgage loan securitisation. A REMIC is a creature of the federal tax code and any form of entity (eg partnerships, trusts and corporations) may elect to be treated as a REMIC. Treatment as a REMIC generally permits the issuer to avoid federal income taxation. The following three requirements must be met:

- The issuer must elect to be treated as a REMIC in its federal tax filings.
- Ownership interests in the issuer must be represented by 'regular interests' and only one class of residual interest. Regular interests are treated as debt for tax purposes and generally must have:

- (1) fixed terms;
- (2) an unconditional entitlement to a specified principal amount (to the extent the security holder is entitled to any principal amount); and
- (3) interest payments payable based on a fixed rate or a qualifying variable rate.

The residual interest is treated as equity for tax purposes and is taxable on its net taxable income (which may be non-cash, or 'phantom', income).

- By the third month following the closing of the securitisation transaction, all of the assets must be either 'qualified mortgages' or 'permitted investments.' A qualified mortgage must be secured by real estate no later than the creation of the REMIC at no worse than a 125 per cent loan-to-value ratio and the sponsor must not reasonably believe that the mortgage loan is about to default or enter foreclosure proceedings. Since a REMIC is a fixed pool of assets, the ability to modify a mortgage loan is restricted unless a default occurs. Permitted investments generally include temporary cashflow investments and foreclosure property.

US Investment Company Act

Sponsors must consider the registration requirements under the US Investment Company Act, which is designed to protect

investors who entrust the management and diversification of their savings to others. The Investment Company Act imposes limitations on the management, capital structure, and investment policies of the company and requires extensive reporting. The cost of meeting these requirements would negate the economic advantages that securitisations are intended to provide. It is therefore essential that the sponsor structure the securitisation so as to fit within one of the statutory exemptions to registration under the Investment Company Act.

In general, the issuer may rely on one of the following exemptions: Rule 3a-7 promulgated under the Investment Company Act, and Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act, all of which address the concerns of the Investment Company Act by either restricting the holding of the securities to certain investors or otherwise limiting the structure of the investment vehicle. In addition, in a securitisation of mortgage loans, the issuer may rely on an exemption in Section 3(c)(5)(C) of the Investment Company Act.

Rule 3a-7

The exemption under Rule 3a-7 permits the securities to be sold either to investors in a public offering (so long as the securities are rated in one of the four highest-rating categories) or institutional investors that meet certain minimum income or assets tests. Thus, this exemption is useful for securities that will be marketed, at least in part, to the general public. However, the issuer must comply with the following additional limitations:

- the assets must consist of only those types that convert into cash within a finite time period;
- the pool of assets must be fixed at the outset of the securitisation and cannot be actively managed during the term of the securitisation to take advantage of market value changes; and
- the securities cannot be redeemable.

Section 3(c)(1)

Issuers that cannot rely on the exemption under Rule 3a-7 can look to Section 3(c)(1) which provides an exemption where the issuer does not propose to engage in a public offering and where the beneficial owners of all outstanding securities of the issuer (other than short-term paper) number no more than 100 at any given time. It is important to note, however, that under certain circumstances, persons or entities will be deemed as holding the issuer's securities, even though these persons or entities do not

themselves directly hold any of these securities. Thus, this exemption is useful where the issuer knows it can identify the number of security holders in accordance with Section 3(c)(1) at any time the securities are outstanding.

Section 3(c)(7)

Issuers may also rely upon the exemption set forth under Section 3(c)(7). The requirements of this section are that the issuer will not make a public offering of the securities and that the securities are owned solely by certain qualified purchasers. These purchasers are those individuals or institutions that meet certain minimum income or asset tests. Issuers will need to rely upon this section if compliance with the other exemptions is not feasible.

Section 3(c)(5)(C)

Issuers of mortgage-backed securities may generally also rely on the exemption under Section 3(c)(5)(C) of the Investment Company Act. This exemption requires that the assets primarily consist of mortgage loans or other real estate interests. This exemption does not restrict the issuer from engaging in a public offering.

Summing up

Every securitisation will give rise to its own set of legal issues. This discussion has provided an introduction to those legal issues that sponsors of a securitisation should be sure to address.